Journal of Post Keynesian Economics

ISSN: 0160-3477 (Print) 1557-7821 (Online) Journal homepage: http://www.tandfonline.com/loi/mpke20

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To cite this article: Mario Damill & Roberto Frenkel (2017): Symposium: Dilemmas of exchange rate and monetary policies in Latin America, Journal of Post Keynesian Economics, DOI: 10.1080/01603477.2017.1343079

To link to this article: http://dx.doi.org/10.1080/01603477.2017.1343079

Published online: 07 Jul 2017.

JOURNAL OF POST KEYNESIAN ECONOMICS
2017, VOL. 40, NO. 1, 1–8
https://doi.org/10.1080/01603477.2017.1343079

Symposium: Dilemmas of exchange rate and monetary policies in Latin America

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Latin American economies are facing the consequences of falling commodity prices, the appreciation of the dollar, the deceleration of China, the uncertainty arising from the difficulties facing the periphery of the Eurozone, and the prospect of upcoming increases in interest rates by the Federal Reserve.

The challenges that these difficulties pose to central bank and macro policy in Argentina, Venezuela and five "floating cum inflation target" (FIT) countries: Brazil, Chile, Colombia, Mexico and Peru are presented in this symposium, along with suggested alternatives to current policy orientations.[1]

This introduction presents an overview of exchange rates and monetary policies in L.A. in the 2000s that is a common framework to the Symposium papers which provide more detailed analysis of particular national cases.

The changes in international environment mentioned above follow a prolonged period that may be characterized by symptoms of "Dutch Disease". The negative impact on the productive structures have weakened the reaction of the Latin American economies to the new circumstances, for example slowing the responses of the tradable sectors to exchange rate signals, after long periods of real appreciation.

In some national cases, reductions in inflation, the decline in the burden of external indebtedness and the accumulation of reserves during the early 2000's are important assets for macro policies in the new conditions, but imbalances in the external accounts and in some cases in fiscal accounts worsened considerably, as for instance in Colombia with falling oil and other export prices, and similarly in Chile, exposing significant vulnerabilities.

During the early years of the 2000s, most Latin American countries had already introduced floating exchange rate regimes: Mexico following its 1995 crisis; Brazil, Colombia and Chile in 1999. Argentina and Uruguay maintained fixed exchange rates until their end-of-decade crises and recovered from them with floating exchange rates in 2002. Peru has had a managed floating exchange rate regime since the 1990s and formally adopted an inflation targeting regime in 2002.

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[1]The papers present the results of a Ford Foundation research project led by CEDES (Centro de Estudios de Estado y Sociedad), Buenos Aires.

During these years the IMF stood strongly behind the free floating of exchange rates; intervention in foreign exchange markets was discouraged, either because they destined to fail to affect real exchange rates or because the effects would be distortive.

Nevertheless, Latin American countries, who did not at the time need IMF resources and thus not subject to conditionality, did not strictly follow these recommendations. While exchange rates were left to be set in foreign exchange markets, central banks reserved for themselves the faculty to intervene discretionally in these markets. Under these 'managed floating regimes', some central banks such as Chile and Mexico have not intervened frequently, while others, such as Argentina, Brazil, Colombia and Peru were more active. Compared to fixed exchange rate regimes, managed floating has the advantage of flexibility. At the same time, in managed floating regimes the central bank retains the ability to intervene in the market to restrain or to smooth unwanted appreciation or depreciation trends.

The central bank's capacity to intervene as a seller in foreign exchange markets in order to smooth depreciations depends on the amount of its international reserves. Many countries in the region took advantage of the period of high commodity prices and large capital inflows to accumulate foreign assets (as well as, in the case of Chile, via creation of a sovereign investment fund).

There is a visible correlation between these innovations and the fact that there have not been new crises in the region since the beginning of the 2000s. It is striking that the 2008 global crisis did not trigger crises in Latin American economies, despite the fact that their negative impacts, both in financial and real terms, were of similar magnitude than those of the Asian and Russian crises of 1997-98.

