Introduction to Monetary Policy Challenges in Latin America

Fernando Toledo and Louis-Philippe Rochon

Latin American countries (LACs) are facing a number of severe monetary policy challenges in the aftermath of the Global Financial Crisis and Great Recession, the post-pandemic scenario, and the war in Ukraine. Indeed, following these various crises, regional central banks must tackle an international situation characterized by inflationary pressures, output contraction, external vulnerabilities, tightness in advanced central banks’ monetary policies, nominal dollar appreciation, and falling commodity prices (Bank for International Settlements [BIS], 2022; World Economic Outlook, 2022). They also face several risks and, as such, should care about the climate of uncertainty of this unusual “shock-after-shock” global context. The monetary policy challenges faced by central banks in LACs are intrinsically interrelated with the following ten stylized facts that have become even more important nowadays, given the unprecedented circumstances:

1. LACs’ central banks, international currency hierarchy, and reduced monetary policy space

In contrast to developed countries, LACs’ central banks have less monetary policy space to confront the complexity of this juncture. The subordination of regional and local currencies in the international currency hierarchy (ICH) contributes to explaining this fact (Kaltenbrunner, 2022; Bibow, 2021; Toporowski, 2021). LACs’ currencies are not accepted at the global level, and in some of these economies, they are not even used in full for domestic purposes (Levy Orlik et al., 2021). As a negative consequence of ICH, LACs usually borrow from abroad in foreign currency, which not only generates currency mismatches on balance sheets (Tobal, 2014), but also lessens the monetary policy space of LACs’ central banks for attending to their policy objectives.

2. The exchange rate is a key transmission mechanism of monetary policy in Latin America
The transmission channels of monetary policy are different in comparing advanced economies and LACs. The role of an exchange rate channel instead of the credit channel is of paramount importance in Latin America for understanding how monetary policy works in practice (Agénor and Pereira da Silva, 2019). The nominal exchange rate affects inflation and the output gap in two important ways (Agénor and Montiel, 2015). First, there exists a direct one-way relationship between the prices of imported final goods on domestic consumer prices (the pass-through effect), and second, an indirect link between aggregate demand and aggregate supply. Through its impact on the real exchange rate, the nominal exchange rate modifies relative prices and influences aggregate demand, output, and inflation. The supply side of nominal exchange rate variations is reflected in the cost of imported intermediate inputs and in the consequent adjustment of nominal wages to movements in consumer prices. LACs’ central banks should be cautious of these exchange rate changes under inflation-targeting regimes because they spread the effects of variations in policy interest rates and domestic or foreign shocks to regional countries.

3. **LACs’ central banks, inflation targeting, “fear of floating,” and financial instability**

The use of inflation targeting as a monetary policy framework is also one feature that deserves attention among some economies of the region, particularly due to its intrinsic instability related to the adoption of a floating exchange rate regime and the “fear of floating” that regional policy makers usually display. Since several LACs’ central banks have taken political actions to intervene in their foreign exchange markets, they show concern about the excessive nominal exchange rate volatility, a phenomenon known as the “fear of floating” (Calvo and Reinhart, 2002). Some regional monetary authorities have also shown some “fear of appreciation,” particularly when they must face a completely deregulated financial account and high nominal interest rates that attract capital inflows. High volatility of the nominal exchange rate could be detrimental in dollarized inflation-targeting LACs because greater fluctuations of this variable usually impinge on banking and financial instability.

