From Tail Winds to Head Winds:

Dilemmas and Trade-offs for Monetary Policy in LAC

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Aims and caveats

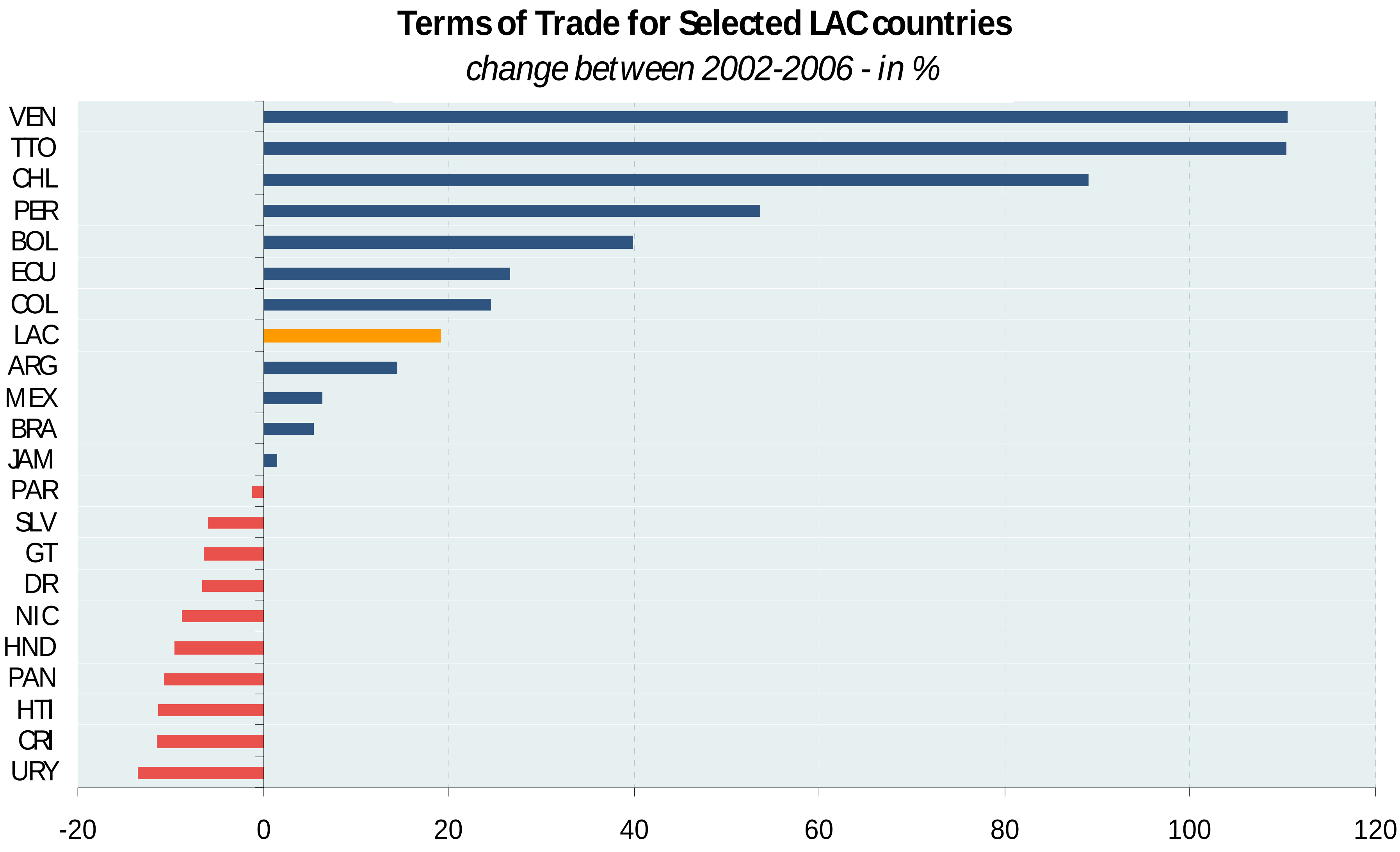
- Two aims:
  - Summarize the current policy dilemma and ask broad questions on how to address it
  - Provide a broad regional perspective of policy responses thus far, by monetary regime
- Two (main) caveats:
  - No answers here… (there are certainly no easy answers, but much less at this level of generality)
  - Very broad brush overview has to be viewed with care (simple averages can be misleading)

Outline

- Assessing the shocks
  - Demand or supply?
  - Transitory or permanent?
- Formulating a response
  - The response so far
  - Tackling the exchange rate
  - Better mañana?...
  - Expanding the policy frontier

Demand or supply?

Demand pressures would certainly be expected in countries facing positive terms of trade shocks



Source: World Bank staff (LCRCE) calculations, ECLAC and Haver Analitics.

But even for the other countries, strong demand pressures are also likely to be present

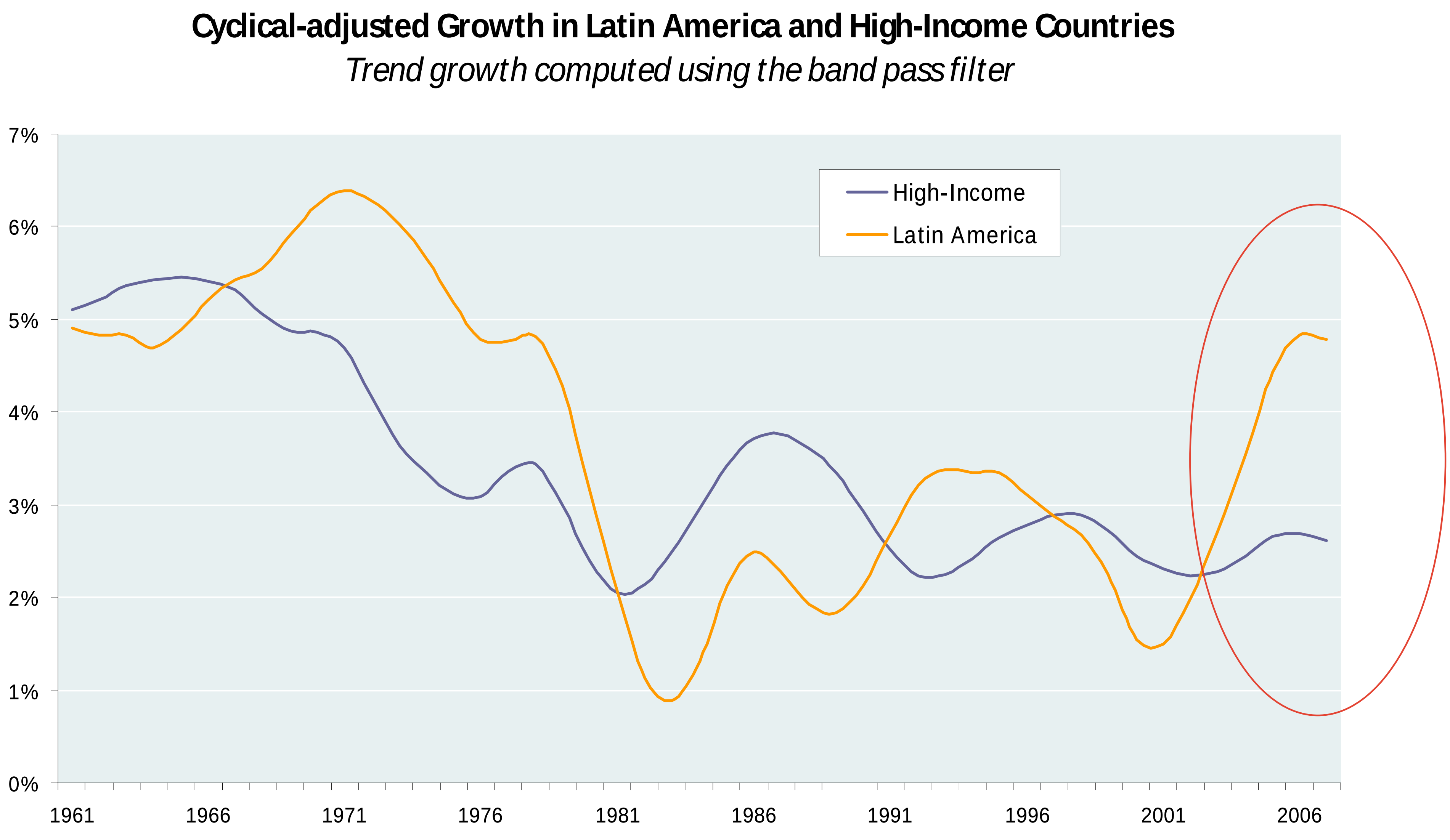
- The rise in commodity prices coincides (and largely results from) a booming world demand

  =>Non-commodity exporters also benefit

- Lots of free capital roaming around for higher returns (even more so since the Fed’s reduction in interest rates)