But the modification in exchange rate regimes was not the only novelty of the 2000s. The commodity price boom that began in 2003-4 generated current account surpluses in almost every South American country, so that external financial fragility was relatively subdued when the 2008 negative shock impacted the region. The new exchange rate flexibility allowed these countries to use the foreign exchange market as a buffer, depreciating local currencies at the end of 2008. The evidence suggests that exchange rate flexibility is a good vaccine to avoid the balance of payments-financial crises that were frequent in developing economies during the first thirty years of globalization.

To have avoided these crises is a great virtue, but the difficult situation that Latin America is currently facing suggests that the optimum policies in conditions of international financial integration have yet to be found. In developing economies, macroeconomics, in addition to ensuring stability, has to be a macroeconomics for development. To find more precise answers we have to go a little further in the analysis of the macroeconomic policies that have been implemented by the countries that chose these innovative exchange rate regimes.

According to the *trilemma*, a country open to financial globalization cannot simultaneously target three objectives: free capital mobility, interest rate policy and control of the exchange rate by intervening in the foreign exchange market. In a context of free capital mobility, the *trilemma* concludes that if a government chooses to determine the exchange rate it loses the ability to control the interest rate (it loses the control of monetary policy). The conflict inherent in the trilemma is the main justification for pure floating exchange rate regimes.

But the *trilemma* is not valid in every circumstance. It is not valid when the central bank intervenes in a context of abundant supply of foreign currency that pushes the exchange rate towards appreciation. Latin America experienced this circumstance in the 2000s, until recently. In this situation it is possible to control the exchange rate without losing the control of monetary policy.

Under certain conditions it is possible and sustainable to maintain control over the local interest rate while at the same time having a central bank that intervenes as a buyer in the foreign exchange market to avoid the appreciation of the local currency. The central bank can sterilize the monetary base expansion that results from purchases in the forex market. By doing this, it preserves its policy interest rate. The key issue at this point is the possibility to sustain sterilization operations over time. It depends on the financial cost incurred by the central bank through its foreign exchange interventions and sterilization efforts.

The conditions that make this policy possible and sustainable are: i) at the nominal exchange rate that the central bank has targeted there is an excess supply in the foreign exchange market (that is, the central bank's intervention is aimed at avoiding currency appreciation); ii) the local interest rate is moderate. This means that there is a maximum rate that allows the sustainability of sterilized interventions. Interest rates higher than this threshold would lead to an unsustainable increase in the central bank's financial deficit. But below that threshold the *trilemma* is not valid: the exchange rate and the interest rate can be jointly controlled while free capital mobility is maintained. It is valid, on the contrary, when there is an excess demand for foreign currency at the exchange rate that the central bank wishes to defend (that is, when the central bank wants to avoid the depreciation of the local currency). In this case the exchange rate policy faces the limit imposed by the availability of international reserves and an increase of the local interest rate becomes essential to halt the loss of reserves.

Until recently, particularly in South America, many countries had balance of payments conditions that invalidated the *trilemma* and that would have allowed central banks to control the exchange rate without losing control over monetary policy. Many economies simultaneously experienced current account surpluses and important net capital inflows. In the countries that had current account deficits (Colombia and Mexico, for example), net capital inflows were even larger, thus these economies also experienced balance of payments surpluses that would have permitted them to defend real exchange rates from appreciation.

Some of the Latin American countries had, in addition, adequate domestic financial conditions to make central bank intervention sustainable. Such is the case of low-inflation countries such as Chile, Colombia and Peru.

Some other countries, even with adequate balance of payments conditions, did not have the domestic financial conditions that would have allowed them to undertake sustainable purchases in foreign exchange market. Brazil, for example, maintained policy interest rates higher than the ones that would have permitted a sustainable sterilization policy. The Brazilian central bank bought foreign currency for years without being able to stop the tendency towards appreciation. It sterilized its currency purchases by issuing bonds at the high real interest rates that the central bank thought necessary to control inflation. As a consequence, the central bank's financial deficit made a significant contribution to the increase of the Brazilian public debt.