4. **LACs’ central banks, exchange rate targeting, and the risk of inflationary pressures**

Some LACs’ central banks use a de facto exchange rate policy that focuses on international competitiveness, economic growth, and employment generation as their main objectives. Real exchange rate targeting, or preserving a stable and competitive real exchange rate, proves to be convenient for promoting economic growth through the expansion of modern tradable sectors (Frenkel and Rapetti, 2015). The managed floating strategy (targeting the real exchange
rates) also affects resource allocation, particularly if they show stability during a long last period (Frenkel and Taylor, 2006). A competitive and stable real exchange rate could boost aggregate demand and employment and promotes economic development. However, regional monetary authorities should not only consider that sustaining a competitive and stable exchange rate should be a desirable goal. They also must pay attention to its potential inflationary consequences, particularly related to higher cost-push pressures and conflicting claims outcomes (Taylor and Barbosa Filho, 2021). Bastian and Setterfield (2020) present a post-Keynesian-Structuralist (PK-S) theoretical model in a structural form that identifies how conflicting claims give place to either an equilibrium regime with a low inflation rate or a disequilibrium regime with a high and increasing inflation rate. In a similar vein, Abeles and Panigo (2015) propose a theoretical PK-S model that focuses on cost-push factors (i.e., the international commodities market). The formal contribution of this model is identifying the political and institutional factors, such as particular structural characteristics that explain the different speed and magnitude of the pass-through from the international prices of exported commodities to inflation rates in the case of small open developing economies, such as the LACs.

5. **LACs’ central banks and international reserve accumulation**

International reserve accumulation as a buffer stock that reduces vulnerability to external shocks should be a more widespread practice adopted by several LACs’ monetary policy makers, such as the Latin American Reserve Fund proposal (Corbo et al., 2019; Titelman et al., 2014). The configuration of the international financial system in the case of LACs has been characterized by a greater tendency toward managed floating, higher monetary policy independence, and segmented financial integration to international capital markets. The accumulation of international reserves seems to be of paramount importance given this context, and particularly in providing LACs’ central banks with greater monetary policy autonomy in decision-making. The role of international reserves as buffer stock and self-insurance against the volatility of capital flows has been recognized by several scholars (Aizenman and Riera-Crichton, 2014; Eichengreen, 2006). In contrast to the experience of some Asian economies (particularly China), the main challenge for LACs’ central banks is to adopt monetary policies that improve the accumulation of international reserves at a faster pace.

6. **LACs’ central banks’ vulnerability to global liquidity shocks, and the transmission of the Global Financial Cycle**

The higher vulnerability to the different phases of the Global Financial Cycle (GFCy) and the global liquidity changes are two topics that have increased
the attention of LACs’ central banks during the last few years. Monetary policy shocks in the financial centers are one of the main determinants of GFCy (Miranda-Agrippino and Rey, 2021; Jordà et al., 2018). The monetary policy international spillovers from financial centers to Emerging Markets and Developing Economies (EMDEs; including LACs) are transmitted through different channels, such as the commercial and financial ones. A fall in US monetary policy interest rates stimulates a greater appetite for risk among global investors, who decide to reallocate their financial funds mostly to developing economies. Thus, lower policy interest rates in the US trigger nominal appreciation in small open economies driven by portfolio flows and cross-border lending (Bonizzi and Kaltenbrunner, 2021; Yilmaz and Godin, 2020). These external funds are reverted when the Federal Reserve announces an increase in its nominal interest rate policy. In such a case, we observe increases in global risk aversion that stimulate flight-to-quality behavior and higher exchange rate market pressure in LACs, even though these economies show solid macroeconomic fundamentals (Kohler, 2021; Botta, 2021).

7. LACs’ central banks, capital controls, and macro-prudential regulations

The need to apply capital controls and macro-prudential measures that increase financial stability has also been of greater concern in LACs’ central banks’ policy agendas, particularly after the Global Financial Crisis of 2007–08 (Bastourre and Zeolla, 2018). Since the 1990s, there has been a rapid transformation in international finance that has brought financial globalization to unprecedented levels. LACs have not escaped this general trend. These processes, far from generating the benefits predicted by theory, led early to debt, currency, and financial crises. After the international economic crisis of 2008–2009, both the practices toward the liberalization of the financial account and the conventional theory on the subject tended to be revised (Pasricha and Nier, 2022). Driven by the experience of developing countries, a reassessment of capital flow management measures arose in which Latin America actively participated (Grabel, 2016). However, despite some re-regulations, the degree of capital and financial account management in LACs is currently below that of other comparable emerging economies. So, this is one other important monetary policy challenge that LACs’ central banks face.