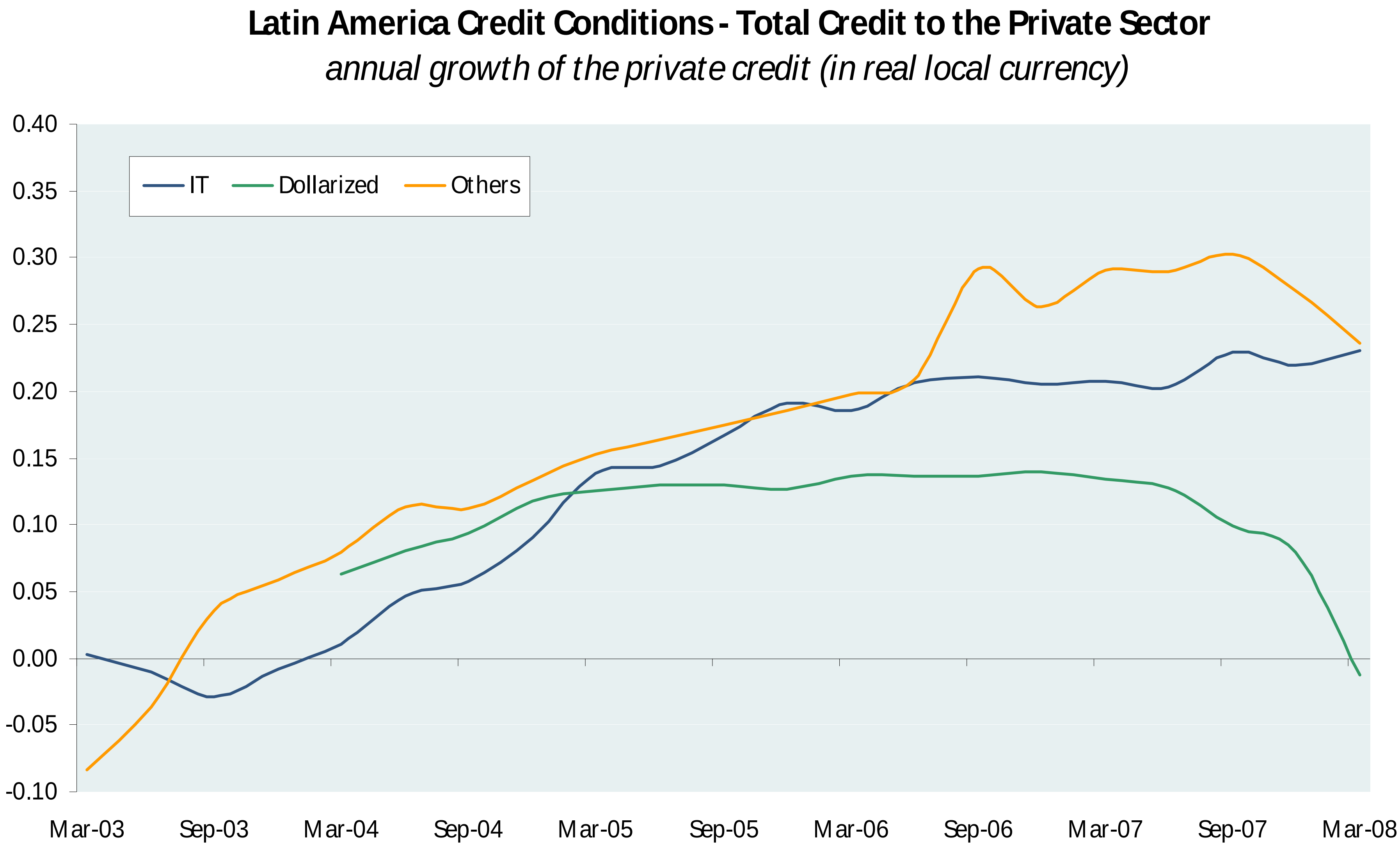
  =>Low real interest rate environment

LAC output growth is (at present) the highest it has been in decades…

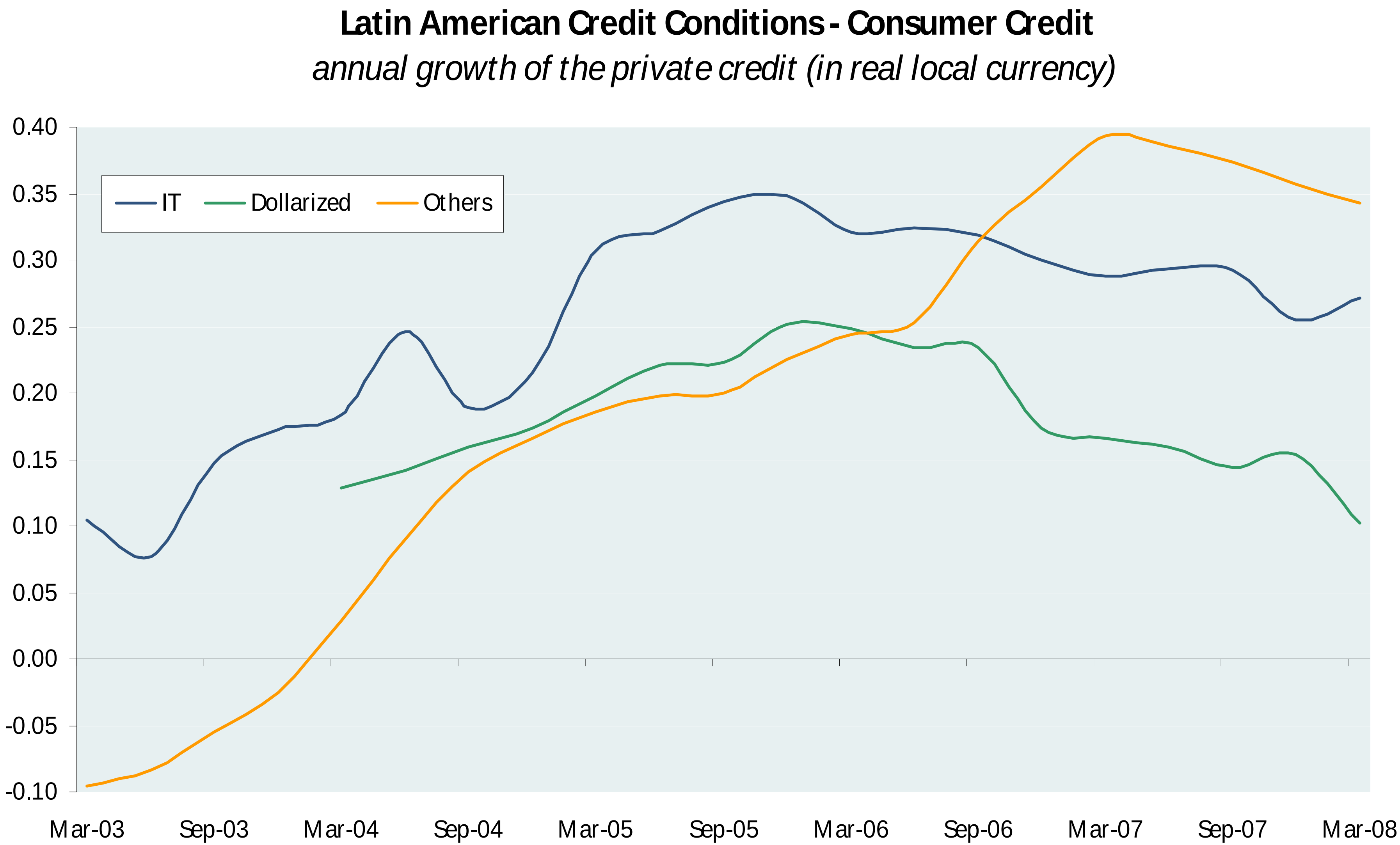


Source: WDI – World Bank; National Authorities. Cyclical component of growth is computed using the band-pass filter.

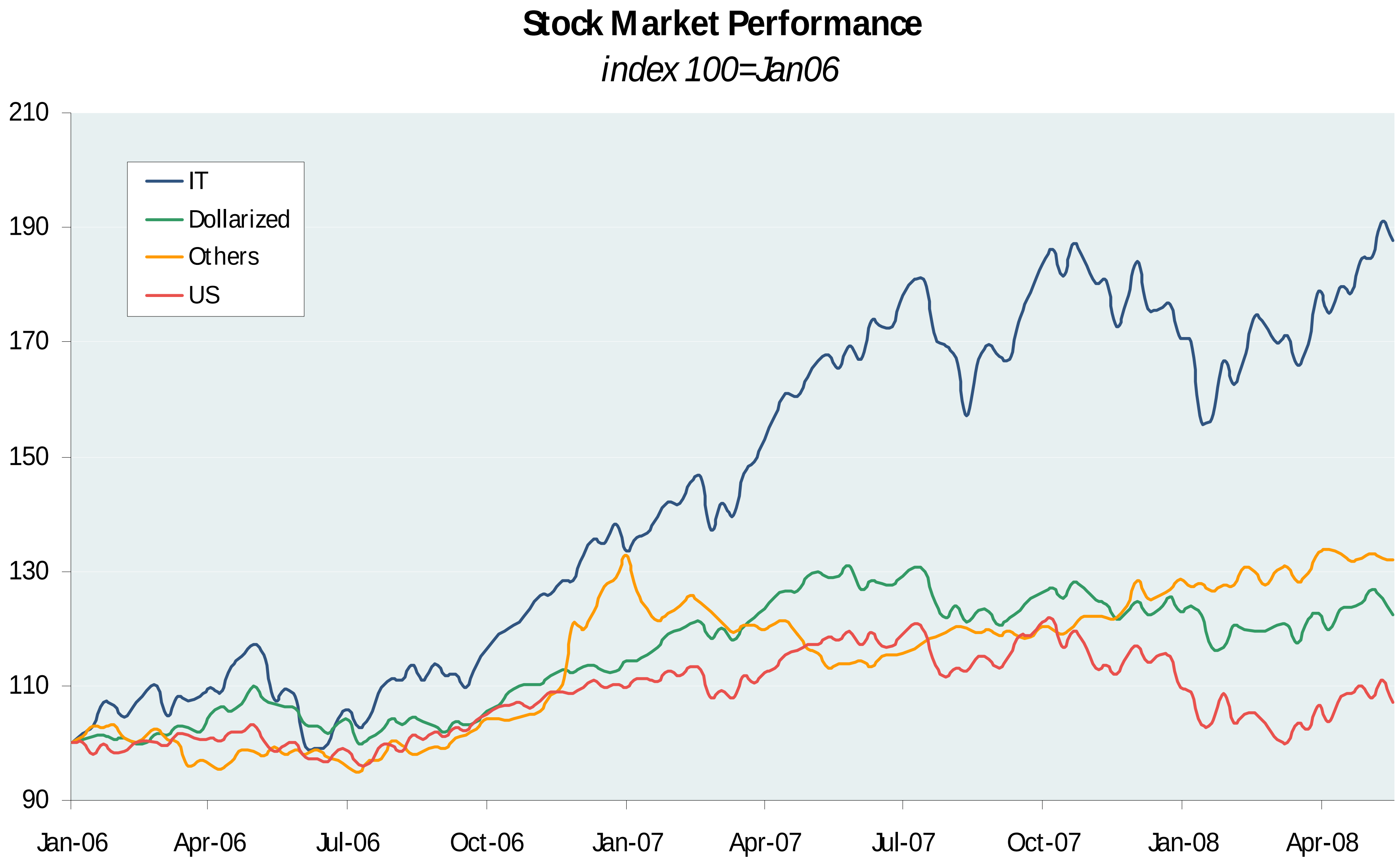
…credit is booming…



…spurred by consumer lending…



…and still very high asset prices, particularly for the IT countries



Transitory or permanent?

There are strong uncertainties about the world cycle

- Is the current inflation outburst due to a temporary squeeze in the world output gap?
  - Is the cycle finally about to crash, courtesy of the US subȸ prime market?
  - Or will there be an orderly restrain in world demand, allowing supply to catch up?
    - Will there be a policy turnaround at the FED?
    - Can China control its demand?...
- Or are the growth bottlenecks “structural” and unlikely to disappear any time soon?

Is it nominal or real?...

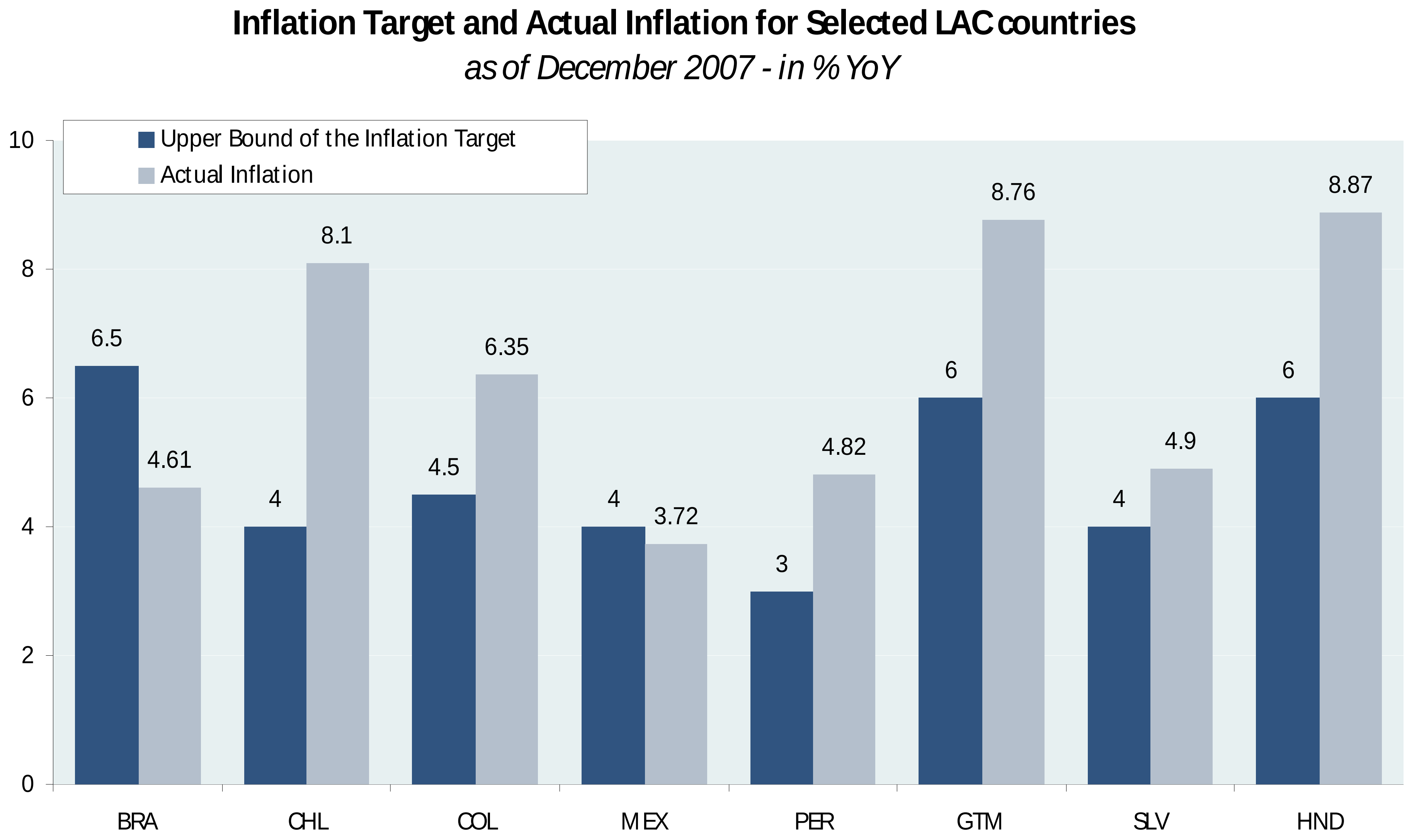
- Relative price adjustments cannot go on forever and can only have transitory impacts on inflation…
- But what happens when both demand and supply elasticities for food and energy are very low?
- If accomodated, real adjustments can trigger runaway inflation as a way to reconcile conflicting ex-ante claims (the old structuralist story…):
  - Real wage rigidities (inflationary erosion of nominal wages)
  - Consumption rigidities (inflationary erosion of budgetary appropriations for special food purchases or subsidies)

The response so far

What does the book say?

