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Fear of floating or monetary policy as usual? A structural analysis of Mexico's monetary policy

Gabriela Best^{a,b,*}

^a University of California, Irvine, Department of Economics, 3151 Social Science Plaza, Irvine, CA 92697-5100, United States

^b Missouri State University, Economics Department, 901 S. National Ave., Springfield, MO 65897, United States

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ABSTRACT

This paper uses Bayesian methods to estimate a small open economy dynamic stochastic general equilibrium (DSGE) model for the period in Mexico after the 1994 crisis. I consider a Taylor rule as the expression of the evolution of monetary policy to gauge its response to the exchange rate in the post-crisis period. The estimation results favor a consistent response of the nominal interest rate to the short-run nominal exchange rate after 1994. Although fear of floating is present, Mexico's monetary policy has taken steps toward a credible free-floating exchange rate that targets inflation.

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1. Introduction

Fear of floating¹ has been an endemic problem in emerging market countries for the past several decades. This issue developed after the contagion of financial and balance of payments crises in

* Present address: California State University, Fullerton, Department of Economics, Steven G. Mihaylo College of Business and Economics, Fullerton, CA 92834-6848, United States. Tel.: +1 657 278 2228; fax: +1 657 278 3097.

E-mail addresses: gbestuci14@gmail.com, gbest@missouristate.edu, gbest@uci.edu, gbest@fullerton.edu

¹ By "fear of floating" I mean that monetary policymakers take "deliberate policy actions to stabilize the exchange rate" (Calvo & Reinhart, 2002).

emerging markets (e.g., Mexico in 1994). Before the crises such countries had as a common characteristic pegged or managed exchange rate policies. As part of their recovery, several countries allowed the exchange rate to float.² In Mexico's case, low international reserves, a large current account deficit, and lack of credibility drove policymakers to adopt a floating exchange rate regime. However, Calvo and Reinhart (2002) conclude that most emerging markets are not true floaters. Instead, they are characterized by fear of floating.

This paper examines the Mexican economy experience after its 1994 financial and balance of payments crisis. I estimate a structural model that includes a Taylor rule as the expression of the evolution of monetary policy. The monetary policy rule evaluates the extent to which the interest rate responds to inflation or the exchange rate in the post-crisis period. This approach allows me to evaluate whether the Mexican central bank's post-1994 monetary policy targeted inflation or reflected fear of floating.

Announced central bank policy was characterized by a significant regime change after the 1994 crisis. Policy shifted from a predetermined exchange rate to a floating exchange rate thereby making monetary policy the nominal anchor of the economy after the crisis. Aside from the desire to stabilize inflation through the exchange rate, several reasons explain why emerging markets—in this case, Mexico—have sought to establish a predetermined exchange rate. Emerging markets have adopted predetermined exchange rates in part because of the association of currency devaluations with recessions. In addition, a large portion of these countries' debt is denominated in dollars, which make defaults and general debt servicing more pervasive if the exchange rate varies widely. If large depreciations occur, adjustments in the current account are more pronounced in emerging markets. Moreover, large swings in the exchange rate have a larger impact on trade mostly because trade is invoiced in U.S. dollars in these countries (Calvo & Reinhart, 2002).

Calvo and Reinhart (2002) compare the behavior of the volatility of the interest rate, the exchange rate, and the international reserves from different countries, including Mexico, in which fear of floating is suspected with the behavior of such variables in true floater countries such as Japan and the United States. Ball and Reyes (2004) use the same analytical approach as Calvo and Reinhart (2002) in addition to a vector autoregressive (VAR) analysis to determine (i) whether Mexico exhibits fear of floating or targets inflation and (ii) if the two are empirically distinguishable.³ Ball and Reyes (2004) find that Mexico indeed exhibits fear of floating by standard measures. Their results also suggest that a rise in the exchange rate today signals future higher inflation. Therefore, they find evidence of both inflation targeting and fear of floating with more weight on inflation targeting. The contribution of the present study is that it estimates a small open economy model under two different regimes: one that is known for having a managed exchange rate and the second that targets inflation but in which fear of floating might be present.

To attain my goal I estimate a New Keynesian small open economy model using likelihood-based Bayesian methods. The small open economy model framework, derived from micro-foundations, offers a structural channel for the study of monetary policy. The New Keynesian DSGE model has been a widely used to study monetary policy. Large New Keynesian DSGE models have been estimated for the United States and the euro area, and small open economy models have been estimated for countries such as Australia, Canada, Chile, and New Zealand, among others. In this paper, I estimate a small open economy DSGE model for Mexico's emerging market economy. The estimated model is based on a simplification of the Galí and Monacelli (2005) small open economy model by Lubik and Schorfheide (2007).

The estimation of a DSGE model for Mexico is performed for two subsamples: the period before and after the 1994 crisis. Within this framework my paper builds on the work of Kamin and Rogers (1996) and Martinez, Sanchez, and Werner (2000), who estimate a Taylor-type policy rule for the periods before and after the crisis, respectively. Furthermore, multiple equation models have been estimated in Santaella and Vela (1999) before the crisis, in Martinez et al. (2000) for the period after the crisis,

² Cabral (2010) considers that these crises led to a 'two corner solution' approach to exchange rate policy. Countries should either float freely or implement a strong pegged regime in order to avoid credibility problems. In particular in Latin America, the strong peg translated into official dollarization.

³ A similar methodology to Ball and Reyes (2004) was used to study fear of floating in Brazil after the late-1990s financial crises (Nogueira & Leon-Ledesma, 2009).

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