8. LACs’ central banks and the need for coordination of monetary and fiscal policies in high-inflation economies

The historical record of high inflation and the lack of coordination of monetary and fiscal policies have been of paramount importance, particularly in Argentina (Heymann, 2015). This economy is nowadays reporting a change of regime from chronic to high inflation. The control of nominal variables
has become a serious problem for policy makers. Inflation expectations are de-anchored, and monetary and fiscal policies face serious difficulties coordinating them in a virtuous way. Disorder in relative prices expresses some of the hurdles faced by monetary authorities, which must confront several limitations in terms of the degree of maneuver of their policy instruments to stabilize the economy. One of the main monetary policy challenges that Argentina faces is thinking about the design and implementation of a stabilization program that improves the credibility of policy announcements and minimizes the sacrifice output ratio (Calvo and Végh, 1999). The coordination between fiscal and monetary policies seems to be of critical importance to accomplish this goal.

9. **LACs’ central banks, external debt, and greater financial vulnerabilities**

LACs’ central banks should also care about the composition of total debt, public and private, especially to avoid currency mismatches and the resulting negative social implications linked to greater exchange rate market pressures (Goldberg and Krogrstrup, 2018). The distinction between external and domestic debt is of vital importance, particularly for LACs. External debt generally implies greater challenges for monetary policy makers. They do not only take care of the generation of fiscal surplus to accomplish their obligations. They also need to guarantee continuous access to foreign currency (Moreno-Brid, 2003). Excessive external debt profiles usually correlate with currency crises and lower growth paths. They also relate to currency mismatch issues and greater financial vulnerabilities. So, the main monetary policy challenge that LACs’ central banks realize here is to regulate and monitor external debt indicators at macro and micro dimensions, while also promoting the financial depth of local currency bonds.

10. **LACs’ central banks, climate change, and the green finance agenda**

Climate change, sustainable growth, and green finance have been other key topics of LACs’ monetary policy makers’ agendas (CAF, 2022). Climate change and the conservation of natural capital are the main environmental challenges facing society. Latin America is a continent that emits in proportion to its economic activity and its population. Funding for activities that catalyze transformation in LACs is critical to achieving both its climate goals and other development goals. Climate change and the policies to combat it will affect the financial system through its physical impacts and through the changes inherent to the transition itself. Understanding how banks are adapting to this new environment is critical to fostering a dynamic transition in a stable environment. The Network of Central Banks and Supervisors for the greening of the financial system has developed a set of models that make it possible to establish different scenarios of the relationship between the economy and
climate change with a special focus on financial risks (Economic Commission for Latin America and the Caribbean [CEPAL], 2022).

THE STRUCTURE OF THE BOOK

This book includes contributions that analyze the main monetary policy challenges in LACs. The chapters show the paramount importance of identifying some of the topics that deserve attention by central banks in the region in a synergic way. The goal of the compiled material is not only to list the problems but also to invite policy makers to reflect on the numerous ways in which monetary policy and related issues could be thought of.

Part I of the book is titled “Alternative Views about Central Banks and Monetary Policy in LACs” and comprises two chapters. In Chapter 1, Sebastián Valdecantos assesses the prescriptions of the Integrated Monetary Policy Framework (IPF) of the International Monetary Fund using an empirical stock-flow consistent model for Argentina, a country that for the last ten years has been suffering a balance of payments crisis. One possible representation of the IPF is designed and counterfactually tested for the years 2016 and 2017, when Argentina was indeed a net recipient of foreign financial flows. The goal is to examine whether this suggested policy mix would have generated more sustainable dynamics than observed ones, ending in a currency crisis in 2018. This author makes some reflections on which lessons about the IPF can be generalized to other small open economies and which results should be understood as specific to the Argentinian context. In Chapter 2, Simone Deos and Enzo Gerioni suggest that the ICH literature can be inconsistent with the endogenous money approach when related to basic elements, such as the nature of money, its distinguishing characteristics, and consequently monetary and mainly fiscal policies—the last of which is almost completely neglected in the ICH literature. Going further, and focusing on the Brazilian economy, they observe that both monetary and fiscal policies are autonomously set by governments that issue their own sovereign currency, despite different degrees of freedom and sovereignty related to conditions that are specific to each economy.

