Introduction to Central Banks and Monetary Regimes in Emerging Countries

Fernando Ferrari-Filho and Luiz Fernando de Paula

Since the 1990s, the current globalization process – that is, the increased international mobility of trade and, mainly due to financial liberalization, capital – has seen the world economy face several economic crises, the most notable of which was the 2007–2008 international financial crisis (IFC) that resulted in the 2009 Great Recession (GR). More recently, in 2020, the lockdown restrictions due to the COVID-19 pandemic initiated the largest economic recession in the history of world economy, with a huge negative impact on GDP growth.

The effects of these crises were not neutral in economic and social terms, mainly because the crises have substantially altered the dynamic process of the international economy and have represented a major turning point. Governments of both the G7 countries and the emerging countries have responded to the IFC, and mainly the COVID-19 crisis with massive countercyclical fiscal and monetary policies.

As is well known, in The General Theory of Employment, Interest and Money, Keynes shows that in monetary economics, fluctuations in effective demand and in the level of employment occur because, in a world where the future is uncertain and unknown, economic agents prefer to withdraw currency. Consequently, their decisions to spend, whether on consumption or investment, are deferred. In other words, economic agents withhold currency as a kind of safeguard against the uncertainty that comes with their precarious knowledge about expected yields from their production plans. This situation occurred during the IFC and, partially, in the COVID-19 crisis, and for this reason Keynesian macroeconomic policies, in both conception and practice, were implemented, aiming to recover levels of effective demand for the purpose of mitigating the impacts of both crises. Thus, for that purpose, in 2008 and 2009, and in 2020, policymakers adopted countercyclical macroeconomic policies in such a way as to (i) operationalize fiscal policies designed to stimulate effective demand and reduce social inequalities; (ii) make for more flexible monetary policy so as to galvanize levels of consumption and invest-

ment; and (iii) coordinate and regulate financial and foreign-exchange markets in order to stabilize capital flows and exchange rates.

In line with this analysis, in Brazil and other Latin American countries, State intervention and central banks’ actions, which involved important monetary, credit, financial and exchange rate measures, in the two recent crises – IFC and GR, and COVID-19 – have sparked a timely debate about which policies should be prioritized and why.

Given the above, the objective of this book, *Central Banks and Monetary Regimes in Emerging Countries: Theoretical and Empirical Analysis of Latin America*, is to analyse how the central banks’ actions and the monetary regimes of the emerging countries, with a special focus on Latin America, have affected the economic performance of these countries, mainly in response to the IFC, and COVID-19 crisis.

To achieve this aim, the book has 10 chapters that analyse, theoretically and empirically, the central banks’ actions and the monetary regimes of the most important Latin American countries, including, amongst others, Argentina, Brazil and Mexico. As most big Latin American economies have implemented an inflation targeting regime since the 1990s and 2000s, a special focus will be given on these experiences and how central banks dealt with IFC and COVID-19 crisis.

The opening chapter, ‘Costs and benefits of currency internationalisation: Theory and the experience of emerging countries’, by Bianca Orsi, Antonio José Alves Junior, and André de Melo Modenesi analyses the currency internationalization process, with a special focus on emerging economies. According to the authors, in the context of financial globalization, the increasing foreign demand for an international currency is, on the one hand, subjected to excessive exchange rate volatility and, thus, increasing uncertainty, and on the other hand it is related to external constraints whose main result is the loss of monetary policy autonomy. Given that, the chapter aims at discussing whether the actual costs outweigh the benefits of currency internationalization, mainly in emerging economies.

In the second chapter, ‘Monetary institutions and economic performance in Latin America: the experience with an inflation targeting regime in the period 2000–2020’, Eliane Araujo, Elisangela Araujo and Mateus Ramalho Ribeiro da Fonseca analyse, theoretically and empirically, the Inflation Targeting Regime (ITR) and the monetary policy operation for six Latin American economies: Brazil, Chile, Colombia, Guatemala, Mexico, and Peru. In the empirical part of the chapter, an econometric exercise was carried out for six of the eight countries that adopted ITR in the region. This evidenced, among other aspects, that, despite the relative price stability, the countries which adopted ITR experienced a worsening of external insertion and prolonged...
economic stagnation, which has the conduct of monetary policy as one of its relevant explanations.

