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Monetary policy in a dollarized economy where balance sheets matter ☆

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Abstract

Does the dollarization of liabilites and the resulting balance sheet vulnerability prevent monetary policy from serving its conventional countercyclical role? We study this question in a model of a small open economy in which domestic firms face an imperfect capital market, with risk premia depending on net worth as in Bernanke and Gertler [Am. Econ. Rev. 79 (1989) 14.]. In spite of the financial fragility channels present in the model, the conventional wisdom still holds: under a floating exchange rate, countercyclical monetary policy does help cushion the impact of foreign real shocks.

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1. Introduction

Monetary and interest rate policy remains the most contentious aspect of the response to the recent crisis in Asia and other emerging markets. Many analysts, led by the IMF's Stanley Fischer, contend that stopping the collapse of national

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currencies was priority number one; confidence, a reversal of capital flows, and growth would follow. Referring to the 1995 example of Mexico, Dornbusch (1998) wrote:

> Mexico fully implemented a stark US-IMF program of tight money to stabilize the currency and restore confidence. Starting in a near-meltdown situation, confidence returned and within a year the country was on the second leg of a V-shaped recovery. The IMF is unqualifiedly right in its insistence on high rates as the front end of stabilization.

Not everyone agreed. The attack on high rates was spearheaded by Joseph Stiglitz, then the Chief Economist at the World Bank, whose objections included the "traditional criticism" of tough monetary policies to defend a fixed exchange rate, namely that they are too costly in terms of output or employment. But the concerns went further, since in East Asia and elsewhere such policies seemed not only to be painful, but also ineffective. Notably, the 1998 Global Economic Prospects published by the World Bank worried that high interest rates had little success in reducing pressure on currencies or stabilizing investor confidence, while at the same time imposing large output costs. This was the case whether the initial package entailed new agreements with the multilateral institutions (Indonesia, Korea and Thailand) or not (Malaysia and Philippines).[2]

That the Chief Economist of the World Bank should be disagreeing with his institution's own policies was peculiar. Even more peculiar was that this debate should be taking place at all. After all, monetary policies are supposed to be used countercyclically: in the Mundell–Fleming world, under flexible rates or an adjustable peg, a monetary expansion is called for to offset an adverse shock to productivity or world demand. But what the IMF and Dornbusch were advocating was a *pro*cyclical monetary policy: tightening in response to adverse shocks.

They were not alone in this advocacy, for procyclical policies are apparently what many policy-makers prefer. Not only did the Asian countries eventually tighten in response to adverse shocks, both internal and external. In response to the 1997–1998 external shocks, most Latin American countries (including those that were nominally floating such as Mexico, Peru, and to a lesser extent Chile) also used tight money and high interest rates to prop up their currencies.[3] Gavin et al. (1999) and Calvo and Reinhart (2000) have documented this pattern in a systematic manner for most emerging markets.

[2] Arguably these problems resulted from policies that were "too little, too late." Corsetti et al. (1998), in particular, maintain that the common perception that high interest rates were the prevalent East Asian response to the crisis is a half-truth at best. The IMF insisted on the policy, but whether countries followed it is a different matter. There is also an issue of timing. Tight money was adopted with much delay in several countries.

[3] Things have changed more recently, with Chile and Colombia relaxing monetary policy and going for a clean float, with the resulting nominal and real depreciation.