



Caught in the Crossfire:

The Frustrations of Latin
American Central Bankers

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How Economic Thinking Influences Policy
November 13, 2002




Introduction

- **Historically extreme instability and volatility**
 - **Generally favorable evolution recently**
 - **Most prevailing problems not associated with monetary policy**
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Constraints on Monetary Policy

- **Gets lost in discussion on exchange rate regime**
 - **Often dictated by fiscal policy**
 - **Underdeveloped financial systems**
 - **Need to maintain foreign investment**
 - **Lack of central bank independence**
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Three Monetary Policy Options

- **Hard exchange rate peg**
 - **Monetary targeting**
 - **Inflation targeting**
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Hard Peg—Two Options

- **Currency Board**
- **Dollarization**
- **Both eliminate discretionary monetary policy**



Hard Peg—Advantages

- **Controls inflation**
- **Greatly reduces currency risk**
- **Adjusts monetary policy automatically**
- **Simple and clear**

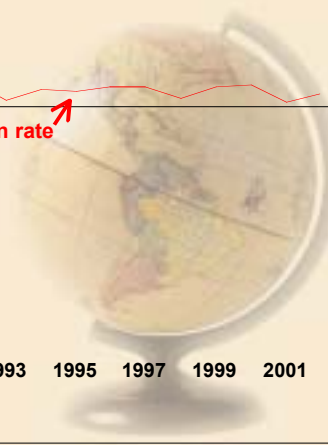
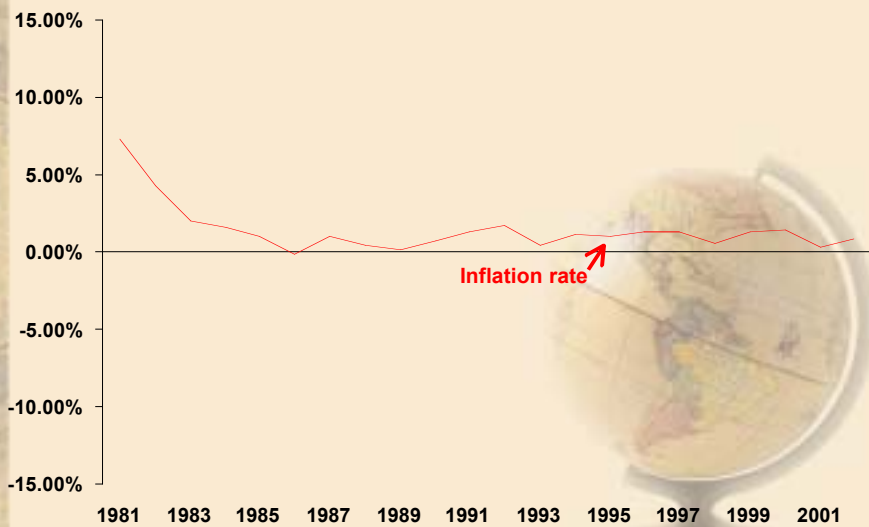


Hard Peg—Disadvantages

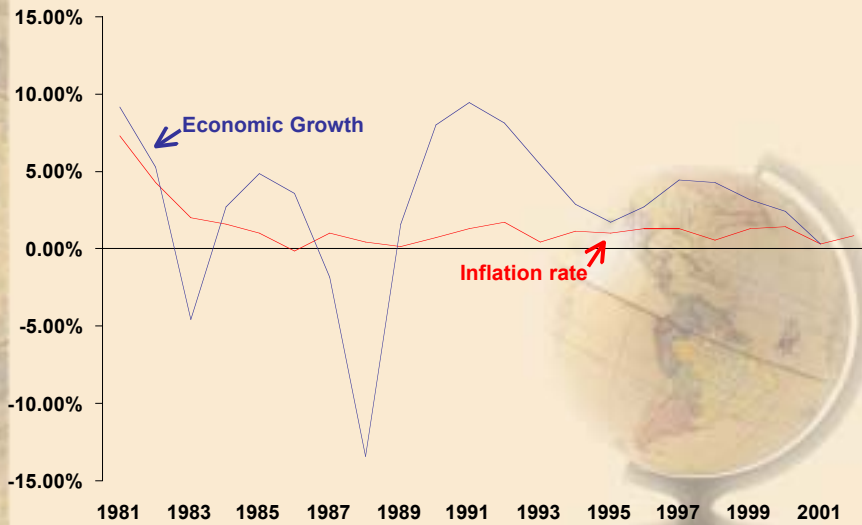
- Unable to set discretionary monetary policy
- Central bank loses lender of last resort role
- Currency board vs. full dollarization



