

XXI Meeting of Central Banks and Finance Ministries Network

Session I. Outlook for the World Economy

U.S. Dollar in International Markets

Michael Dooley addressed the medium and long-term prospects of the U.S. dollar by contrasting the conventional and pessimistic view with an unconventional and somewhat milder assessment. The standard view is that high U.S. current account and fiscal deficits will eventually set in motion a chain of events leading to currency crises, a large dollar depreciation, banking crises, a rapid rise in U.S. yields and sharp recessions. These dire predictions, however, have not yet materialized in spite of being expected for approximately the last five years, which ultimately calls into question the model and assumptions on which those predictions are based.

An alternative approach is that Asian central banks will continue to support the dollar for the foreseeable future in order to support their own dollar-pegged exchange rates. Although the export of capital by emerging-market countries is at first glance counterintuitive, it appears that capital exports serve as collateral for asset trade with more developed countries, particularly the United States. This situation, driven primarily by Chinese development policy, is expected to continue for the foreseeable future, although this trajectory could be disrupted by geopolitical rivalry between China and the United States.

Vincent Reinhart presented an analysis closer to the consensus view, noting that the sustainability of U.S. deficits depends on foreigners' willingness to hold dollar-denominated assets. The persistence of these deficits suggests that an adjustment in the dollar is inevitable, but it may happen gradually rather than in an abrupt manner. China's current policy of maintaining the yuan at an overvalued peg in relation to the dollar, which indirectly subsidizes rural production and slows migration to the cities, is unlikely to change soon. Moreover, the build-up of Chinese dollar reserves may represent a pre-purchase of dollars that will later be wanted domestically.

A sudden stop in capital flows to the United States, however, may force that country's current account to be brought into balance through depreciation in the dollar and eventually through increased domestic manufacturing to meet foreign demand. This type of automatic correction is apparently easier for analysts and policymakers to discuss than the domestic policy choices that may precipitate or accompany such an event. In a world of risk-sharing, though, a sudden realignment in the dollar is likely to hold more risk for other countries than for the United States.

In comments following the presentations, Guillermo Calvo noted two conundrums in U.S. economic conditions. First, short-term government lending rates have risen, while long-term rates are either stable or declining. Second, current accounts are increasing even as the real exchange rate depreciates. The former may be explained by emerging market countries' willingness to accumulate dollar reserves in order to purchase

credibility in international financial markets, while the latter may be explained by increasing trade in services through international outsourcing, which had previously been considered nontradable. Alejandro Werner noted that Chinese reserve accumulation may be a response to U.S. policies. He raised two additional questions: i) why has the United States, rather than Europe, served as a vehicle for Chinese adjustment? and ii) how are financial institutions addressing China's urbanization process? Enrique Alberola asked whether an adjustment of only a few percentage points in the dollar-renminbi exchange rate would undermine the financing of U.S. deficits.

Responding to these and other comments, Michael Dooley noted that in the long run the relative price effect is conditioned by the speed of movement between trade and non-trade accounts, and that a slow adjustment is likely in the absence of a sudden stop. In discussing scenarios for currency adjustment, he further observed that there has not been a speculative attack on a strong currency since 1973. Japan's motivations for holding large amounts of dollar reserves represent a cyclical movement rather than a long-term development, assuming that Japan has no position on the U.S. fiscal deficit, which in relation to GDP is smaller than the Euro zone average. A particularly interesting question in the years ahead is whether a sudden increase in deficits may be worse than a high deficit sustained over time. In his response, Vincent Reinhart noted that U.S. monetary policymakers have acted forcefully to address employment and demand issues. A U.S. current account adjustment in the short term, however, is complicated by the failure of other governments to reciprocate U.S. actions.

Exchange Rates in Latin America

José Luis Escrivá noted that many of the region's currencies have appreciated in the last 12 months, driven by a global economic recovery that has increased demand and prices for the goods exported by most countries in the region. In addition, the current high liquidity and low risk aversion of international financial markets have contributed to growth and currency appreciation. These external changes have been accompanied by a variety of positive structural exchanges within many countries. These changes include increasing openness to trade, an increase in manufactured exports as opposed to primary goods, improvements in public sector fiscal management, monetary policies that have held down inflation, and a significant reduction in non-performing loans in the banking system.