Part II of the book, “Monetary Policy Transmission Channels in LACs,” includes three chapters. In Chapter 3, Esteban Pérez Caldentey and Matías Vernengo argue that the adoption of inflation targeting was a result of a policy shift that began with the Washington Consensus, and that materialized sequentially in increased financial openness and greater exchange rate flexibility. These authors sustain that, in the case of an open economy, the use of inflation targeting leads to incoherent and contradictory results that severely question its alleged superiority over other monetary policy frameworks. Finally, they posit the need for comprehensive regulatory frameworks to deal with the complex dynamics and transmission mechanisms that characterize economies that
have a high degree of financial openness, such as those of Latin America. In Chapter 4, Noemi Levy Orlik revises the discussion of the views of monetary policy dominant during the 21st century, looking at how developed and developing economies were affected, specifically in Mexico. Also, she analyzes the alternative views that have been strengthened considering the COVID-19 crisis. Levy Orlik suggests that central banks will continue to determine an objective rate of interest, used as a policy instrument, guided by different goals. Considering the 2008 Global Financial Crisis and the COVID-19 crisis, short- and long-term liquidity requirements need to be considered by the central bank reaction function, which means that the central bank ought to recognize the need to stabilize the yield curve. To pursue this objective, the monetary and fiscal authorities need to resume coordination around economic growth objectives and financial stability. In Chapter 5, Gabriel Michelena and Fernando Toledo analyze the bust GFCy transmission to EMDEs through a Neo-Kaleckian model of growth, inflation, income distribution, and external debt. These authors calibrate and simulate the model to evaluate the effects of this phase of GFCy spread on income distribution, capacity utilization, and real exchange rates. They propose several monetary policy rules to examine how financial centers’ monetary spillovers could be mitigated during the bust GFCy stage. These scholars find that external financial shocks conducted by GFCy to EMDEs could be magnified or dampened out, depending on the kind of monetary policy rules followed by EMDEs’ central banks.

Part III of the book is titled “Monetary Policies and Exchange Rates in LACs” and includes three chapters. In Chapter 6, Annina Kaltenbrunner, Gary Dymski, and Daniel Pérez-Ruiz discuss whether exchange rates should be managed by laying the foundations for defining what they term the “Policy Target Exchange Rate.” These authors support their discussion with experience from Latin America since exchange rates in this region are among the most important policy variables and the idea of exchange rate targeting has been widely discussed. Their aim is to build the groundwork for a post-Keynesian theoretical approach to the challenges of exchange rate management. In Chapter 7, Nelson H. Barbosa-Filho shows how some sensible economic assumptions create two nonlinearities in the economy through a simple formal model, one between the real exchange rate and growth and the other between the real exchange rate and inflation, which then makes an exogenous inflation target set boundaries to the real exchange rate and economic growth itself. In Chapter 8, Gabriel Montes-Rojas and Nicolás Bertholet present empirical evidence on the short- and medium-run contractionary effects of exchange rate shocks and currency devaluations for bi-monetary (i.e., highly dollarized) countries. These scholars estimate a vector autoregression model with quantile heterogeneity for Argentina during the period January 2004–December 2018, with four macroeconomic variables (exchange rate variations, inflation,
economic activity, and nominal wage growth). The empirical results show a 30 percent price pass-through effect and a bimodal effect on output, with both positive and negative effects. Wages adjust less than prices, with the consequent effect that real wages have a negative elasticity of 0.23 with respect to exchange rate shocks. Further analysis of the multivariate responses shows that the negative effect on output is associated with a decline in real wages: a 1 percent fall in real wages after a currency devaluation produces a 2.3 percent decline in output.