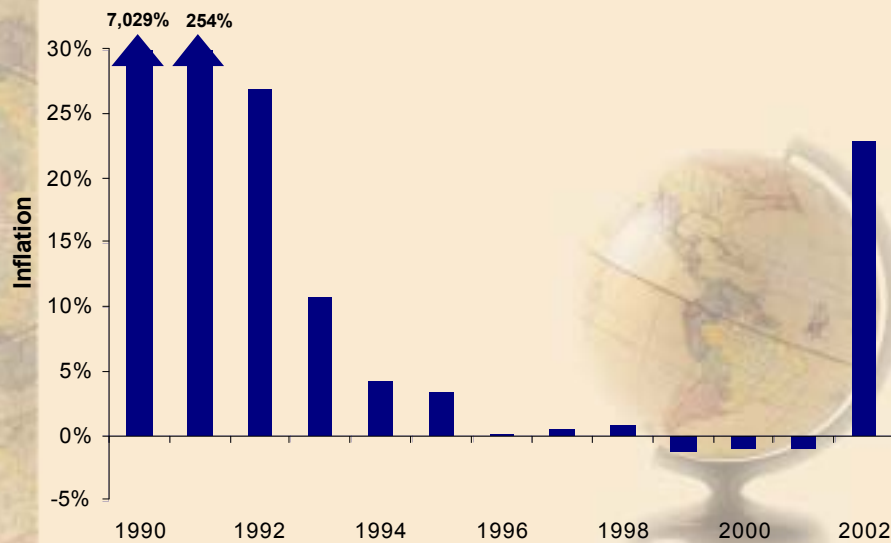
Panama: Pure Dollarization



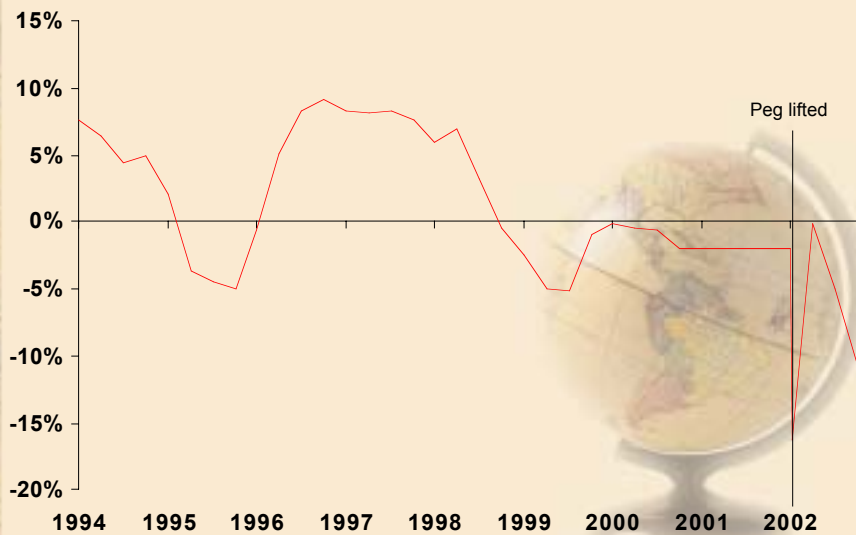
Panama: Pure Dollarization



Inflation in Argentina: Before, During and After



Argentina Real GDP Growth: Before, During and After




Hard Peg—Conclusions

- **Two necessary conditions for success:**
 - **Solid financial system**
 - **Sound and sustainable fiscal policies**
- **Subject to speculative attacks**
- **No easy exit strategy**

Inflation Targeting—Main Elements

- **Public announcement of medium term targets**
 - **Set as primary goal of monetary policy**
 - **Transparent policy strategy**
 - **Credibility and accountability of central bank**
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Inflation Targeting—Advantages

- **Can respond to domestic and foreign shocks**
 - **Easily understood and highly transparent**
 - **Central bank can do this on sustainable basis**
 - **Increases accountability of central bank**
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Inflation Targeting—Disadvantages

- **Perceived disadvantages**
 - **Too rigid**
 - **Equivalent to full discretion**
 - **Increases output volatility and instability**
 - **Hurts economic growth**

