Comments on Emiliano Basco and Sebastian Katz "Monetary Policy under regime change and high volatility"

By Zenón Quispe

- This paper addresses three main issues:
  - The first issue is related to the discussion of channels of propagation of volatility shocks to the economy.
  - The second issue is related to the discussion of implications for economic policy, monetary policy in particular, of regime changes and uncertainty in an environment of economic agent's adaptative behavior due to deep macroeconomic misalignments.
  - The third issue is related to the discussion of the institutional framework requirements for a proper monetary policy design in a context of economic transition from a collapsed policy regime to a new macroeconomic regime.

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- Concerning the first issue, about the channels of propagation of volatility shocks to the economy; Sebastian, after providing empirical global evidence of the relationship of GDP growth volatility with openness (positive), with the degree of financial intermediation (negative), and with the degree of capital mobility (positive); shows, for Argentina, evidence of amplifying effects of the full capital liberalization combined with lower degree of economic openness during the financial crisis of 2001-2002. Moreover, the banking crisis, despite the financial system soundness reached during the 90´s, enhanced the aggregate volatility.
- To complement these findings and to provide some figures about the monetary policy performance, it would be helpful to present evidence on the inflation and GDP growth volatility trade-offs for each sub-period of analysis in order to compare the welfare costs of inflation management.

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- Concerning the second issue, related to the implications for monetary policy of regime changes and uncertainty; this paper highlights the fact that all three, data uncertainty, parameter uncertainty and model uncertainty are active in an environment of economic agent´s adaptative behavior towards deep macroeconomic misalignments, urging for careful risk management of monetary policy.
- The fact that economic agent´s adaptative behavior incorporates high probability to a future regime change subscribes the ideas of this paper within models of “Endogenous monetary policy regime change” (e.g. Davig and Leeper, 2006. NBER WP 12405). These models are considered natural ways to formally model preemptive policy actions.

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- As Sebastian mentions, the policy action recommendations derived from those preemptive policy rules, combined with monetary policymaker's own judgments would be useful for decision making.
- Precisely, concerning the relevance of judgment for monetary policy Svensson and Tetlow (2005) state that "All models are drastic simplifications of the economy, and data give a very imperfect view of the state of the economy. Therefore, judgmental adjustments in both the use of models and the interpretation of their results –adjustments due to information, knowledge, and views outside the scope of any particular model-are a necessary and essential component in modern monetary policy" 1/.

1/. Svensson and Tetlow (2005), Optimal Policy Projections. Finance and Economic Discussion Series. FRB. 2005-34.

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- Concerning the third issue, on the institutional framework requirements for a proper monetary policy design during transitions between policy regimes in a context of low credibility (due to highly discretional policies, and extremely rigid schemes); Sebastian highlights the necessity of full knowledge and transparency of the new framework; the price stability as the main goal of monetary policy, and coordination of policies without fiscal, financial or external dominance.
- These, are in fact important institutional features for a independent monetary policy pursuing price stability.

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- Based on Sebastian's analysis, to me it looks like Inflation Targeting would be a coherent monetary policy regime for Argentina, flexible enough to modify the policy instrument ever since the most probable actual state of the economy suggests deviations of the inflation forecasts, based on the most likely model, from the long term target; or to reduce any perverse economic effect of domestic shocks without affecting the inflation goals.
- It is clear that an independent, transparent and preemptive monetary policy regime, committed to its price stability goal, would be more successful in managing expectations and, after building credibility, would require lower policy changes to signal its position, implying lower welfare costs.
- Concerning the implications of the financial dollarization, the Peruvian experience suggests that a floating exchange rate scheme combined with foreign exchange interventions in order to reduce volatility seems to be compatible with the inflation targeting framework.