The appreciation brought about by these changes, though, has raised concerns that exports may eventually be affected, even as other macroeconomic issues remain to be addressed. Moreover, Central Banks and governments have responded to this appreciation in a variety of ways. The Central Banks of Brazil and Mexico are currently focused on controlling inflation, while those of Argentina and Venezuela are concentrating on growth recovery. In addition, some countries have been actively increasing their international reserves, with a resulting reduction in exchange rate volatility. Similar reductions in other countries suggest that Central Banks may be intervening as well. Countries with particularly strong fears of overshooting desirable exchange rates through overvaluation have displayed a mercantilist concern with keeping

rates low, while countries with more experience in macroeconomic and monetary management, such as Chile, have faced the current round of appreciation with greater calm.

Surveying the region's economy with a particular focus on exchange rates, Ernesto Talvi observed that Latin America is benefiting from a resurgence in international lending, with low spreads over tightening U.S. interest rates, and a revival of domestic bank credit. The region is additionally benefiting from a boom in asset prices and high commodity prices, with a corresponding improvement in terms of trade. Growth in GDP and investment is accelerating, and there is a particularly strong rebound in Argentina, Uruguay and Venezuela, which experienced collapses in recent years.

These conditions lead to the dilemma of real exchange rate appreciation in spite of international reserves accumulation. A likely explanation for this development is that bilateral real exchange rates have appreciated against a weakening U.S. dollar while depreciating against the euro and remaining essentially neutral in relation to the yen. Under these circumstances, real appreciation has not significantly reduced competitiveness; it must be particularly borne in mind that the denomination of a country's trade is not necessarily the same as the denomination of its debt. Given these circumstances, it is unclear why Central Banks in the region have been concerned with dollar exchange rates.

He additionally surveyed Argentina's recent debt restructuring, noting that, with a major exercise of fiscal discipline, Argentina may be able to regain access to international financial markets even without a new IMF accord. Amortizing the country's debt with the Fund, a possibility in light of fiscal surpluses and seigniorage revenues, would release Argentina from the need to enter into future agreements and take on further conditions. Whether others would accept a debt rollover in the absence of an IMF accord, however, remains uncertain.

Enrique Alberola discussed exchange rate regimes in relation to the region's progress toward fiscal discipline and improved macroeconomic management. Although the movement toward flexible exchange rate regimes in much of the region was brought about by crises in several countries, the results of this change have proven highly favorable. Inflation has remained under control, and newly flexible exchange rates have remained fairly stable in relation to the dollar; fiscal discipline and improvements in primary balances are in part responsible. Remaining vulnerabilities, however, include the size and composition of public debt and the persistence of procyclical fiscal policies. The present situation nonetheless contrasts with the 1990s, where pegged exchange rates, which initially brought about higher revenues in an expansionary phase and improved access to credit, led to a relaxation of fiscal discipline and ultimately proved self-defeating. Flexible exchange rates represent a distinct improvement over this dynamic, but a continuing tendency to intervene in exchange rates, the "fear of floating" phenomenon, may prove counterproductive once the present expansionary phase has ended.

Following the presentations, Rodrigo Valdés noted the absence of a voracity effect and observed that since 2002 the current account of many countries has not been in equilibrium. He also raised the specific of what are the specific effects of exchange rate interventions. Eduardo Lora noted that the link between an announced exchange rate and a relaxation of fiscal policy seemed strange. Fernando Avalos questioned Argentina's ability to become independent from a relationship with the IMF because of the limited benefits of seigniorage and the possibility temporary availability of funds for amortizing debt.

Luncheon Speech, Anoop Singh

A central question at present is whether the current resurgence of growth in Latin America is self-sustaining or merely another cyclical peak, to be followed by a decline.

The region is currently benefiting from largely positive external and internal developments. The global economic environment remains favorable, with high growth rates and only a moderate slowdown expected, particularly in the United States; strong productivity growth is expected to continue as well. The major source of global risk, on the other hand, is an imbalance in growth rates.