The third chapter, ‘Monetary policy in Brazil under the inflation targeting regime from a Contested Terrain Approach’, by Assilio Araujo and Fernando Ferrari-Filho, shows that, based on the Contested Terrain Approach, the central bank is not a neutral institution because its actions are guided by a concern with the ‘general interests’. Considering this idea, the chapter aims at explaining why the Central Bank of Brazil has presented, since at the least the Real Plan, a well-marked ‘conservative bias’, reacting much more strongly to inflationary expectations than to the level of economic activity, beyond the constraints imposed by the ITR.

In the subsequent chapter, ‘The unfinished stabilization of the Real Plan: An analysis of the indexation of the Brazilian economy’, José Luís Oreiro and Julio Fernando Costa Santos show the historical context of the emergence and evolution of the indexation of prices, wages and contracts in the Brazilian economy, as well as discuss the economic impacts of a possible full de-indexation of the Brazilian economy. According to the authors, the Real Plan, the Brazilian stabilization process, implemented in the middle of the 1990s, is an incomplete price stabilization of the Brazilian economy due to the fact that it did not fully eliminate the wage and price indexation in Brazil. In order to argue that, the authors formulate four econometric models that capture the relationship between the main variables (exchange rate, real interest rate, inflation expectations, inertia) and the four main price indexes (IPCA, IGP-M, IPA, IPC). Their conclusion is that there is strong evidence to suggest the implementation of a monetary reform in Brazil to eliminate any remaining price and wage indexation.

Chapter 5, ‘The role of capital flow management measures when the bubble bursts: The Brazilian experience in the global financial crisis and in the COVID-19 Pandemic’, by Luiza Peruffo, Pedro Perfeito da Silva and André Moreira Cunha, shows that there is a striking difference between the performance of the Brazilian economy during the 2007–2008 Global Financial Crisis (GFC) and during the ongoing COVID-19 pandemic. The objective is to discuss the role of capital flow management measures (CFMs) to (i) manage the global financial cycle in developing and emerging economies (DEEs) and (ii) create policy space for them to fight crises. In particular, it investigates the relationship between the degree of financial integration and macroeconomic performance by looking at CFMs put forward by Brazil before, during and after the two global crises of the 21st century. Empirically, the authors develop a vector autoregressive model with error correction to evaluate the relationship between Brazil’s degree of financial integration and its macroeconomic performance. The chapter argues that the contrasting performance of Brazil in these two crises can be attributed both to a structural component of the international
monetary and financial system, in which Brazil and other DEEs occupy an unprivileged position, and to Brazil’s domestic policy decisions which have shaped the profile of its integration into global markets.

In the sixth chapter, ‘Back to a high-inflation regime? The Argentine economy from the 2000s to the COVID-19 crisis’, written by Hernán E. Neyra and Andrés Ferrari Haines, it is shown that, since the 1989 hyperinflation in Argentina, anti-inflationary views and policies have been dominated by an orthodox outlook. Hence, different forms of ‘excess of money supply’ controls have been followed. Thus, the Central Bank of Argentina’s (CBA’s) role in the economy has been mainly relegated to achieve the end of inflation. Matters concerning economic growth and full-employment have been delegated to the ‘market’. This has meant that output became fundamentally an outcome of external trade. The chapter also argues that such a limited scope for CBA behaviour has resulted in inflationary pressures, even under a ‘bonanza’, because of the erratic and unstable economic context. As a result, agents push for a review of their prices and incomes as fluctuations are taken merely as an unjustified loss of purchasing power. Over time, an indexation mechanism gradually reappeared in a rather disorganized manner, which meant the CBA ended validation because of political and social pressures.

Chapter 7, ‘The new foreign debt trap and its long run consequences: The persistence of Monetarism as a social doctrine in Argentina’, by Juan Matías De Lucchi and Matías Vernengo, offers a detailed analysis of the problem of the current crisis of the external sector that the Argentine economy has been going through, starting with the election of the Mauricio Macri administration at the end of 2015. The focus of this analysis is placed on the errors of the previous national government, both diagnostic, theoretical and operational, which has led to a situation of complex sustainability in terms of indebtedness, which puts future possibilities of economic growth at risk. The return of Monetarism in Argentina led to a new foreign debt cycle, and the current pandemic has only aggravated the instability of the economy and the possibilities of default.