Part IV of the book, “Monetary Policies, International Reserves, and Sustainable Finance in LACs,” contains two chapters. In Chapter 9, William N. Kring highlights the unique and important role that the Latin American Reserve Fund (FLAR) plays in advising member countries on macroeconomic stability efforts and in responding to balance of payments and liquidity challenges. This author remarks how adaptability is one of the FLAR’s keys to success over its history and demonstrates how members broadened FLAR’s scope and bolstered the mechanism’s lending capacity to US$6.8 billion in response to the COVID-19 crisis. The chapter concludes with a brief discussion of how further efforts toward regional integration and the expansion of existing efforts, such as FLAR, could help to further foster financial stability in the region. In Chapter 10, Pablo G. Bortz and Nicole Toftum review the alternatives available to Emerging Market Economies (EMEs) to finance the investment required to mitigate and adapt to climate change. Since the requirements dwarf the financial capabilities of the public sector in EMEs, these scholars explore possible funding channels, focusing on international financial markets. They identify potential obstacles to a smooth and sustainable finance provision, including the influence of the GFCy on credit supply, risks related to currency mismatch and creditworthiness assessment, and mispricing of risks. The review also identifies the challenges to the exporting profile and, therefore, the sustainability of the balance of payments of EMEs. Finally, they provide some reflections on the limits of domestic private capital markets to bridge the “environmental financial gap” and call for the deeper involvement of specialized and official financial institutions.

Part V of the book is titled “Monetary Policies, Central Banks, Income Inequality, and Fiscal Policies in LACs” and encompasses four chapters. In Chapter 11, Jorge Carrera, Pablo de la Vega, and Fernando Toledo assess the fiscal policy responses of EMDEs’ governments to unexpected shocks that increase income inequality. These scholars focus on the relationship between income inequality and public expenditure, progressive taxation, and public debt. They aim particularly at the strategic use of public debt to finance greater public expenditure targeted to lessen the negative effects of hikes in income inequality. To this end, these authors estimate dynamic panel models for 49 EMDEs with annual data for the 1990–2015 period. They find that the
marginal effect of inequality on the public debt is increasing in the share of the executive term completed, and it becomes statistically significant after completing 85 percent of the corresponding term. This finding is robust to different empirical specifications and is more pronounced in LACs and in economies with higher external liabilities. In Chapter 12, Damián Pierri studies the connection between monetary policy and capital markets in Argentina since 2019. After the sudden stop observed in 2018, there were several fundamental changes in the design of economic policy, especially following the 2019 national election, which implied a turnover in the ruling party. These changes have major implications for the relative behavior of Argentina with respect to other middle-income countries. Having a clear diagnosis is essential to anticipate the future macroeconomic outlook of the country, considering especially the limitations to restoring macroeconomic stability implied by COVID-19. In Chapter 13, Sylvio Antonio Kappes analyzes the four most important items in the Brazilian Central Bank balance sheet: on the asset side, the international reserves and the treasury bills; and on the liabilities side, the repurchase agreements and the treasury account. This author observes that these four items evolved due to the same policy decisions and institutional features. Their evolution began with the decision to accumulate international reserves. A second decision, regarding the sterilization of the liquidity created by this first incident, explains the increase in both repos and treasury bills. Finally, the legal framework connects the first decision to the increase in the treasury account. In Chapter 14, Alfredo Schclarek Curutchet empirically explores the relationship between external debt and growth for 20 Latin American and Caribbean countries. Using a dynamic system generalized method of moments panel estimator, he finds that higher (lower) total external debt levels are associated with lower (higher) growth rates, and that this negative relationship is driven by the incidence of public external debt levels, and not by private external debt levels. This scholar does not find evidence of non-linear effects for these relationships.

REFERENCES