Although Latin America trails some other regions, it is nonetheless displaying the strongest growth performance of the last 25 years, buoyed by oil exports and high non-oil commodity prices. In addition to benefiting from these external factors, policymakers in the region are also laying the groundwork for more permanent growth and stability. Exchange rates throughout the region are more flexible than in previous periods, and inflation is entrenched at much lower rates than in the past. Furthermore, countries are avoiding fiscal and current account deficits during the current growth phase and, in contrast to the investment-led 1990s, growth and recoveries are led by exports, particularly in Brazil. Governments have taken advantage of current circumstances to increase their savings, although oil-exporting countries could still be doing more in this regard. International financial markets have rewarded these structural changes, but spreads can rise quickly in response to perceived risk, as shown by the aftermath of recent disturbances in Bolivia and Ecuador.

What follows the present growth phase remains an open and important question, particularly in light of the region's volatile growth rates. The answer to this question depends largely on governments' ability to reduce fiscal volatility, which stems from the gap between countries' insufficient institutional development and their gradually increasing per capita income. A particular problem in some countries is inadequate management of fiscal decentralization, and throughout the region high unemployment and poverty rates are conducive to populist pressures and fiscal indiscipline.

The region faces two short-term challenges in taking advantage of current growth. First, public debt must be reduced. Second, institutional steps must be taken in some countries to reduce the arbitrariness of fiscal move facing the region. Chile, Brazil and Peru have

provided role models to the region through fiscal responsibility rules and sensible arrangements with subnational governments.

Additional structural changes are necessary as well in order to place the region on a sustainable growth path. Trade and capital flows liberalization must be continued, with a corresponding flexibilization of labor markets. In addition, measures must be undertaken to improve the business climate, such as reducing the time needed for approval of a new business, and the banking system must be transformed from a source of vulnerability to a source of growth; Mexico's experience provides a model for the region. No particular policy initiative, however, can substitute for a strong and independent regulatory framework. An additional opportunity for consolidating the growth process—as well as a significant source of risk—exists in the wave of approximately 20 national or nationally significant elections to be held throughout the region in 2005 and 2006.

Session II. Exchange Rate Policies in Latin America

Rodrigo Valdés surveyed Chile's movement toward a flexible exchange rate with inflation targeting and the issues that have arisen from this experience. This shift resulted from Chile's unfortunate experiences with inflexible rates, which constrained the country's ability to adjust to shocks, and a crawling band, which underwent multiple adjustments that affected its credibility.

Chile's current framework, adopted in 2000, consists of floating exchange rates and forward-looking inflation targeting by the Central Bank within a 2 percent to 4 percent band; contingencies are not announced. The Central Bank does, however, reserve the right to intervene in the exchange rate in the event of a market overreaction with negative consequences.

This framework has so far succeeded. Inflation has gradually declined, remaining at most times within the target band. Monetary policy has been strongly countercyclical in recent years, and changes in the real exchange rate facilitated adjustment to negative shocks in 2001 and 2002. Although exchange rate volatility has increased since 2000, valuations of the peso have avoided extremes; this has in part resulted from strong growth in hedge markets since the peso began to float.

Although Chile's model has so far proven successful, it is not necessarily a blueprint for other countries. First, strong institutions are needed to realize the benefits of financial opening. Second, in order to overcome the fear of floating, countries must adopt a credible anti-inflation stance that limits pass-through. Finally balance-sheet effects must be considered.

Hernando Vargas surveyed Colombia's recent experience, which, like Chile's, is based on a floating rate and inflation targeting and has generally succeeded. Following a crawling peg regime with capital controls from 1967, which was accompanied by moderate inflation of 15 to 30 percent from 1973 to 1990, the Central Bank was granted independence in order to preserve the purchasing power of the currency. A process of gradual disinflation followed, as exchange rate flexibility was introduced by means of a

crawling band, and policy was guided by intermediate monetary targets. In addition, most capital controls were removed between 1991 and 1993.

Terms of trade shocks and a sudden stop in 1998 and 1999, however, forced Colombia to move to the present system. Building on previous tools and forecasting methodologies, and working with an explicit commitment to transparency, Central Bank policies have increased foreign reserves while holding down inflation and spreads. In addition, announced exchange rate interventions are permitted under extraordinary conditions..