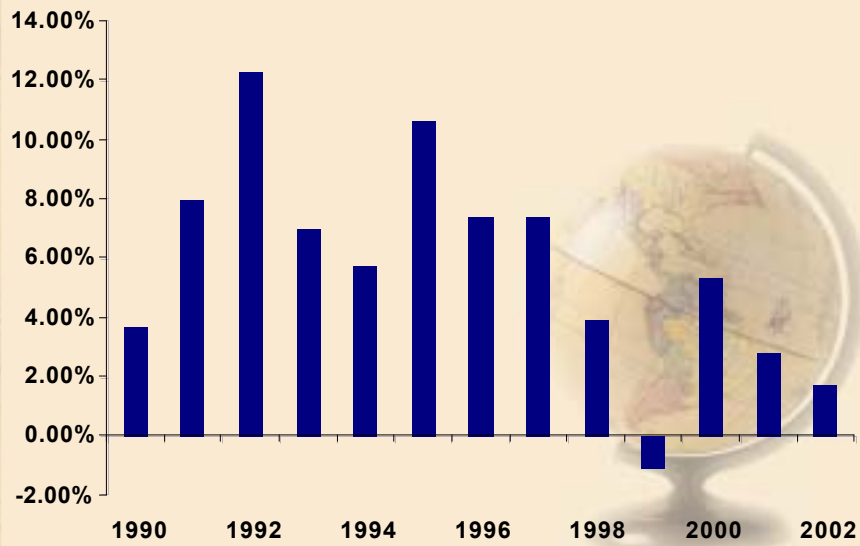


Inflation Targeting—Disadvantages

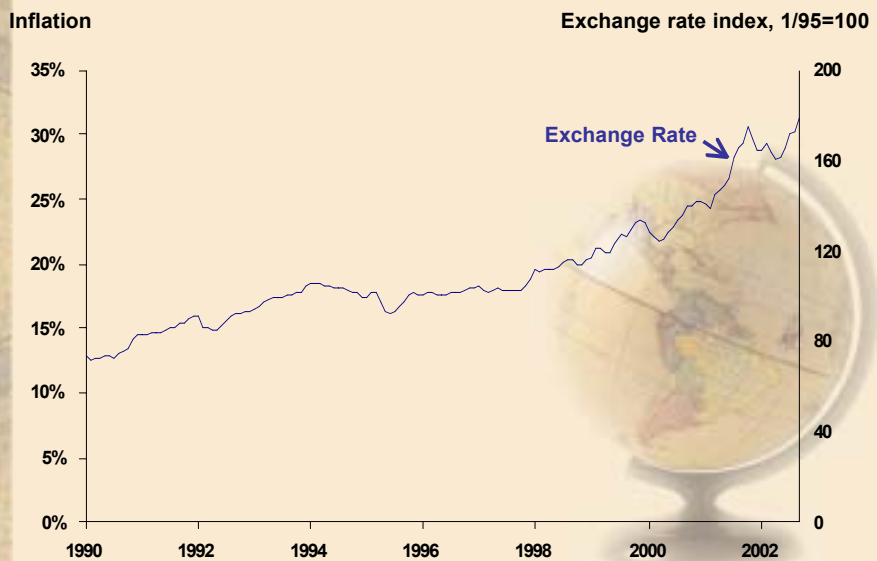
- **True disadvantages**
 - **Can only produce weak central bank accountability**
 - **Cannot prevent fiscal policy dominance**
 - **Could cause financial instability**