In short, a brief analysis of the exchange rate and monetary policies implemented by Latin American countries in recent years shows a varied panorama. Some countries, even when they had the required conditions to control nominal interest rates and preserve competitive and stable real exchange rates, chose not to do so. Instead, they allowed a strong real exchange rate appreciation to be imposed by the markets. Other countries decided to intervene more intensely in forex markets with the goal of mitigating the tendency towards appreciation; they nevertheless refrained from making this objective explicit to avoid being accused of manipulating the exchange rate. These purchases of foreign exchange did not succeed in curbing real exchange rate appreciations. Moreover, some governments took advantage of the short-term expansionary properties of exchange rate appreciations to kick-start populist economic policies. Peru looks like the only country that succeeded in maintaining a relatively stable real exchange rate. But Peru is a particular case because the degree of dollarization of its financial system is a great incentive for the central bank to keep the real exchange rate stable, while at the same time limiting its ability to devalue the local currency in the face of a negative shock.

In a few words, some countries did not want to, other countries did not know how to, and other countries did not succeed. So what is the verdict on Latin America's experience in the 2000s now that terms of trade have fallen and capital outflow dominates in the region? Latin American economies need to cut the current account deficits fuelled by expansion and further aggravated by the drop in commodity prices. Currencies have been subject to large depreciations; growth has stalled across the region and some economies have entered recession. To the contractionary effect of a decrease in export values, it is necessary to note that in the short term depreciation also has a negative impact on aggregate demand and produces inflationary pressure. It has been observed that the pass-through ratio (a measure of the proportion of the depreciation rate that is reflected in a rise in the inflation rate) is larger the larger the inflation rate at the time the currency is devalued. Consequently, it is to be expected that countries with the higher inflation rates see a larger impact on inflation, the largest drops in real wages and the largest contractionary effects of the devaluation. In countries with low inflation, such effects are of a smaller magnitude. However, current account adjustments through devaluation have inflationary effects as well as real and distributive costs: they also have negative financial implications, which might currently not be a cause of crises but that nevertheless contribute to the contraction in GDP.

If a country succeeds at stabilizing inflation and the financial system, readjusting its fiscal situation to the new circumstances and preserving a new set of relative prices that includes a more competitive real exchange rate, it would have succeeded in generating the necessary conditions to recover growth. For some of them (Argentina and Brazil, for example) these goals seem very difficult to secure, creating the risk of rising social and political unrest. Other economies are bearing the adjustment costs with fewer difficulties. However, in every case, the new growth process will have to be based on the production of tradable goods and services that allow a country to increase its exports or to reduce its imports, taking on the role played by the production of commodities in the preceding growth pattern.

A more competitive exchange rate would foster growth through the incentive it provides to the production of tradable goods and complex services (goods and services that can be exported or replace imports). However, this depends on the presence and relative weight of tradable activities in each country's economic structure. This potential is currently smaller than it used to be in Latin America, because such tradable activities have been victims of a *Dutch disease*. The region has experienced a reduction in its capacity to produce tradable goods other than commodities because the persistent increase in foreign currency-denominated unit labour costs impaired profitability of these activities. The share of complex tradable activities in GDP and employment generation dropped in favour of a rise in the importance of commodities, construction and non-tradable services. The region was de-industrialized, and to reverse this process will take time.

The activities that were thus discouraged need new investments to resume growth. Investment is mainly dependent on expected profitability, and is therefore tied to the expectations that the real exchange rate will be maintained at a competitive and stable level in the future. Even if real exchange rates have depreciated substantially (although not in every Latin American country), it will be difficult to convince people to invest in tradable industries after the 'cold shower' of the collapse of the commodities boom years.

Who is to blame? Obviously, the region's governments and central banks (particularly in those countries that gathered the conditions to preserve competitive and stable real exchange rates but chose not to do so). To better understand why we have to consider the incentives they faced.

On one hand, they had political incentives. The tendency towards currency appreciation is appealing. It facilitates and incites an increase in the consumption of tradable goods and services while allowing real wages to grow more than productivity without generating inflationary pressures. Such political incentive is the main cause for real exchange rate appreciation in countries with populist governments, but it is also present to some degree in every case.

We also need to take into account the forces driving central banks in inflation targeting regimes. A mandate that is exclusively focused on inflation biases interest rate policy in favour of real exchange rate appreciation.

This time IMF conditionality cannot be blamed, given that most Latin American economies did not need its assistance. But the IMF has a share of responsibility. Independent central banks – and even those that are not legally independent, such as the Brazilian central bank – believe it is important not to conflict with IMF's orientation, as they don't want to be seen as heterodox by the national and international financial community.