- Supply shocks require a different response than demand shocks:
  - With *nominal* price rigidities for core goods, it would be too expensive to immediately try to offset non core inflation
  - With *real* price and wage rigidities, stabilizing prices destabilizes output (there is a trade-off—no divine coincidence—between output and inflation)
- Hence, unless you are an “inflation-nutter” (strict IT) or there is a risk of second-round effects (possibly undermining the nominal anchor), temporary deviations from target due to pure supply shocks are ok
- But watch for:
  - Shifts in longer term inflationary expectations
  - Pass-through of non core to core inflation (wages)

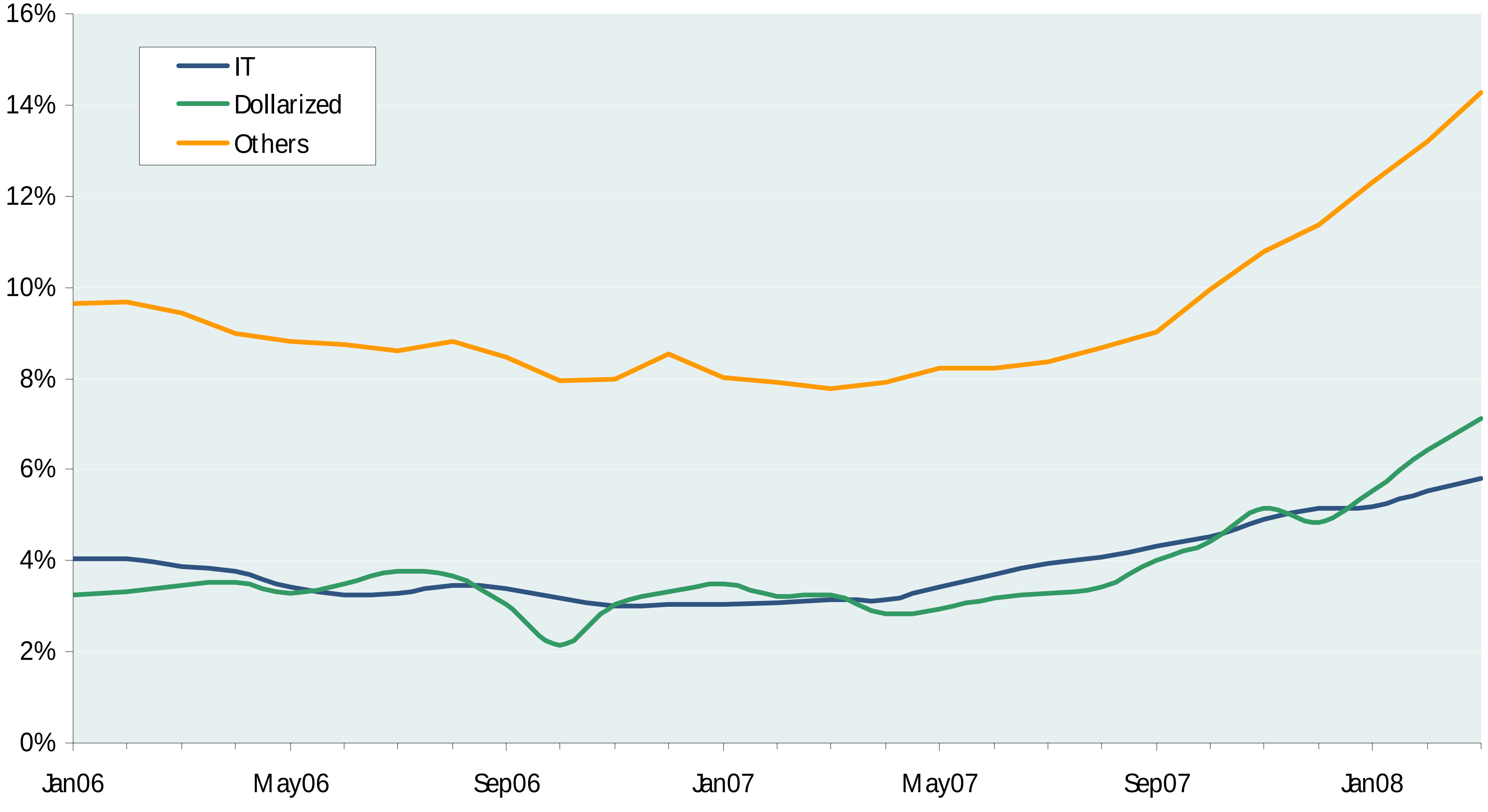
Indeed, many inflation targeters (or near targeters) have so far overshot their target…



…as consumer prices inflation has started rising since the first semester of 2007

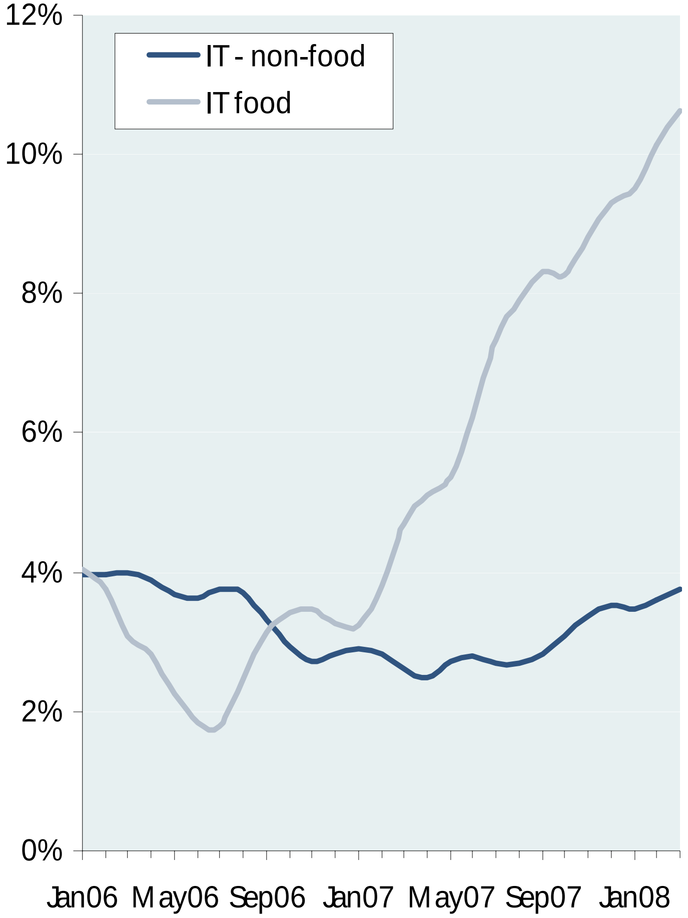
Latin American Consumer Prices Inflation

annual variations, simple average by monetary regime

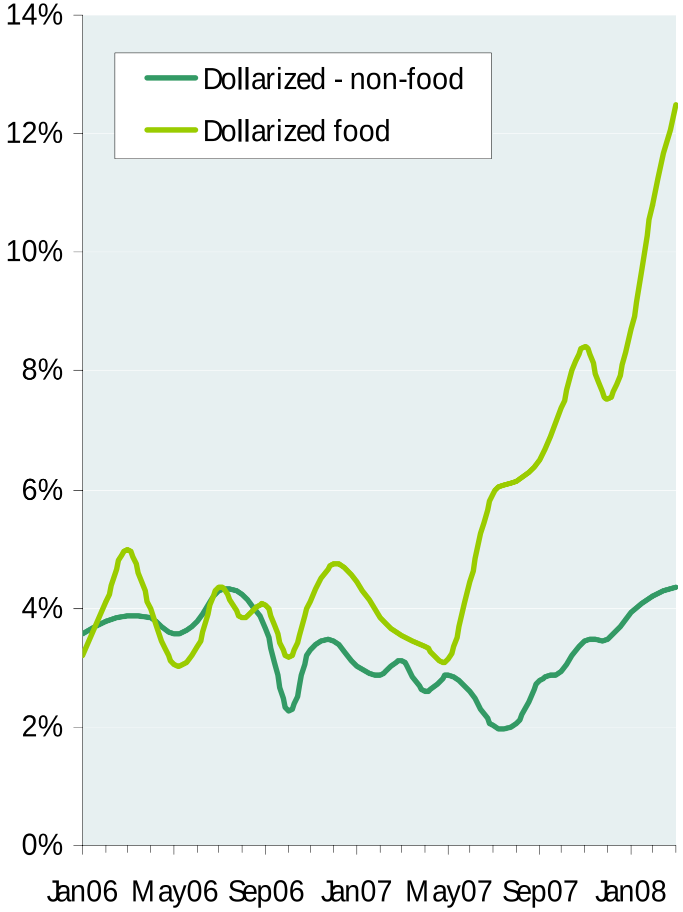


While food inflation is clearly in the lead, non-food inflation also started rising towards end 2007…

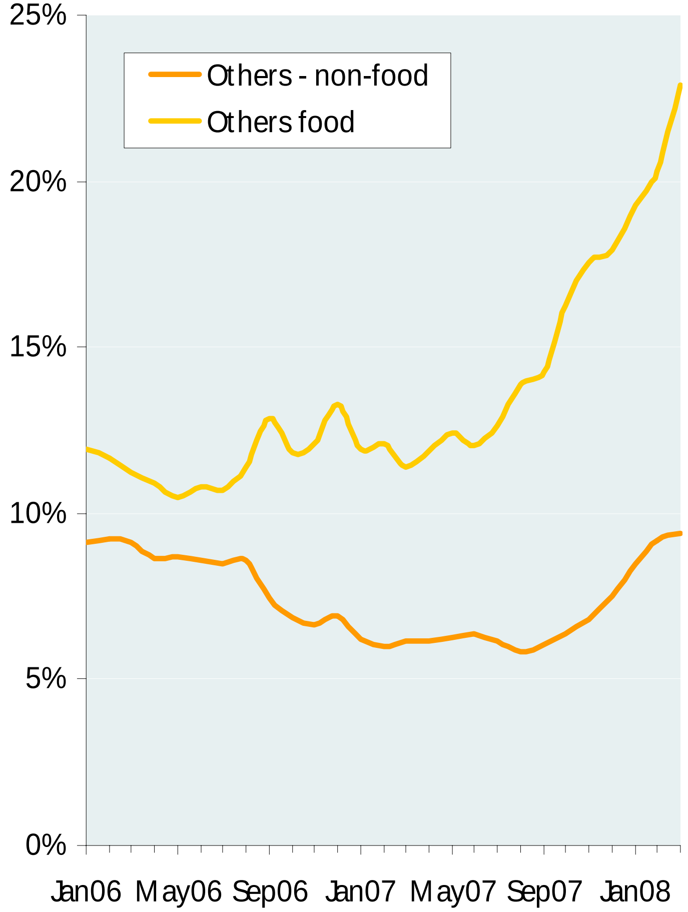
ITs Consumer Prices Inflation
annual variations



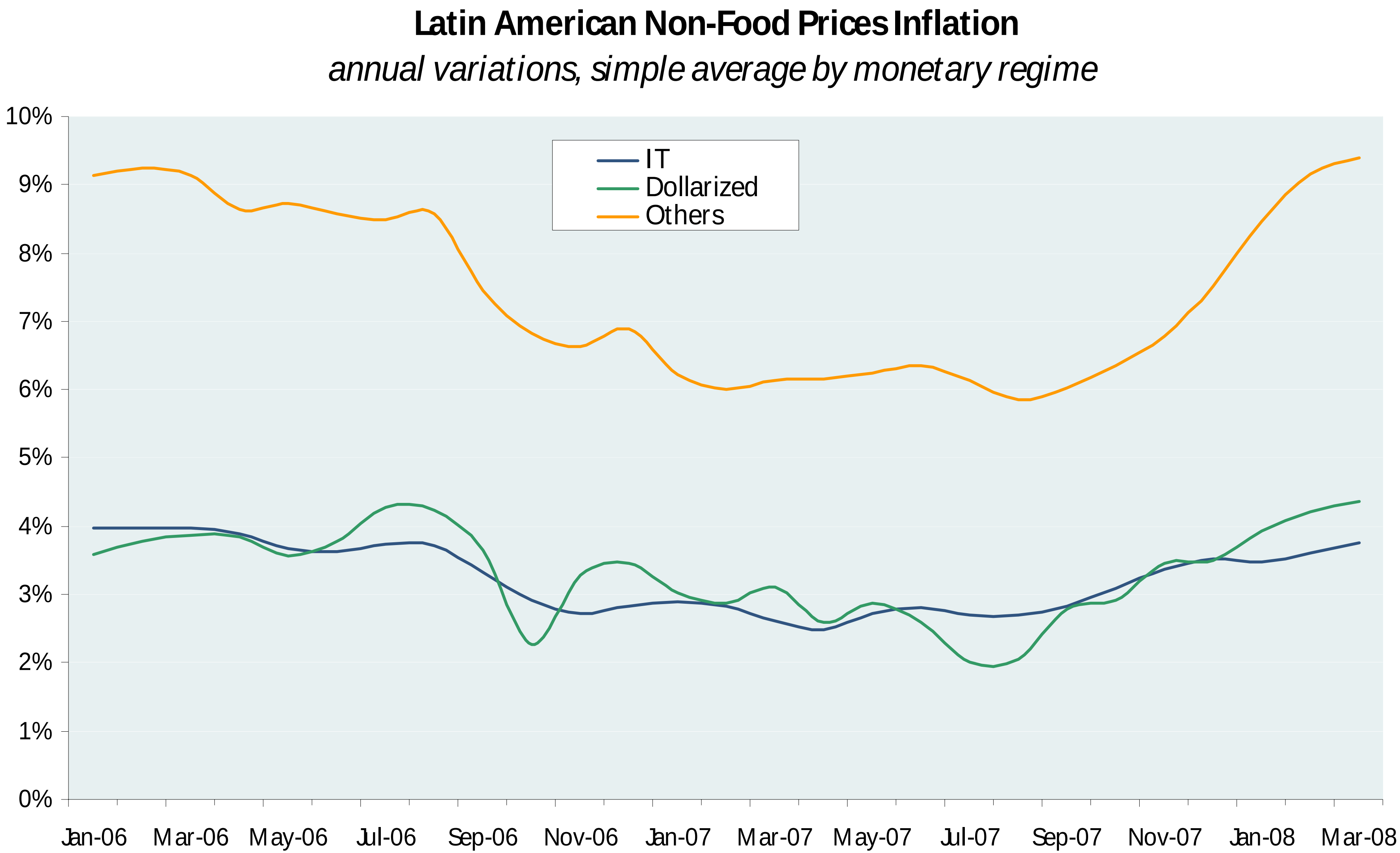
Dollarized Consumer Prices Inflation - *annual variations*