Two episodes of managed floating have occurred since the beginning of the current regime. The first occurred in 2003, when political uncertainty in Brazil and foreign exchange restrictions in Venezuela had led to a 30-percent devaluation in only 10 months. A combination of interest rate increases and sales of dollar reserves reduced inflation and allowed the peso to appreciate. This combined approach avoided the effects on output that could have resulted from an approach based only on raising interest rates. This intervention additionally benefited from being moderate in scale and therefore credible. A second episode began in 2004 when the peso started to appreciate substantially in response to declining inflation, low international interest rates and spreads, and increasing terms of trade. A combination of interest rate relaxation and dollar purchases—the opposite of the previous intervention—is proving effective.

These episodes have provided several lessons for subsequent application. First, foreign exchange intervention becomes more effective when accompanied by monetary policy changes that work in the same direction. Second, intervention must be reduced or eliminated in an inflation-targeting regime when there is a need to tighten monetary policy; otherwise the Central Bank may incur credibility and quasi-fiscal costs. Third, in an intervention episode, large efforts are needed to communicate policy and emphasize consistency; at the same time, however, excessively large interventions may change the Central Bank's position from credit to debtor of the financial system, thus impairing its ability to control monetary policy.

It should be borne in mind that any policy initiative is undertaken in the unique context of Colombia's political economy, which implies several dilemmas. The government uses the real exchange rate as an element of internal security policy by propping up prices for the (tradable) rural sectors and reduce support for armed groups opposed to central control. However, requests for a depreciated real exchange rate may weaken the credibility of monetary policy. Second, in the presence of a large domestic bond market and high central government deficits, a conflict could arise between the sterilization of intervention and the cost of government financing, with a possible reduction in Central Bank credibility. Third, Central Bank losses from excessive sterilized intervention may weaken its position in relation to the executive or legislative branches of government. Fourth, requests by the Congress to use interest rates in order to reduce public external indebtedness may jeopardize Central Bank independence and credibility.

Adrián Armas discussed monetary and exchange rate policy in Peru, where declining but still high levels of dollarization challenge the country's ability to control its monetary

policy in an inflation-targeting regime. Peruvian authorities have attempted to reconcile these concerns through the use of an inflation forecasting system that combines judgment and model-based projections. The measures adopted have thus far achieved notable success, as dollarization of the financial system has decreased from 70 percent in 2000 to 54 percent in 2004. The high level of dollarization that persists, however, leaves the economy vulnerable to the effects of large domestic currency depreciations; this is particularly true for holders of domestic liabilities in dollars. The dedollarization that has taken place so far has been stimulated by building credibility in the inflation target range, so that by the beginning of 2005 inflation targets and previous expectations of inflation converged almost completely. The risks of financial dollarization have also been controlled by issuing long-term Treasury bonds in soles rather than dollars and by instituting high reserve requirements for foreign currency liabilities. Finally, exchange rate intervention to reduce exchange rate variability has allowed Peru to increase international reserves. These measures have resulted in increasing international credibility and reducing the volatility of interest and exchange rates even as the country's dedollarization process has continued.

John Williamson began by noting that the economies discussed were much more professionally managed than they had been in previous years. The Peruvian experience of inflation targeting in the presence of partial dollarization is particularly interesting, as inflation targeting appears to work largely the same there as in other countries.

An issue presented by the experience of the three countries considered is how one should evaluate the new conventional wisdom favoring the combination of a flexible exchange rate and inflation targeting. The comparative analysis of different exchange regimes' performance is complicated, however, by the fact that fixed regimes are sometimes misclassified as mixed. Although mixed regimes can prove effective when well managed, at present most mixed regimes appear to represent a transitional stage on the way to floating exchange rates or regional monetary unions.

Three specific questions arise in relation to the new conventional wisdom. The first is whether the combination of flexible exchange rates and inflation targeting provides a nominal anchor for prices; thus far this combination of instruments has worked. A second concern is whether targeting leads to countercyclical monetary policies. The evidence is mixed, as such policies have been adopted in Chile but not the other countries considered. A third question is how exchange rate strategy relates to overall development strategy. The Latin American experience appears to be different from the East Asian experience, which features export-led development with increasing levels of foreign reserves. The East Asian approach, moreover, is not necessarily a model to emulate, as reserves can and in some instances should be used rather than merely saved. In perhaps the most striking example of excessive savings, China continues to accumulate rather than spend foreign currency reserves even while an estimated 100 million Chinese live on incomes of less than a dollar a day.