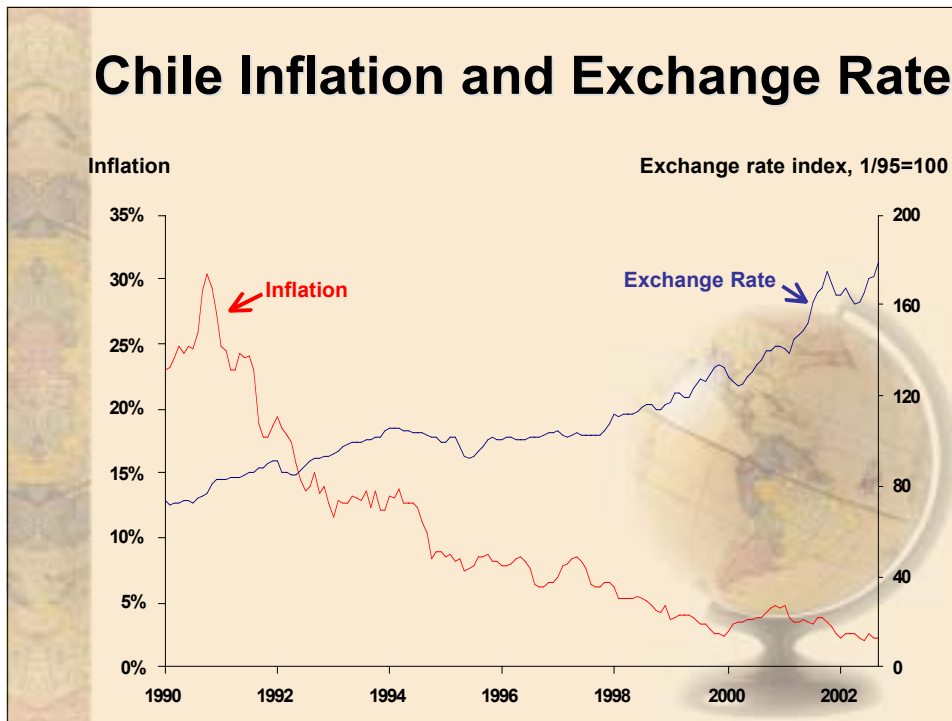
Chile Economic Growth



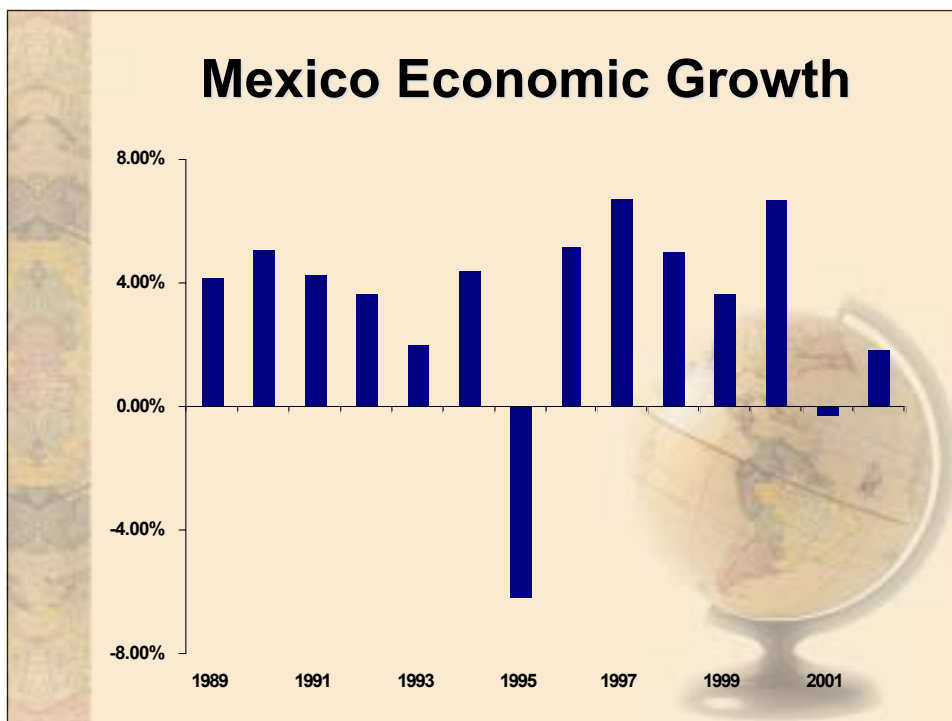
Chile Inflation and Exchange Rate



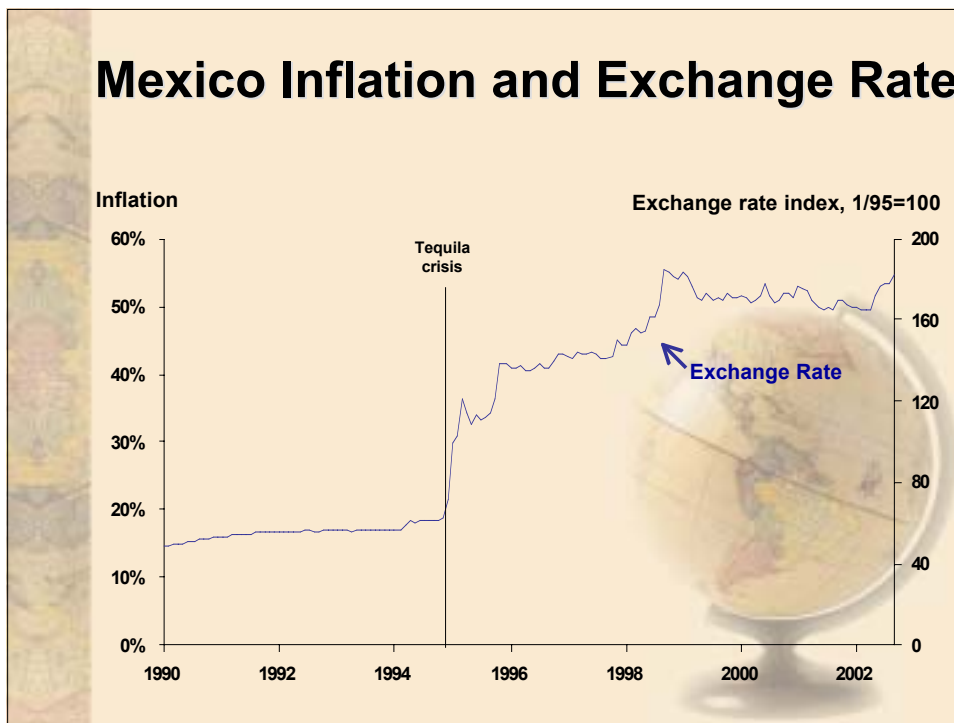
Chile Inflation and Exchange Rate



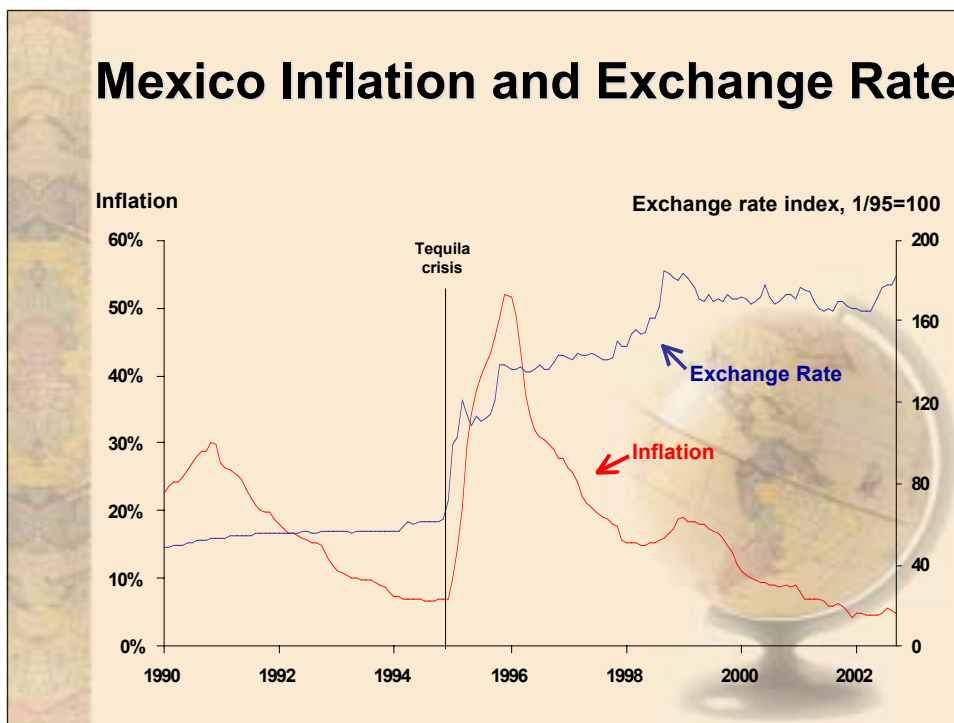
Mexico Economic Growth




Mexico Inflation and Exchange Rate




Mexico Inflation and Exchange Rate



Inflation Targeting—Bottom Line

- **Can be a viable medium term strategy**
 - **Role of exchange rate policy**
 - **How much to manage?**
 - **Advantages of high degree of dollarization**
 - **Requirements**
 - **Fiscal discipline**
 - **Sound financial system**
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Conclusions

- **Key is institutional environment**
 - **No strategy is a panacea by itself**
 - **Monetary policy cannot solve long-standing, underlying problems**
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Questions?



Monetary Targeting

- **Need credibility from monetary policymaker**
 - Rely on their data
 - Targets announced to public
 - Need an accountability mechanism
- **Two necessary conditions**
 - Monetary policy independent of fiscal policy
 - Flexible exchange rate



Monetary Targeting—Advantages

- **Can choose goals for inflation that differ from those of other countries**
- **Allows monetary policy to accommodate shocks**
- **Strategy is easy to monitor**



The Big IF of Monetary Targeting:

There must be a strong and reliable relationship between the goal variable and the monetary aggregate chosen as the target



Monetary Targeting—Conclusion

- **Unstable money-inflation relationship**
- **Depends heavily on central bankers**
- **Never been truly implemented in Latin America**