Others Consumer Prices Inflation - *annual variations*

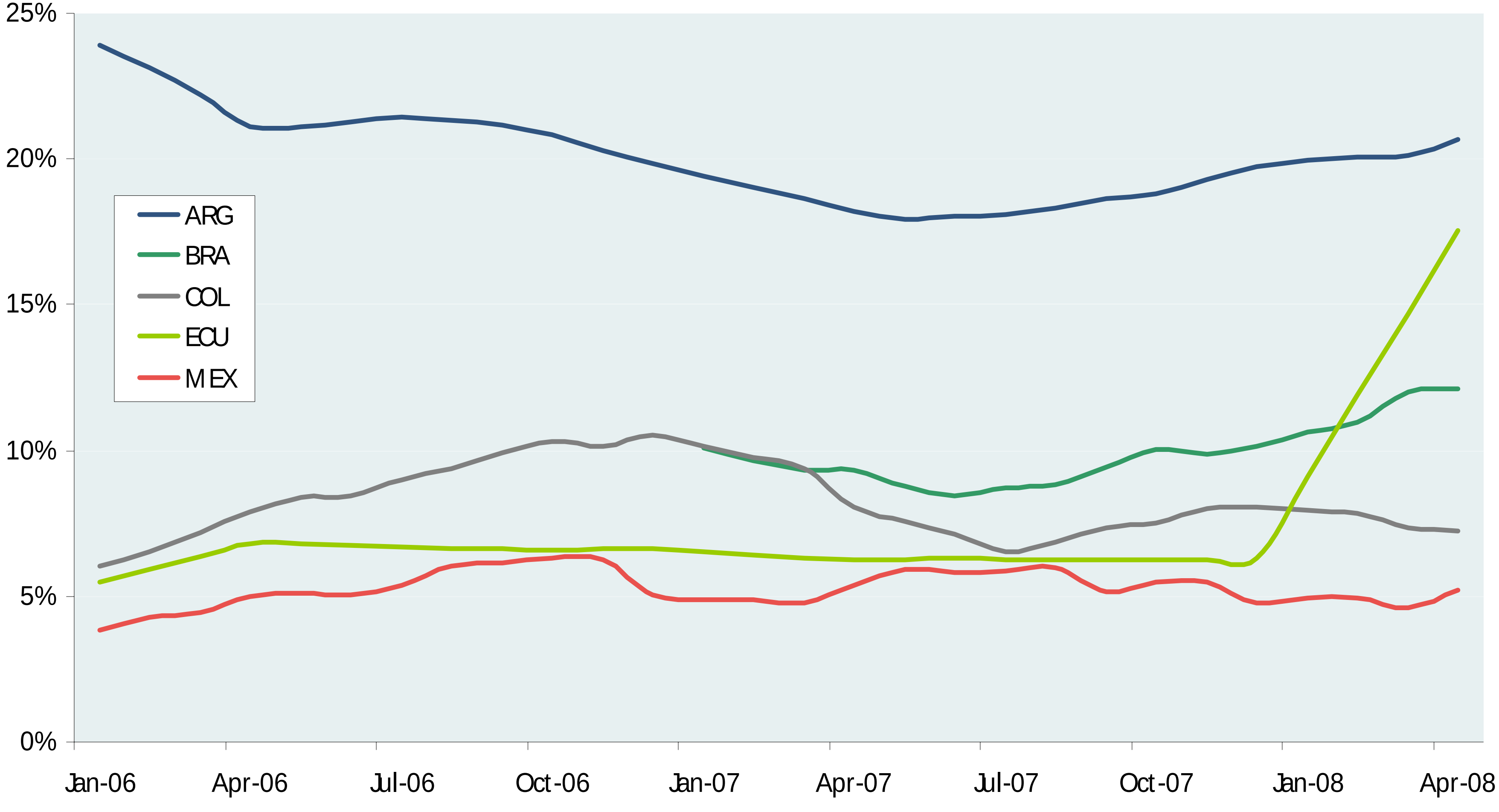


…but has been somewhat more subdued in the IT countries…

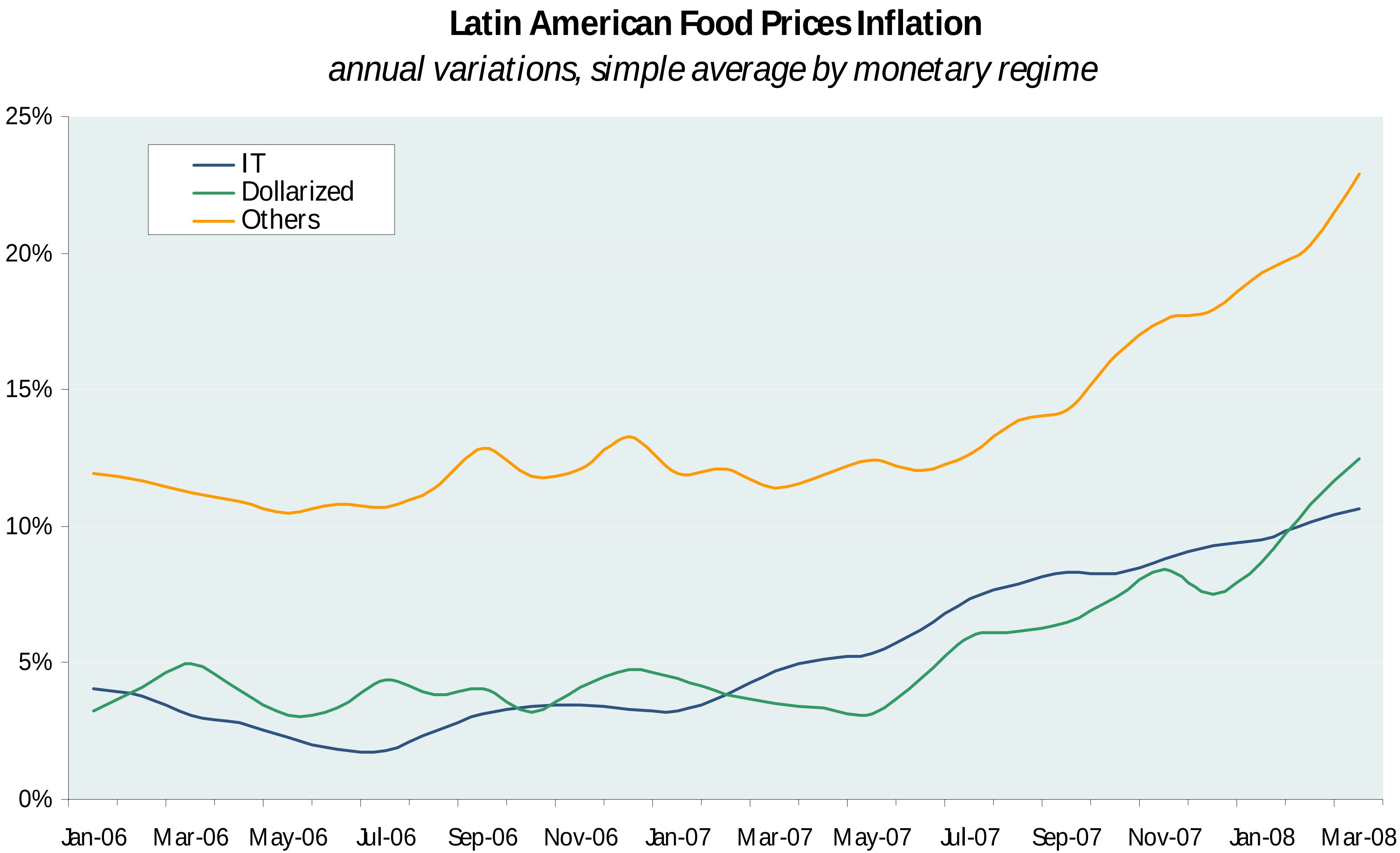


…as the wage response seems to have been thus far rather restrained…

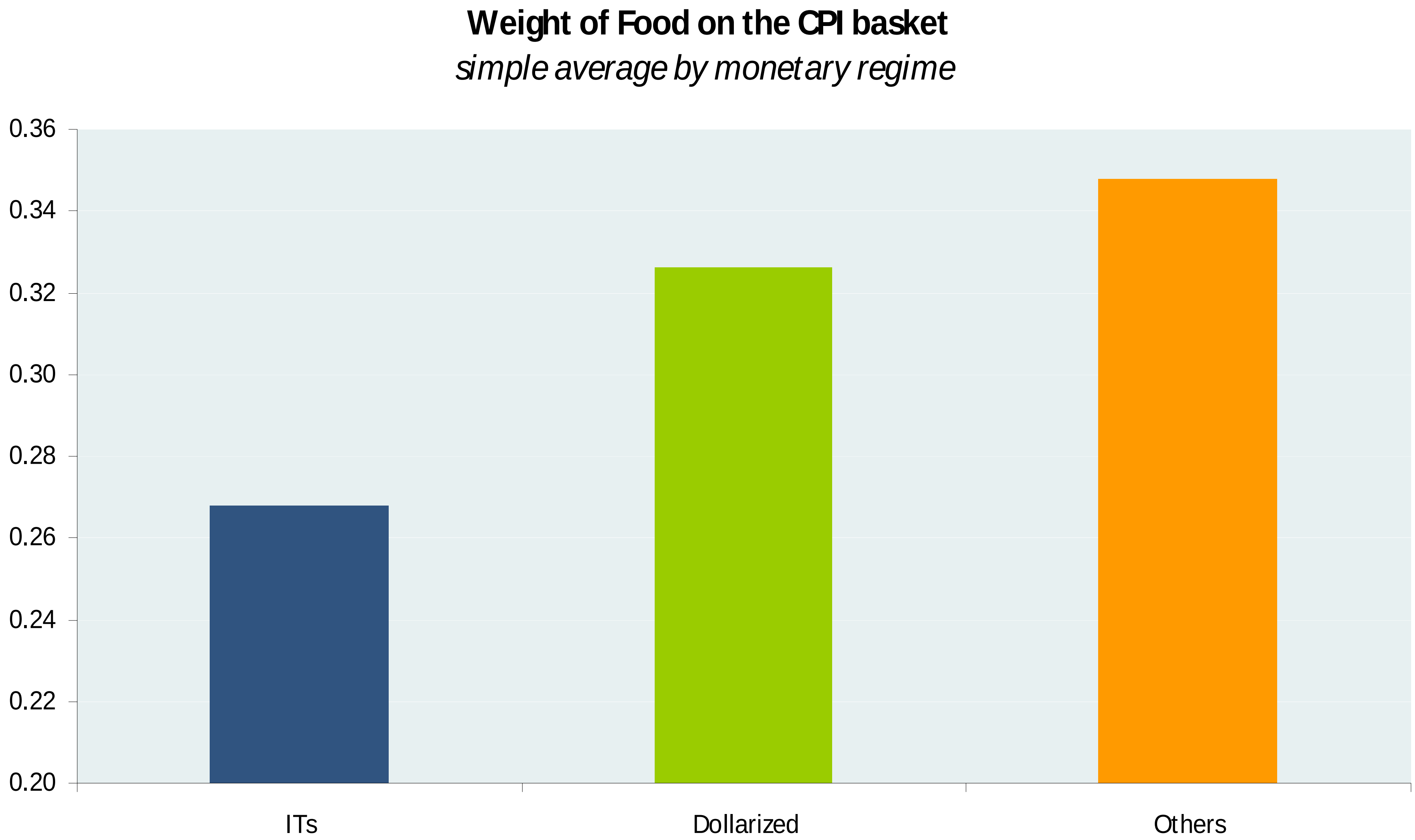
Workers Wages Indexes for Selected LAC countries
annual variation rates