A final issue to consider in a framework of flexible exchange rates and inflation targeting is what countries can do when exchange rates stray from a desirable range. One option is

to intervene indirectly through communication with other governments and financial institutions and through publishing the real exchange rate; these measures can be undertaken while maintaining the primacy of an inflation-targeting approach. A second possibility is retaining the option of using capital controls. The third possibility is changing fiscal policy, particularly through tightening.

Discussing the presentations on Chile, Colombia and Peru, Roberto Chang observed that the countries' experience is marked by notable similarities. All three have recently moved to inflation targeting regimes with announced explicit targets and institutionalized communication with the public through inflation reports. In addition, all three Central Banks have adopted the short-term interest rate as their main (though not exclusive) policy instrument, and all three countries claim to have flexible exchange rates, which is consistent with an inflation-targeting regime, but with intervention under exceptional circumstances. Inflation has subsequently come under control, with a corresponding increase in policy credibility, and output growth in Chile and Peru has been satisfactory by regional standards.

Deviations from flexible exchange rates have occurred for a variety of reasons. Both Colombia and Chile have intervened to address exchange rate movements not justified by fundamentals, while Peru has intervened to reverse large devaluations that could disrupt the financial and payments. Colombia has also cited exchange rate intervention as a complement to monetary policy. These interventions have been carried out by means of either interest rate adjustments or foreign exchange interventions.

Whether such interventions are justified, and how they should be undertaken, remain open questions. Although conventional inflation targeting theory suggests that instruments should be set so as to minimize deviations of forecast inflation from target rates, central bankers appear to be working from two motivations not covered by theory: non-fundamental exchange rate movements and threats to financial stability. While it is not clear what kind of policy intervention is justified by non-fundamental gyrations, interventions to preserve financial stability have a stronger theoretical and empirical basis. Thus countries such as Peru, with high degrees of liability dollarization, currency mismatches and a less developed financial system, may well be justified in intervening in the exchange rate. On the other, in such cases it is not clear how Central Banks should react to exchange rate changes. Sterilized interventions lack conceptual justification and have only weak and short-lived effects on exchange, even as their signaling effect is controversial. A non-sterilized intervention, which can be seen as a sterilized intervention combined with an increase in the money supply, amounts to a change of policy instrument that entails no gain and instead impairs transparency; the experience of Colombia has particularly illustrated this dilemma. Central Banks may thus be forced to rely solely on interest rates rather than attempting foreign exchange interventions, although accumulating foreign reserves when they are relatively cheap may have long-term advantages.

Uncertainties notwithstanding, all three countries have made remarkable progress in monetary policy in recent years, a development aided by sound fiscal policy. A

particularly relevant for these countries now is to avoid excessive modification of policies and instruments that have so far proven effective.

In discussion following the presentations, Guillermo Calvo raised the question of whether the current popularity of inflation targeting is largely a matter of intellectual fashion. Two additional questions arise. The first involves credibility, as the use of liquid bonds as a substitute for cash may not help to fight inflation. Second, there may be an excessive preoccupation with floating exchange rates. To take the idea to its logical extension, if floating exchange rates are especially valuable between countries, why should they not be used within regions of a country? In their present form, however, floating exchange rates may present a barrier to regional currency integration. Vincent Reinhart asked whether dedollarization may bring back an incentive for an inflation tax, and why some countries that are net debtors are acquiring foreign reserves. Alejandro Werner observed that, although inflation targeting has worked, it may not represent the best possible approach in terms of cost or effectiveness, and that fiscal discipline must not be forgotten; in addition, abandoning even rarely used policy instruments may not be in a country's interest. Enrique Alberola noted that inflation targeting is a policy of ends and not of means, and that it is not identical with exchange rate management; issues of reputation must be considered as well.

In further discussion, Rodrigo Valdés suggested that precise definitions of intervention and floating are needed. He further stated that, in reviewing countries' experiences with exchange rate management, New Zealand may not provide a valuable example. Instead, the experience of Australia may provide more useful lessons, which include the creation of a forward currency market. Responding to discussants' points, Hernando Vargas observed that inflation targeting carries risks, as it is undertaken in an atmosphere of uncertainty, and that exchange rate management, which has benefits as well as costs, is complementary to other tools. He also noted that, in the long term, capital controls are not effective for maintaining exchange rates.