Chapter 8, ‘The monetary circuit and the credit channel in Mexico’, by Roberto Valencia Arriaga and Santiago Capraro Rodríguez, aims at demonstrating that, in Mexico, the credit transmission channel of the monetary policy does not work efficiently, so the Central Bank of Mexico’s (CBM’s) interest rate cannot be used as the only instrument to achieve the inflation target as asserted in the traditional ITR. Moreover, the chapter adheres to the Monetary Theory of Production, so it seeks to account for this hypothesis with a theoretical outline using the Stock-Flow methodology, and subsequently through a VAR model. The main result of the empirical analysis is that credit is found to be inelastic to the interest rate charged by commercial banks, while it does respond to changes in investment, so the monetary circuit hypothesis is validated, so it can explain the stagnation process of the Mexican economy.
Finally, the chapter claims that, in economies such as Mexico’s, the control of inflation needs more than one instrument.

Chapter 9, ‘Monetary policy in Latin America during the COVID-19 crisis: Was this time different?’, by Luiz Fernando de Paula, Paulo Saraiva and Mateus Coelho Ferreira, analyses the behaviour of some emerging economies’ central banks, specifically the central banks of Argentina, Brazil, Chile, Colombia, Mexico and Peru, during the COVID-19 crisis. The chapter shows that the reaction of the central banks of these South American economies was different from the central banks’ response during the subprime financial crisis of 2007–2008. According to the authors, at this time, the central banks implemented and eased monetary policy aggressively, by cutting policy rates and introducing some non-conventional monetary policy. They conclude that there are, at least, three reasons for such behaviour: (i) the quick swift monetary policy easing by the Federal Reserve Bank and other advanced economy central banks that calmed global financial conditions; (ii) South American economies’ cyclical position at the time of the COVID-19 shock opened up more room for easing monetary policy compared with other crises; and (iii) the sharp drop in output and inflation that followed the COVID-19 shock compounded the depressed business cycle positions and opened up space for monetary policy easing.

Chapter 10, ‘The Central Bank of Brazil in the face of the COVID-19 economic crisis’, by Isabela Andrade do Carmo and Fábio Henrique Bittes Terra, presents and analyses the measures undertaken by the Central Bank of Brazil (CBB) to offset the economic effects of the COVID-19 crisis. Given the huge impacts coming from the pandemic, the actions of the CBB, in terms of both the number of measures seeking financial stability and the volume of resources employed, were greater than that of the 2007–2008 subprime crisis. This gives special importance to the analysis of the behaviour of the CBB during the COVID-19 pandemic. The authors argue that the monetary policy framework available to the CBB in this crisis was bigger than in any other crisis, whether domestic or external. While in the 2008 Great Financial Crisis the CBB implemented measures to provide liquidity equal to 3.5 percent of the GDP, in the measures throughout the COVID-19 crisis, with some of them going until 2022, the total liquidity provision was 17.5 percent of the GDP. Capital relief measures were not even made in 2008, but in the COVID-19 crisis they totalled 15.8 percent of the GDP.

Finally, in Chapter 11, ‘The financial aspects of the COVID-19 crisis in Brazil: A Minskyan approach’, by Norberto Montani Martins, Ernani Teixeira Torres Filho and Luiz Macahyba, the theoretical framework developed by Hyman Minsky is adapted to understand the financial aspects of the COVID-19 economic crisis in Brazil. Taking the financial instability hypothesis and the concept of survival constraint as starting points, the authors analyse the
COVID-19 crisis and the responses of the Brazilian government from the perspective of three distinct, though interconnected, processes. The first process is characterized by the liquidity squeeze in financial markets and its consequences on prices and the tradability of assets. The second, which will last as long as the pandemic is not overcome, refers to the interruption of cash inflows to firms and households and the resulting disequilibria from the persistence of financial obligations and essential expenditures. Finally, the third process is associated with the deterioration of economic units’ balance sheets, which can lead to failures even after the health emergency is resolved. The authors conclude that liquidity measures adopted by the CBB contributed to avoiding the liquidity squeeze morphing into financial instability. However, the erratic support to business and families was not sufficient to avoid a massive increase in financial fragility.

We would like to thank all contributors for writing and revising their contributions to satisfy our demands and those of the publishers. We also wish to thank our friend Louis-Philippe Rochon for stimulating us to edit this book, introducing us to Edward Elgar Publishing and, mainly, writing the preface of this book. Alan Sturmer from Edward Elgar and his staff were extremely helpful during this project. Finally, we are grateful all these people for making this book possible.