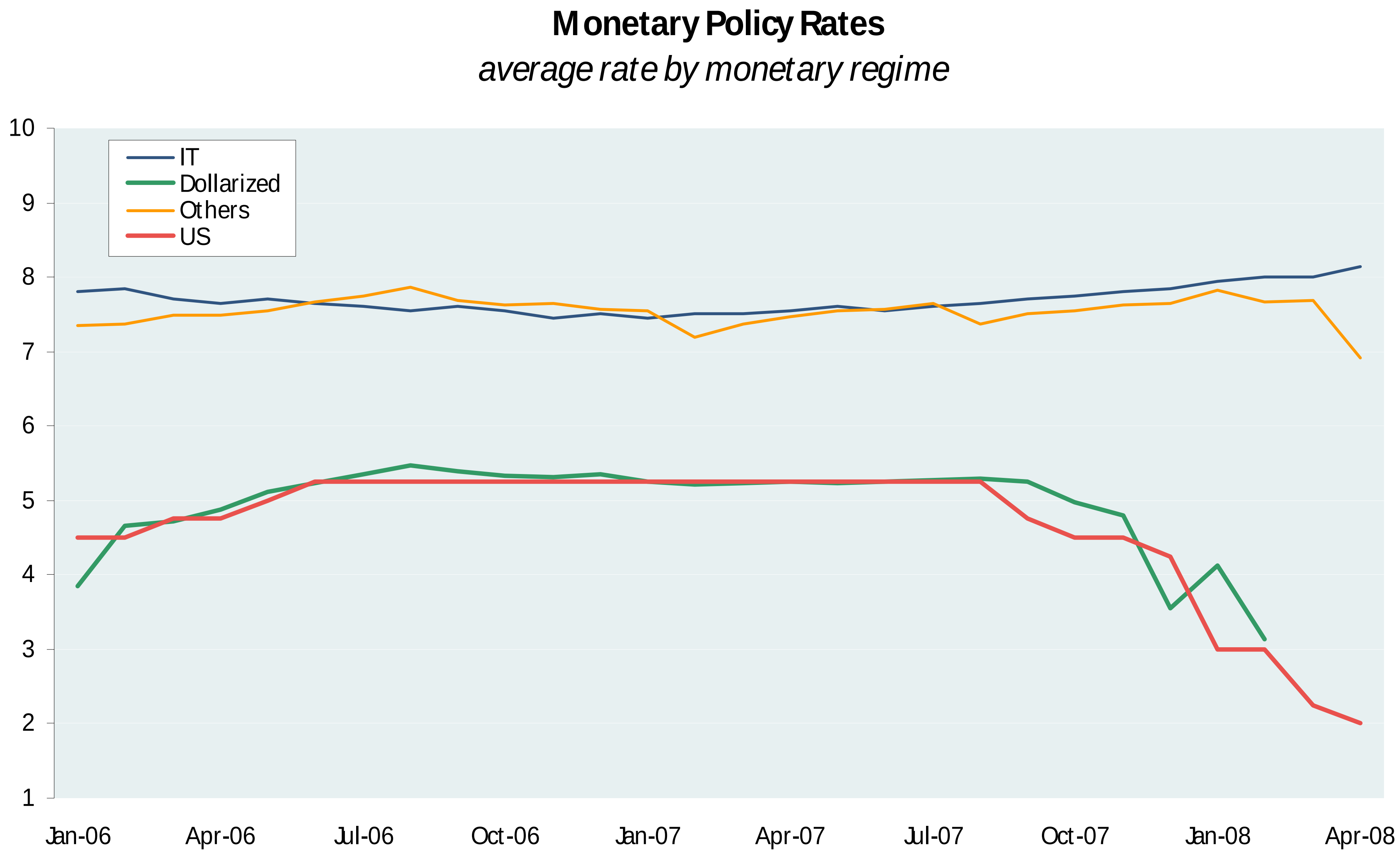
…notwithstanding the high increases in food prices



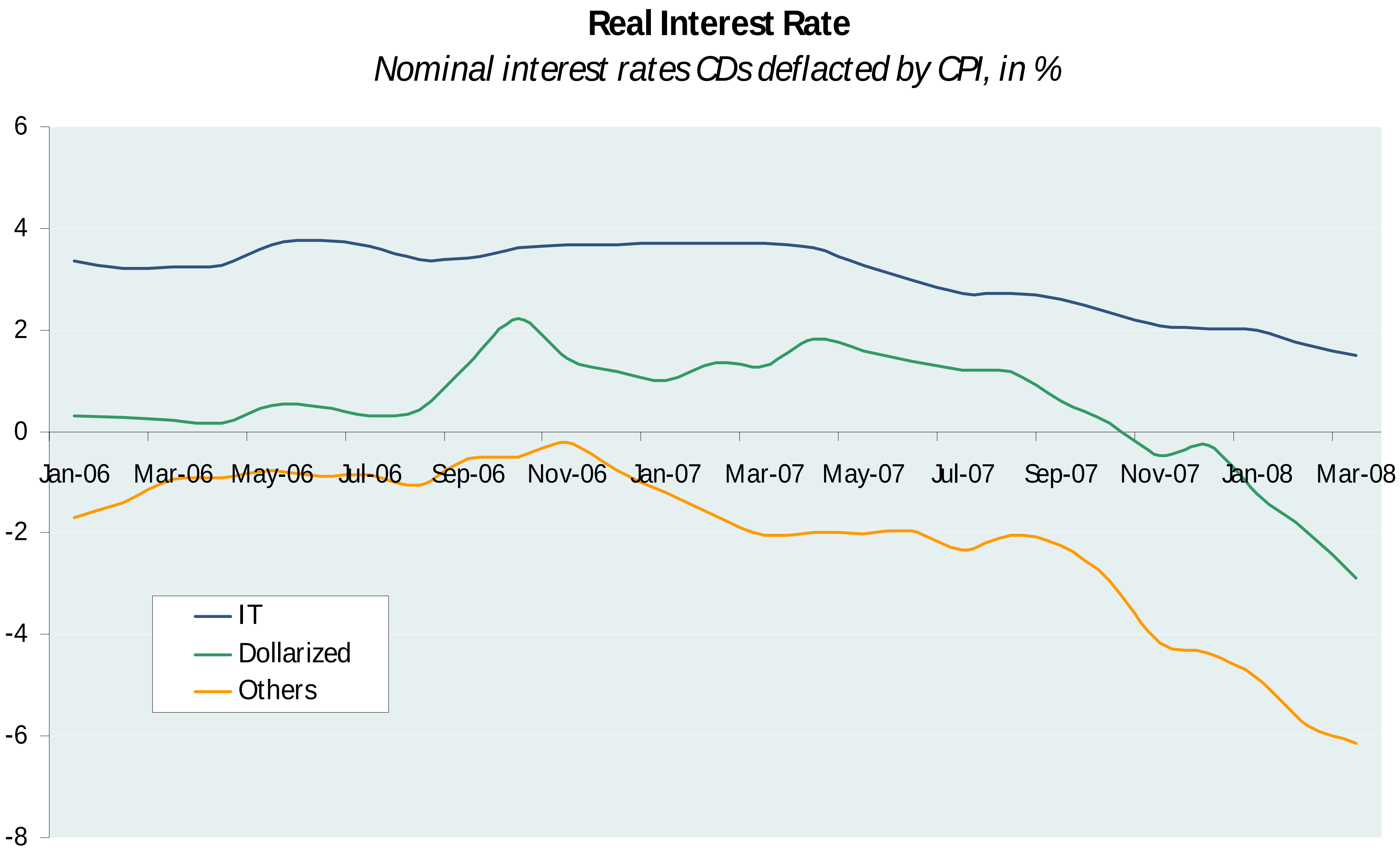
…perhaps partly reflecting the differential impacts of food prices on headline inflation



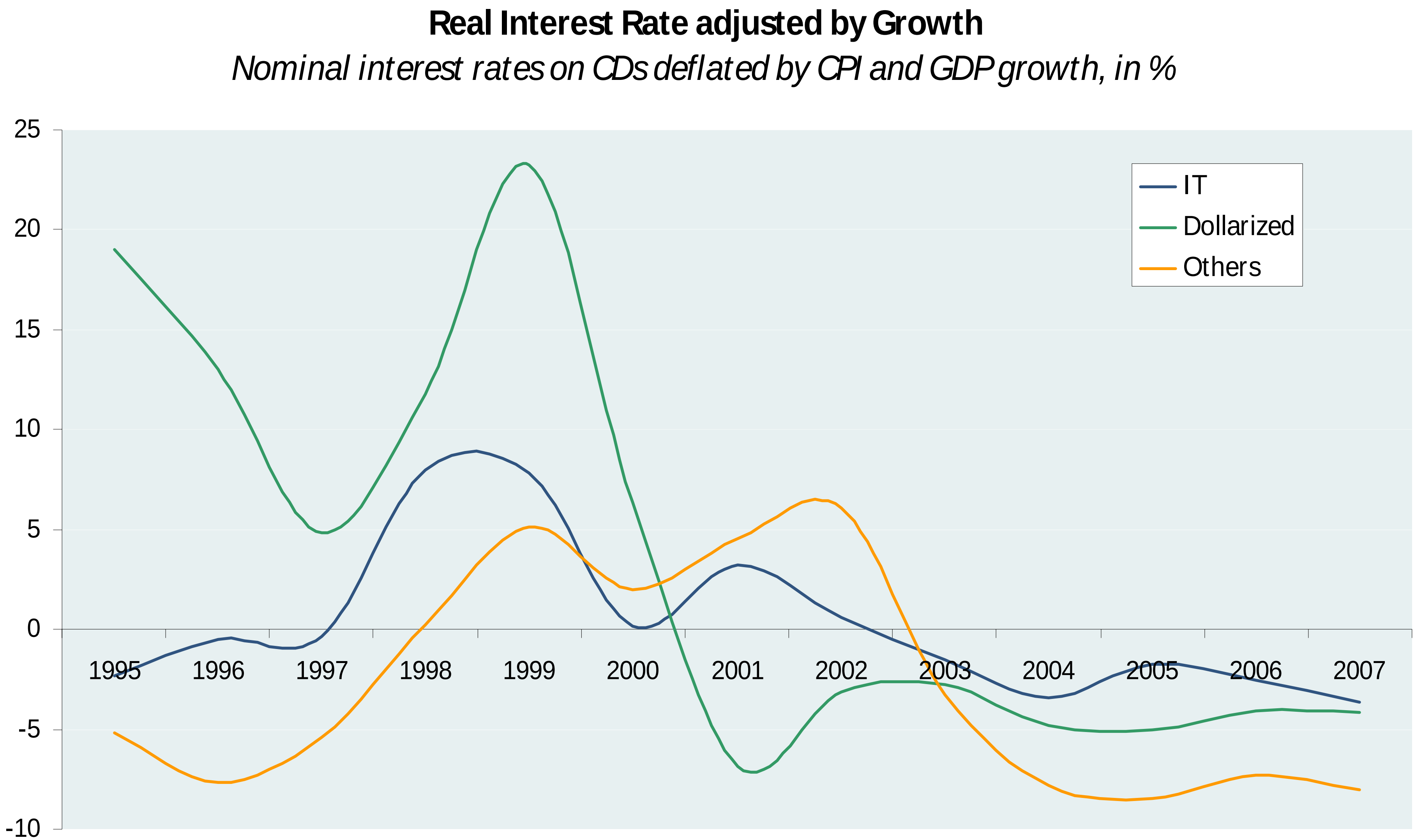
The price response seems to have reflected the monetary response, itself a function of the monetary regime…



…that in turn triggered substantially different real interest rate responses (although all are falling)