When floating exchange rate regimes were adopted at the end of the 1990s the IMF was emphatically in favour of free floating. In the following years, the IMF doctrine allowed for currency interventions intended to soften tendencies towards appreciation or depreciation and to reduce foreign exchange market volatility, but the IMF doctrine is still based upon the diffuse notion of "equilibrium real exchange rate" and the presumption that market players, empowered with rational expectations, know this equilibrium rate with relative precision. As a consequence, the nominal exchange rate must be left to be determined by a free foreign exchange market, given that central bank interventions would be either fruitless or distortive.

In several papers written during the 2000s different economists drew attention to the effects of the *Dutch disease*. They demanded that the real effects of a lengthy currency appreciation be taken into account and avoided through exchange rate policies. This concern was not heeded. Some economists at the IMF believe the *Dutch disease* to be an optimum restructuring of production and employment in the face of new international conditions (high commodity export prices and abundant capital inflows). Now that export prices have fallen and capital is leaving, it is said, it is evident that the new equilibrium real exchange rate is higher than the preceding one. Beyond the theoretical discussion about equilibrium exchange rates and rational expectations in foreign exchange markets there is a common sense question regarding foreign exchange policy management. Economists unanimously accept that policy reaction in the face of a new economic circumstance must differ depending the transitory or permanent nature of the change. A nature that generally it is impossible to know. The IMF accepts this, but its orientation has been equivalent to considering the positive shocks experienced by Latin American economies in the 2000's to be permanent.

Dutch disease effects cannot be reversed in the short term. On the other hand, balance of payments adjustments through devaluation have inflationary, real and financial costs. It would have been wise to be more cautious in the design of economic policies to avoid falling into conditions of *Dutch disease* and to avoid the need for abrupt balance of payments adjustments, precisely because the future is uncertain.

Therefore, an assessment of the contribution made by exchange rate flexibility to macroeconomic performance turns out to be ambiguous. On the positive side, one must acknowledge its help in avoiding the balance of payments-financial crises that had been so frequent and intense in the thirty previous years. On a negative note, the destruction of firms, employment and human capital in the manufacturing sector and other tradable sectors has great weight, and will have hysteresis effects in the future.

The favourable conditions – which we now know were exceptional – that were experienced by Latin American countries in 2003-2013 led to a rarely prolonged period of currency appreciation and consequently to a profound *Dutch disease*. It is of course clear that these results should not be attributed to the managed floating regimes, but rather to the way in which exchange rate policies were designed, particularly in the cases that had the required conditions to preserve competitive and stable real exchange rates. Not every country, however, had such qualifications, and certainly there were countries that even if they had tried could not have succeeded in maintaining a competitive and stable real exchange rate (with Brazil probably as the most relevant example). This comment points toward the need to control capital inflows during booming phases. A central bank's ability to sterilize in a sustained manner its buying interventions depends on the magnitude of the purchases it has to make: difficulties are larger the larger the necessary purchases to avoid appreciation. The problem does not lie on the current account surplus but on the amount of capital inflows. The main driver for financial capital inflows is the foreign-currency profitability of domestic currency assets. This profitability depends on the local interest rate and on future nominal exchange rate expectations. When the local interest rate is high, sterilization efforts are not sustainable and capital inflows are attracted, multiplying the difficulties associated to the goal of defending an exchange rate target. Capital inflows are also larger when the market has firm expectations of currency appreciation, because the expected profitability measured in foreign currency becomes bigger. This is why central bank interventions must fulfil another role, apart from setting the spot nominal exchange rate: they must have an effect in currency expectations, inducing the market to project a stable tendency instead of a tendency towards appreciation. In this respect Latin American economies have clearly failed.

If the central bank succeeds in generating expectations of a stable real exchange rate, the estimated profitability of foreign financial investments will be smaller and capital inflows will decrease in magnitude. In spite of this, there are countries (or particular economic circumstances in some countries) with interest rates that would be attractive for international financial capital even if stable real exchange rates were expected.

This points towards the need to control capital inflows, in order to reduce them in booming stages and make it easier for the central bank to stabilize the real exchange rate. The IMF now believes that placing controls to limit capital inflows is a legitimate policy. This comes a little late, because the IMF is supposed to advise governments by anticipating their problems, not limiting itself to learn from their bad experiences.