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Monetary policy strategies for Latin America ☆

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Abstract

The paper examines possible monetary policy strategies for Latin America that may help lock-in the gains in the fight against inflation attained by the region during the 1990s. Instead of focusing the debate about the conduct of monetary policy on whether the nominal exchange rate should be fixed or flexible, the focus should be on whether the monetary policy regime appropriately constrains discretion in monetary policymaking. This focus suggests that there are three basic frameworks that deserve serious discussion as possible, long-run strategies for monetary policy in Latin America: a hard exchange-rate peg, monetary targeting, and inflation targeting. We look at the advantages and disadvantages of each of these strategies in light of the recent track record of monetary policy in several Latin American countries for clues as to which of the three strategies might be best suited to economies in the region. © 2001 Published by Elsevier Science B.V.

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1. Why the issue is not fixed versus flexible exchange rates

The monetary policy experience of Latin America has not been a happy one. Economies in this region have gone through extreme episodes of monetary instability, swinging from very high inflations, to massive capital flight, to collapses in their financial systems. The unsurprising outcome has been low credibility, slow growth, recurrent recessions and even depressions. However, a

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new era may be dawning in Latin America. In the past decade or so, most countries in the region have become outward looking, and the public, politicians and policymakers have come to recognize the high costs of protectionism and inflation, producing a growing commitment to open markets and price stability. Evidence of this more favorable environment are the successful inflation stabilization programs adopted by many Latin American countries in the early 1990s, and the historically low rates of inflation attained by the region in recent years, falling from an average of over 400% in 1989 to below 10% by 1999. Where should Latin American countries go from here in designing appropriate long-run strategies for the conduct of their monetary policy?

The central issue in addressing this question is whether the countries of the region have a chance of setting up institutions and mechanisms that will effectively and efficiently constrain the discretion of their monetary authorities. Whether the exchange rate is fixed or flexible (and precisely how flexible) follows from the answer one gives to that question. Thus, we believe that there is a need to refocus the debate away form a discussion of whether the nominal exchange rate should be fixed or flexible. One advantage of the alternative approach that focuses on underlying institutions to appropriately constrain monetary policy discretion rather than on the flexibility of the exchange rate is that it allows one to draw on the experiences of countries outside Latin America to a larger extent than what is possible in the present round of the "Fix versus Flex" debate.[1]

In principle, there are four broad monetary policy strategies that can produce a nominal anchor that credibly constrains the discretion of the central bank over the medium term: "hard" exchange-rate pegs, "soft" exchange-rate pegs, monetary targeting, and inflation targeting.[2] The severe shortcomings of soft pegs (in their multiple manifestations) as a *medium-term* strategy for monetary policy have been amply demonstrated by recent experiences in industrial and emerging market economies (including many from Latin America) and need not be repeated here.[3] This leaves us with three potential medium-term strategies for monetary policy

[1] For a discussion of two fallacies that arise recurrently in discussions of monetary policy and exchange rate regimes in Latin America, see Mishkin and Savastano (2000).

[2] A fifth possible strategy that has been suggested by some as best suited for semi-open economies is nominal income targeting (e.g., Frankel, 1995). A major problem with this strategy, however, is that it has never been tried in practice, either in industrial or emerging economies. This, plus the fact that nominal income targeting could be seen as broadly equivalent to inflation targeting under some reasonable assumptions but with some serious disadvantages (McCallum, 1996; Mishkin, 1999a), leads us to drop it from the set of monetary policy strategies that we consider relevant for Latin American countries.

[3] For a review of the main arguments against soft pegs and of the lessons from recent experience, see Obstfeld and Rogoff (1995), Eichengreen and Masson (1998) and Mishkin (1998, 1999a). Note that we are not ruling out the use of exchange-rate pegs, even if not of the hard peg variety, as a tool in the initial phases of a stabilization program. However, the shortcomings of soft pegs indicate that they will be far less useful as a longer-run strategy for monetary policy.