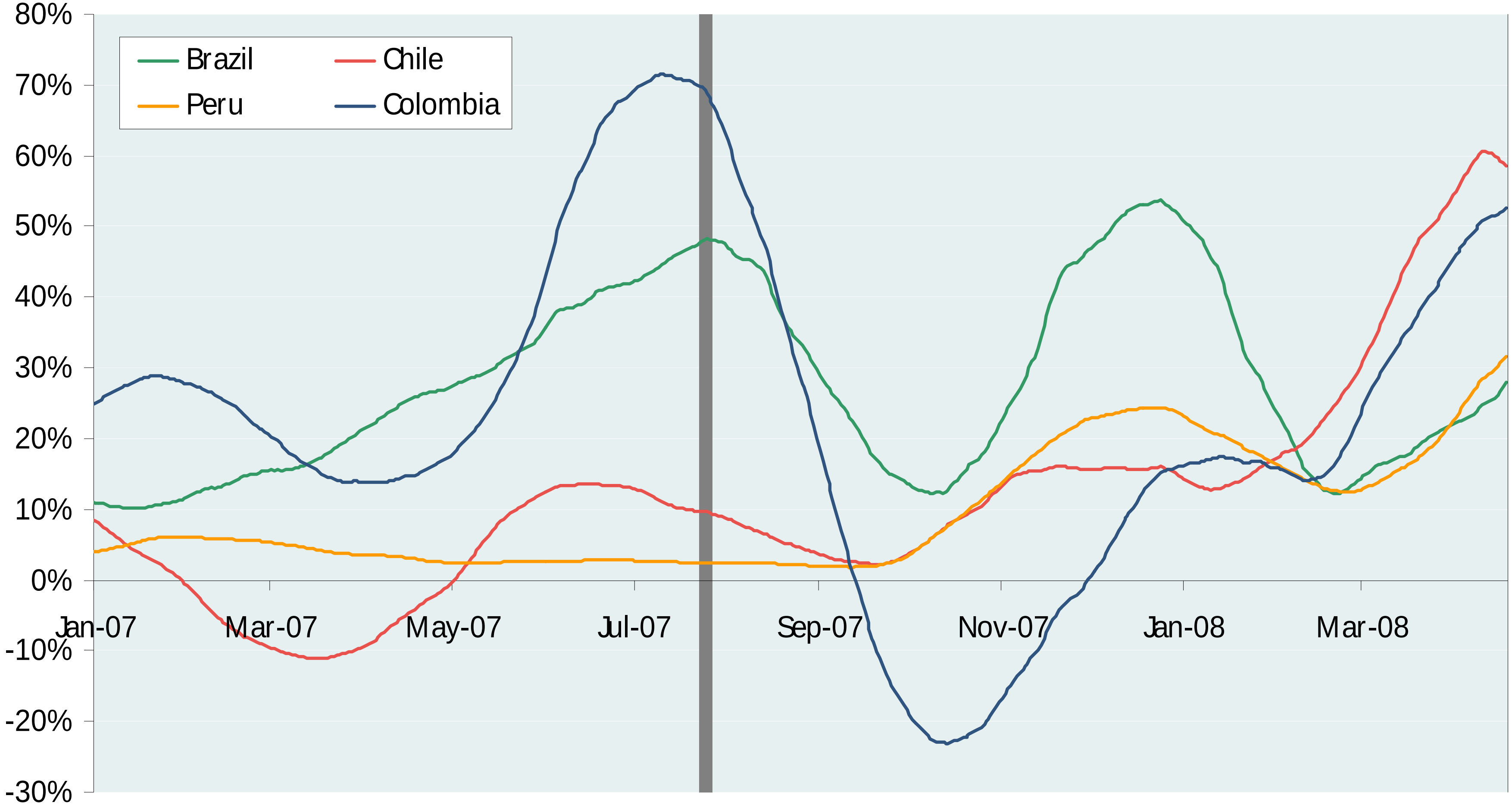
The decline in growth-adjusted real rates is even more dramatic



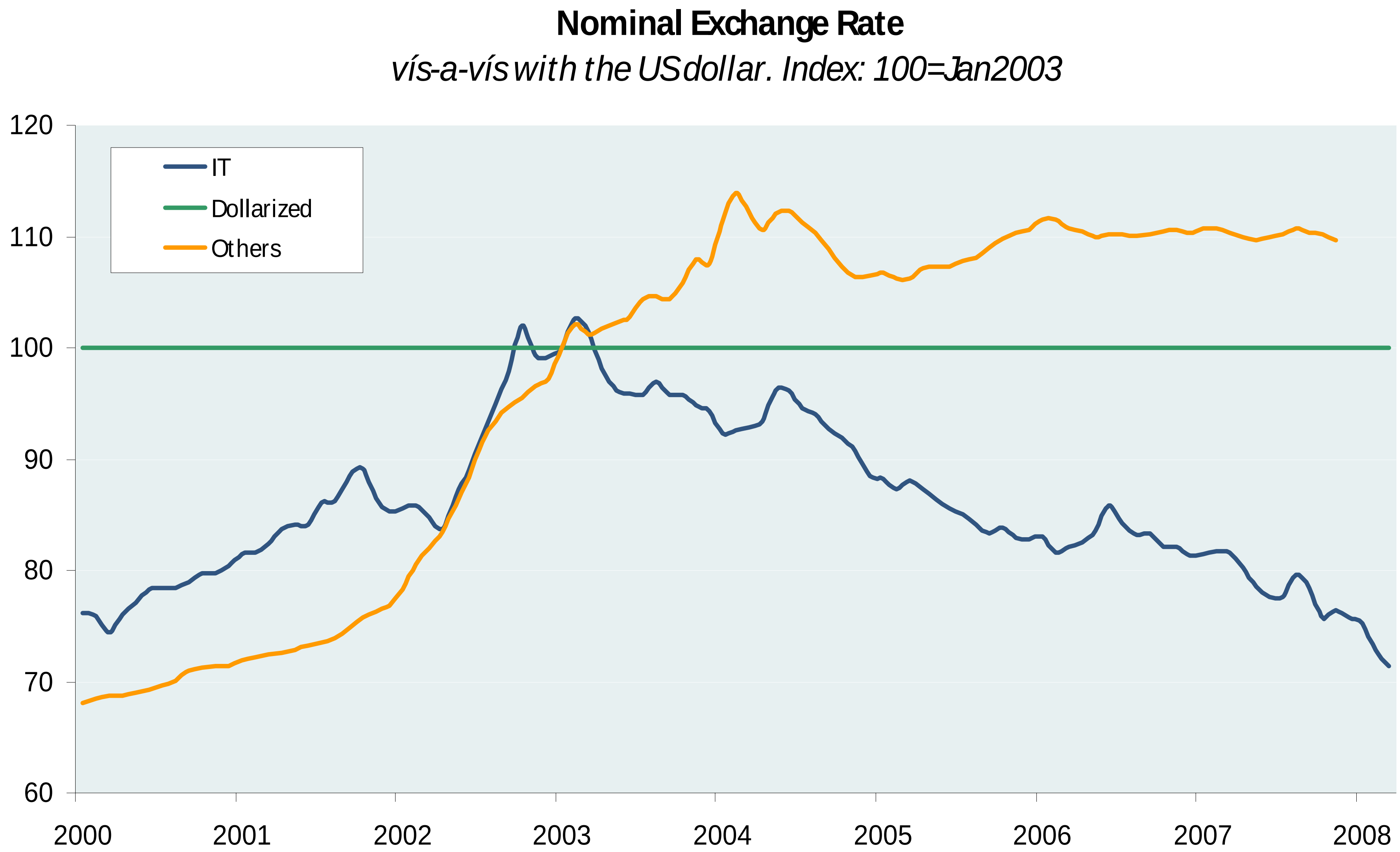
The scope for a stronger response, particularly in the IT countries, has bumped into the carry trade business…

Returns of the Carry Trade for Selected LAC countries

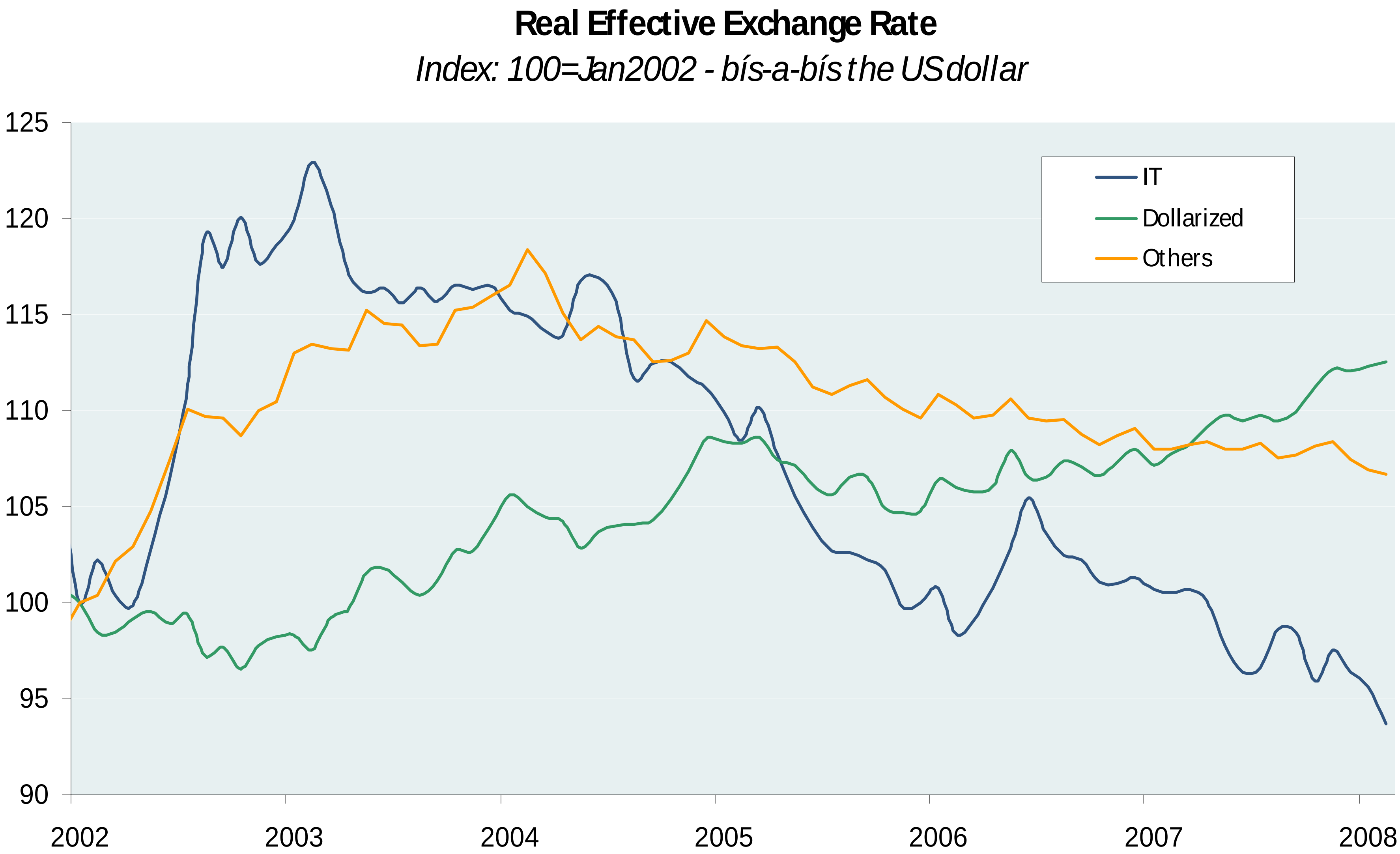
annual ex-post returns - 3M moving averages



…and the concern for nominal appreciation…

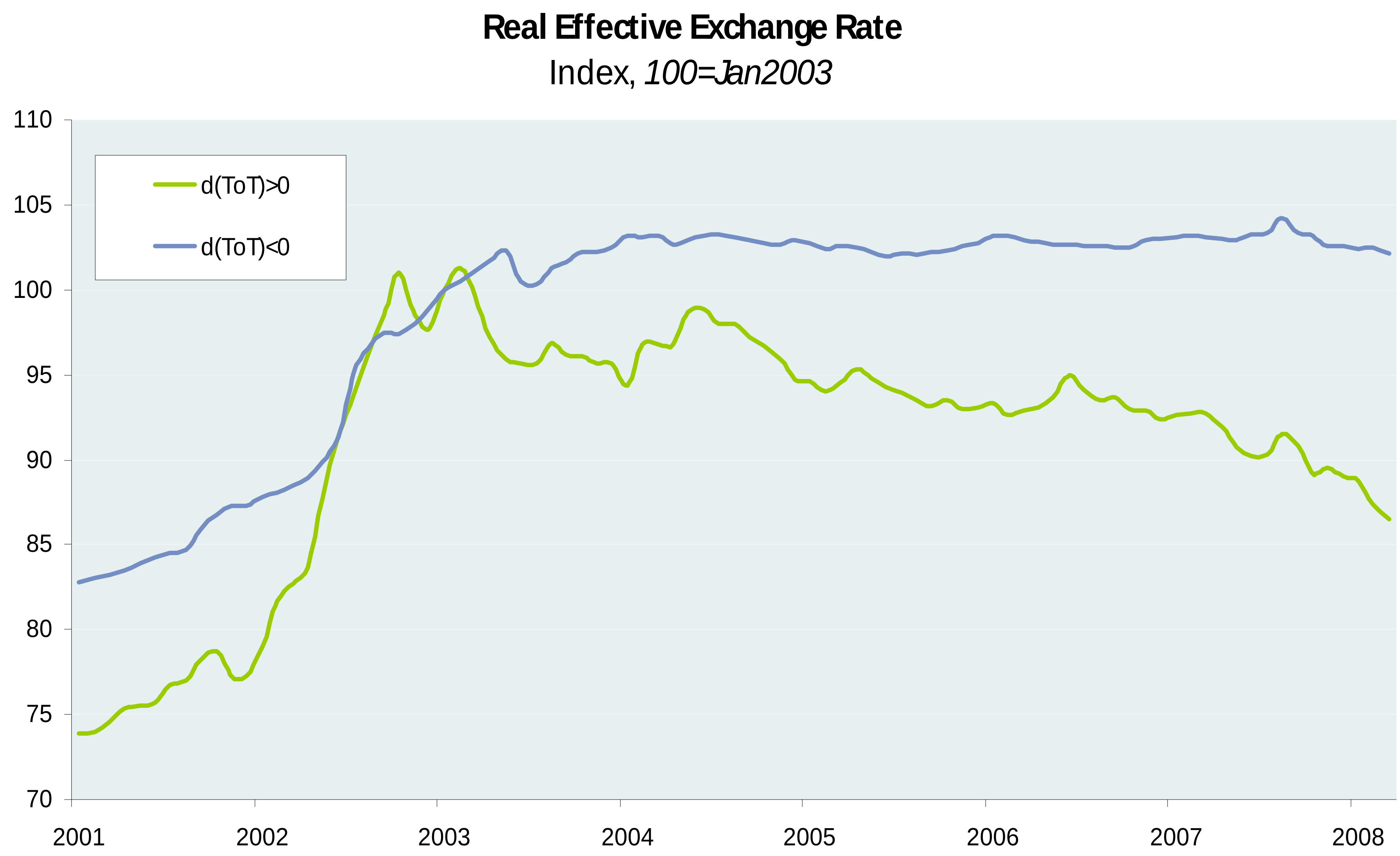


…that resulted in strong real appreciations…



Source: IFS – IMF, Real Effective Exchange Rate.

…although some of the appreciation could well reflect equilibrium adjustments



Tackling the exchange rate

Exchange rate adjustments are likely to play an increasingly important role in IT countries

- Financial globalization is increasingly limiting the scope for deviations from UIP
- Yet, at the same time, IT has led to lower exchange rate passthroughs

$\Rightarrow$More (real) exchange rate volatility

$\Rightarrow$Less direct impact on inflation from a real appreciation

Is this a problem? The conventional view

- Monetary policy cannot have sustained effects on anything else than inflation
- Real exchange rates (both in the short run and the long run) are strictly endogenous
  - Real appreciations (hence adjustments in the tradable sector), as painful as they may be, are unavoidable for countries facing positive terms of trade shocks
  - Targeting the exchange rate has the same drawbacks as targeting asset prices (it can only muddle the waters)
- Hence, only worry about exchange rates if they affect prices and the output gap
- However, to play safe:
  - Target *expected* inflation and *expected* output
  - Target domestic prices rather than the CPI

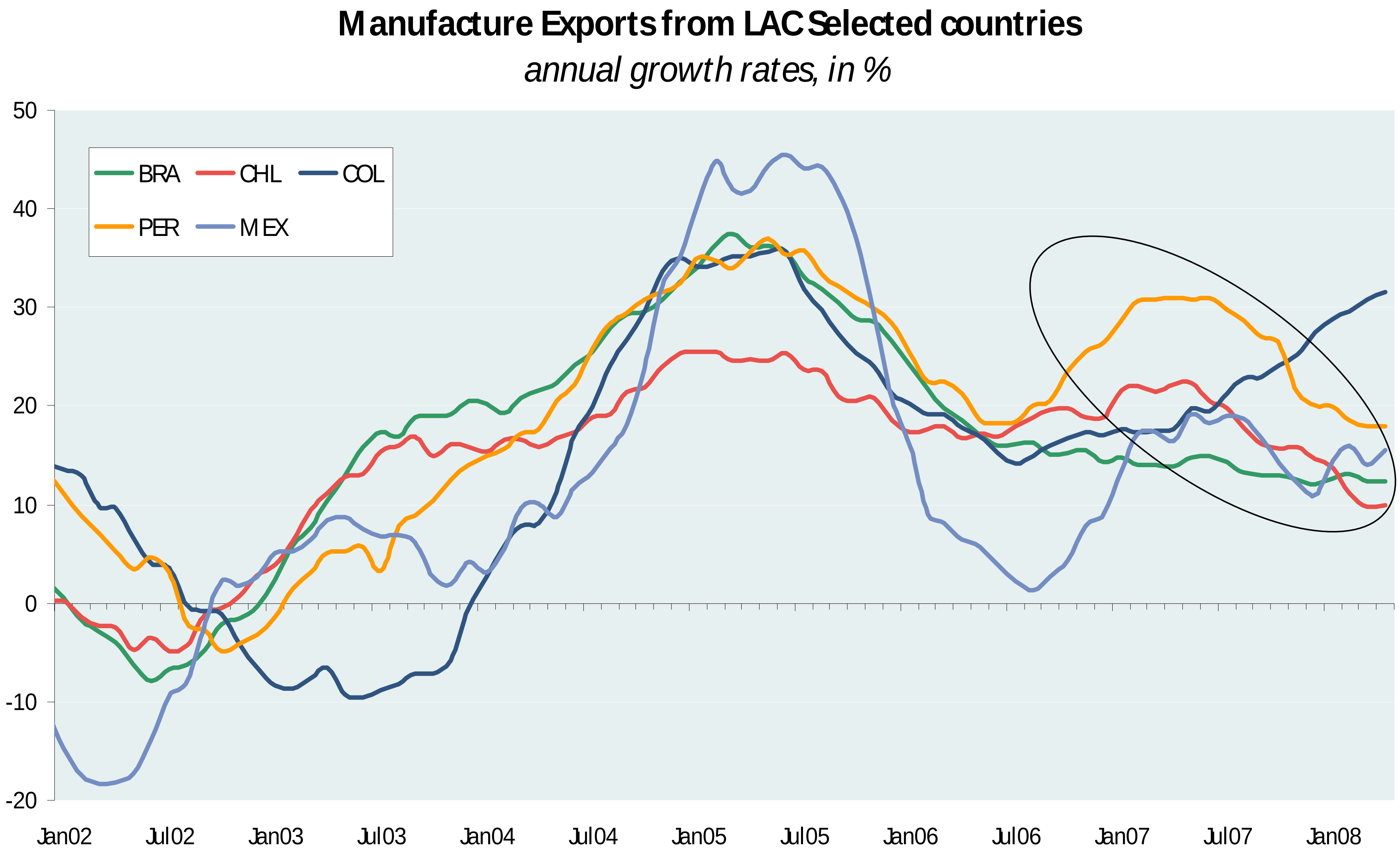
An alternative view

- The conventional IT paradigm is flawed because it is based on a single sector aggregate short-term model:
  - Two-sector models (tradable/nontradable) highlight the higher potential output costs (in the tradable sector) of real appreciations
  - There may be dynamic costs associated with (temporary) real appreciations (investment irreversibility; growth linkages a la Rodrick)

  =>This would suggest limiting exchange rate volatility, hence a more cautious/gradual approach at taming inflationary pressures

- On the other hand, focusing on domestic inflation only could also be dangerous: with real (wage) rigidities, it might be better to kill inflationary dynamics in the bud

Thus far, the appreciations do not seem to have been too detrimental to exports



Better mañana?

Delaying the response has potential benefits…

- Playing for time can:
  - Help clear up some of the uncertainty about the world environment…
  - …and limit the extent of policy asynchronism (hence the potential for exchange rate overshooting)

…but also clear risks

- Inflationary expectations could end up unraveling if:
  - Short-term deviations from a simple policy rule are interpreted as a sign of a weak long-term commitment to stable prices
  - Real income rigidities are systematically accomodated

=> Is the sacrifice ratio tomorrow going to be even steeper than today?

=> Is this the moment of truth for IT in LAC countries: can it deliver more than exchange rate targeting?

Expanding the policy frontier

Could the effectiveness and flexibility of IT be improved through operational adjustments

- Possible adjustments include:
  - Changing the nature of the inflation target
  - Broadening or raising the inflation target
  - Lengthening the targeting horizon
  - Explicitly incorporating other targets (output, changes in real exchange rates, etc.) in the central bank's policy objectives
  - Better communication and transparency (changes in content or strategy)
- Is it the right time for fiddling around with the IT scheme?...

  => Next presentation

Traditional attempts to escape the impossible trinity do not seem to have much rope left…

- The effectiveness of exchange market intervention appears to be questionable when monetary policy needs tightening (Colombia?)
- Throwing sand in the wheels runs against the logic of increasing financial sophistication and globalization
- Price controls discourage supply and run into fiscal constraints

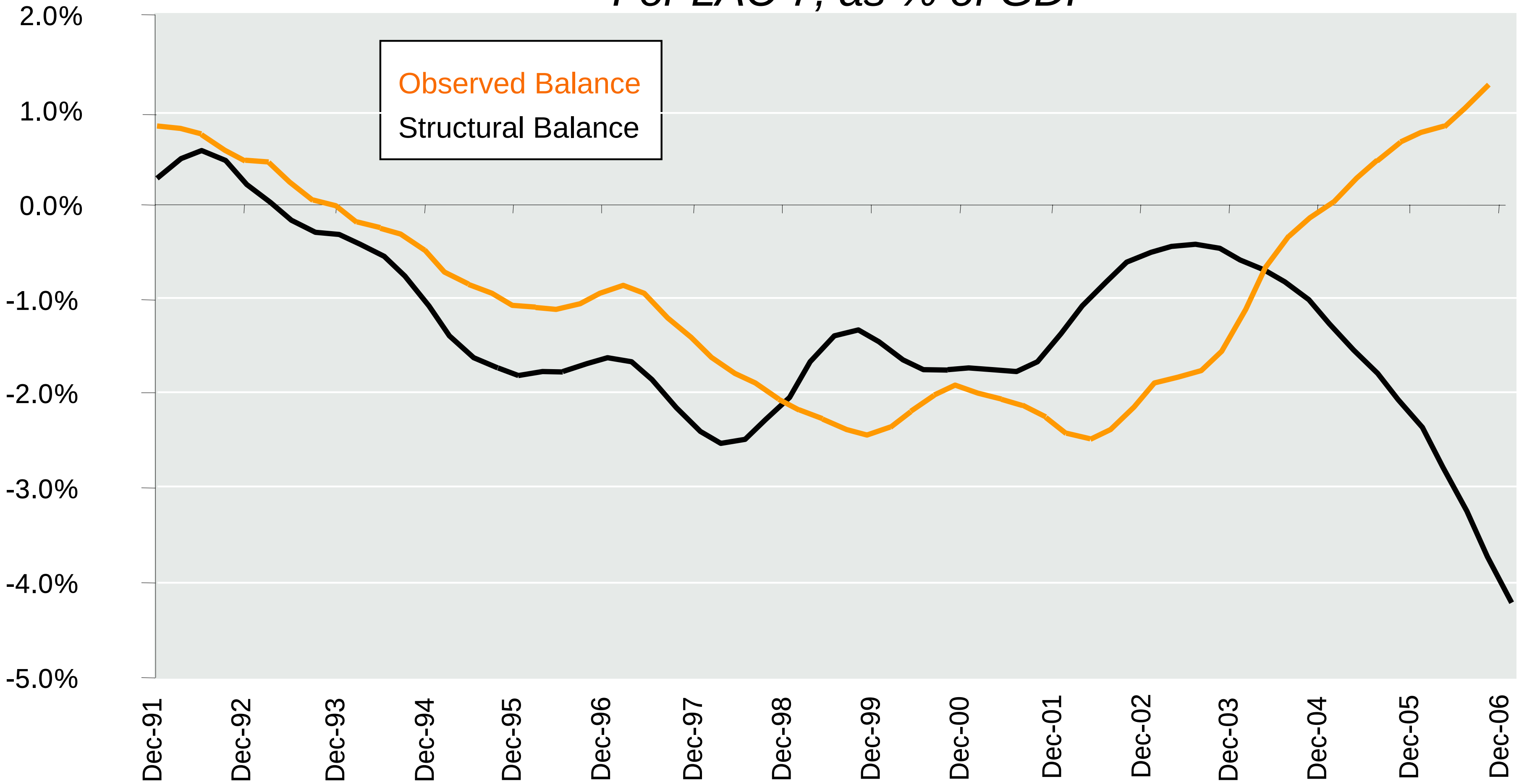
On the other hand, some targeted financial sector measures might help…

- Encouraging capital outflows (institutional investors)
- Encouraging the development of exchange rate hedges
- Raising private domestic savings?...

A more countercyclical fiscal balance might also help raise domestic savings

Structural Fiscal Balance*

For LAC 7, as % of GDP

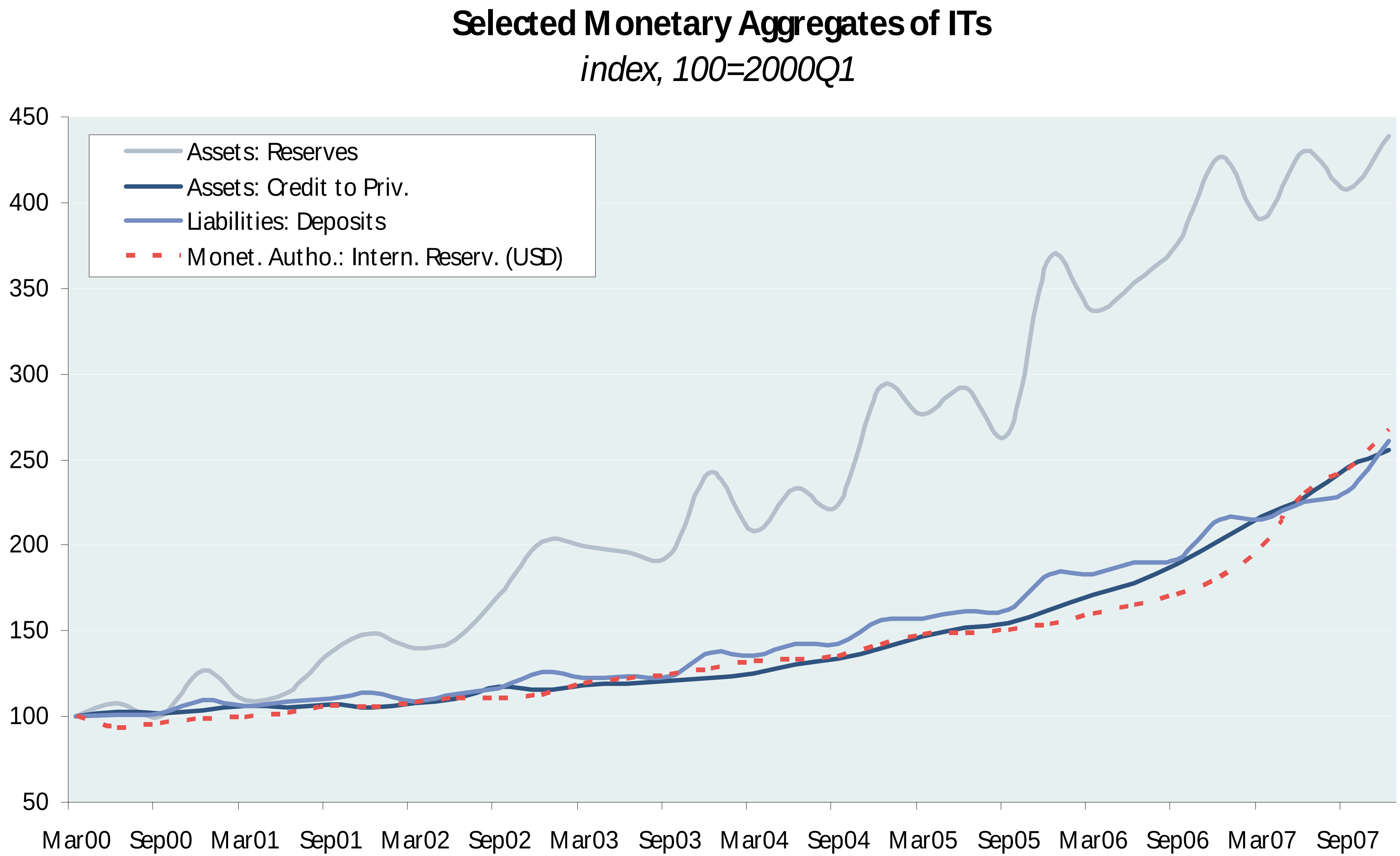


*Source: IDB. *A. Izquierdo, Ottonello, P., Talvi, E. (forthcoming), " If Latin America were Chile: A Comment on Structural Fiscal Balances and Public Debt"*

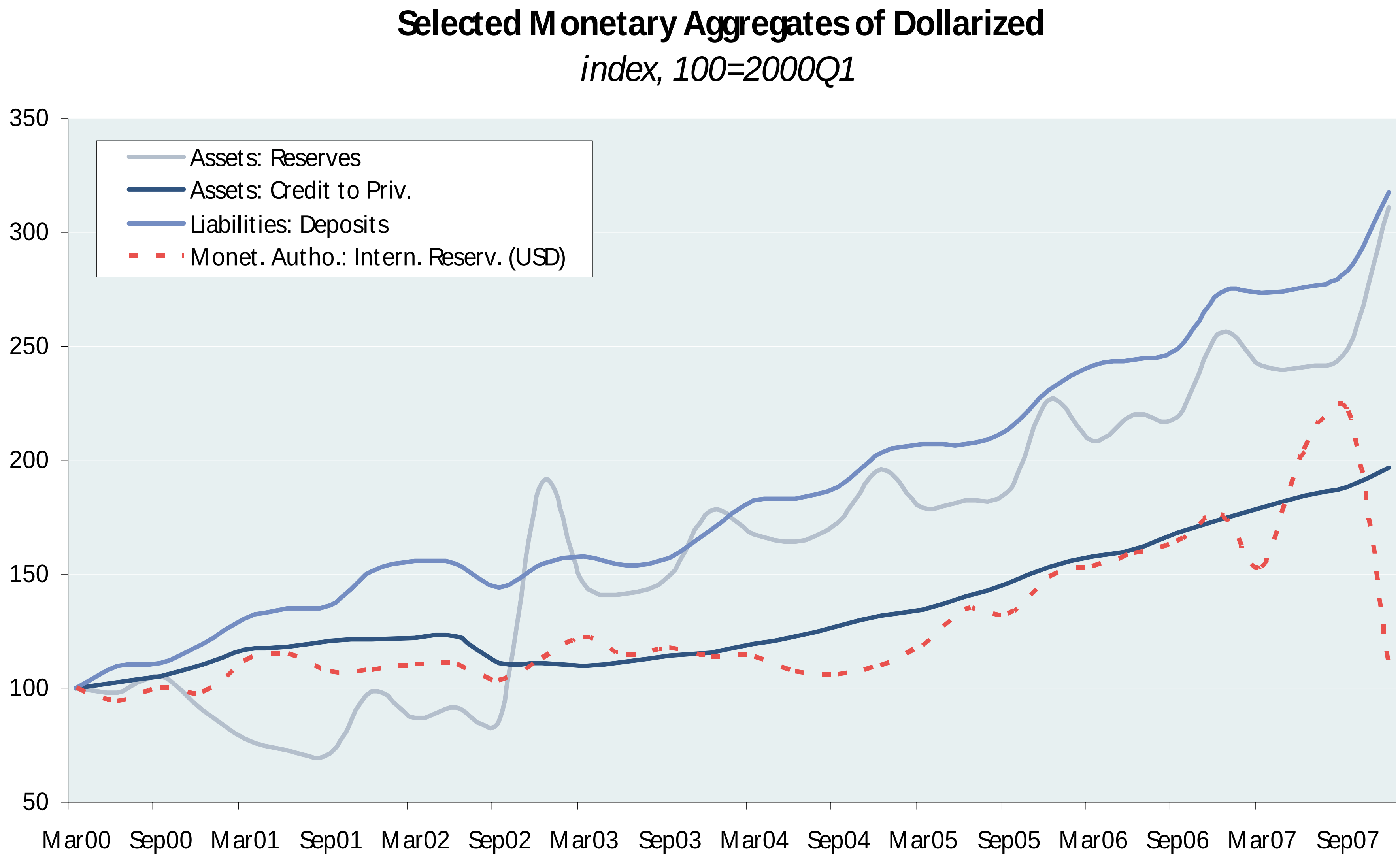
And what about prudential policies?

- In view of the credit booms, are stronger measures to moderate credit growth (provisioning or capital requirements, liquidity requirements, etc.) called for?

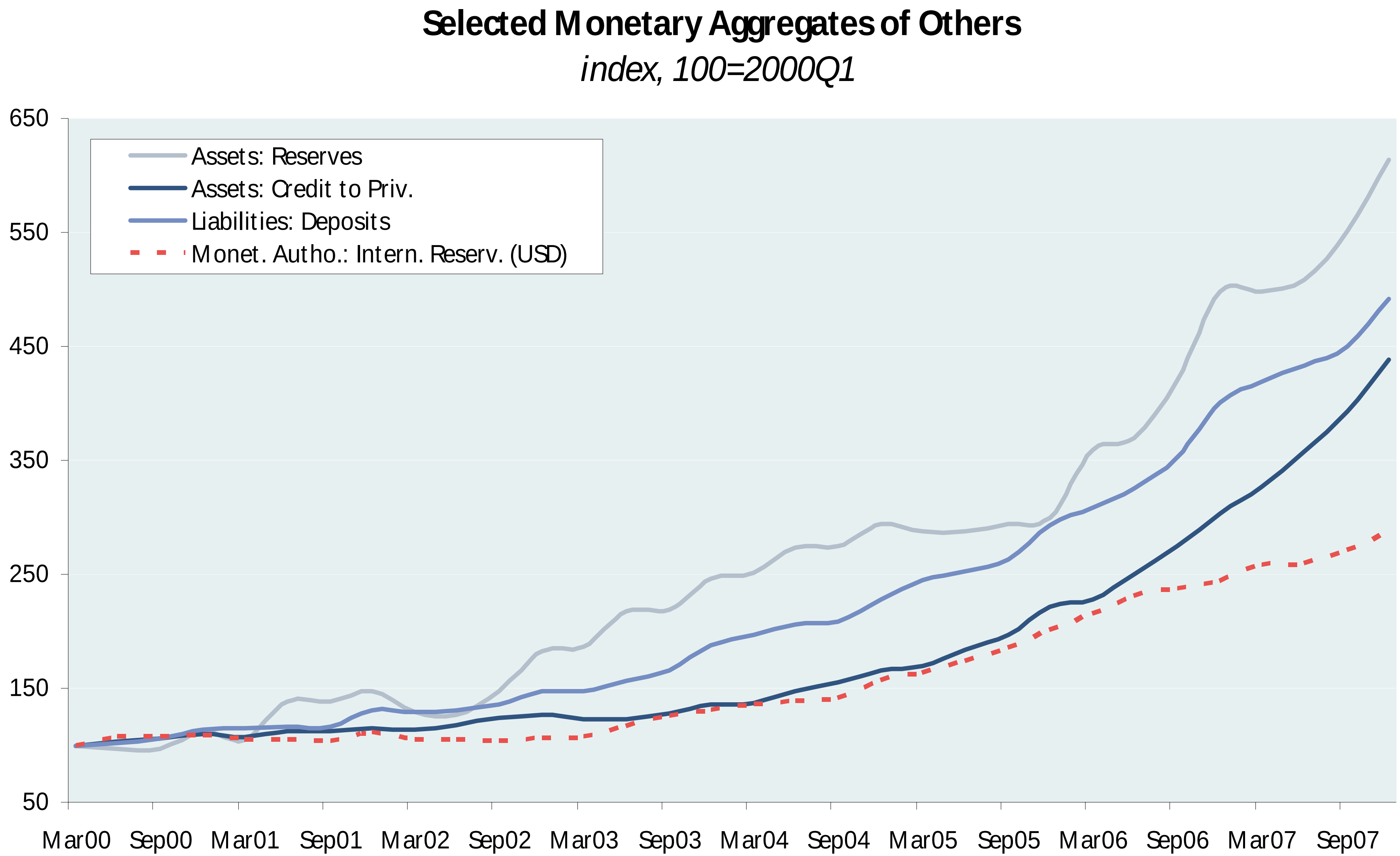
…some of this seems to have already occurred in the IT countries…



…and the dollarized countries…



…but perhaps not so for the other countries



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