Monetary Policy Alternatives for Latin America

MYRIAM QUISPE-AGNOLI

The author is a senior economic analyst in the Atlanta Fed's research department. *She thanks John Robertson, Tom Cunningham, and Michael Chriszt for useful comments and suggestions and Shanza Khan for valuable assistance.*

In 1990, after a decade of poor economic performance and relatively high inflation rates, New Zealand's government introduced a series of sweeping economic and institutional reforms. A cornerstone of these reforms was the creation of an independent central bank whose overriding mandate was to maintain a low, stable inflation rate.

Following New Zealand's lead, Canada, Israel, the United Kingdom, Sweden, Finland, Australia, and Spain also instituted inflation targeting. In implementing inflation targeting, policymakers publicly announce a desired inflation level and communicate the reasons for changes in policy instruments, thereby strengthening policy credibility and supporting the transparency and accountability of the monetary authority.

The track record of inflation targeting among these industrialized nations has been impressive. Table 1 shows that, on average, these countries experienced lower inflation rates in the 1990s than in the previous decade while real economic growth remained stable or even increased. These impressive outcomes have attracted the attention of other countries, including several in Latin America. But is the apparent success of inflation targeting transferable to Latin American economies?

In the 1980s most Latin American countries struggled with recession, inflation, and unemployment as a result of the repercussions of an external debt crisis. These countries witnessed the repeated failure of stabilization policies, resulting in higher inflation rates, larger fiscal deficits, deeper external imbalances, and continuous capital flight. Finally, when inflation became chronic, their economic policies lost credibility.

In the 1990s the economic policies of Latin American governments changed dramatically, away from direct intervention and toward market-based reform. These reforms sought to lower inflation and to achieve economic stability via greater fiscal discipline. The reforms included reducing the size of government, privatizing state-owned enterprises, reforming taxation, and liberalizing trade and financial markets. Monetary policy in many of these countries emphasized the use of the exchange rate or monetary aggregates as intermediate operating targets. In a broad sense these policies were successful. Table 2 compares the average economic performance and inflation rates of selected Latin American countries over the last two decades. In all but one case the inflation rate has been much lower in the 1990s than during the previous decade. The results in terms of real economic growth are more mixed

TABLE 1
Inflation Rate and Economic Growth, Selected Countries

Country	Date of Inflation Targeting Transition	Inflation Rates (Percent) Before Targeting	Inflation Rates (Percent) After Targeting	GDP Growth Rates (Percent) Before Targeting	GDP Growth Rates (Percent) After Targeting
New Zealand	December 1989	11.44	1.75	1.61	2.62
Canada	February 1991	6.29	1.59	2.42	2.98
Israel	December 1991	111.08	8.59	3.70	4.61
United Kingdom	October 1992	7.19	2.62	1.81	2.80
Sweden	January 1993	7.81	1.46	1.50	2.33
Finland	February 1993	6.62	1.49	2.05	4.01
Australia	April 1993	7.35	2.25	2.85	4.34
Spain	November 1994	8.69	2.96	2.37	3.38

Note: The inflation rates and GDP growth rates are averages of the 1980–2000 period.

Source: IMF, Economist Intelligence Unit

TABLE 2
Inflation Rate and Economic Growth, Selected Latin American Countries

Country	Inflation Rates (Percent) 1980–90	Inflation Rates (Percent) 1991–2000	GDP Growth Rates (Percent) 1980–90	GDP Growth Rates (Percent) 1991–2000
Brazil	613.8	549.2	2.9	2.7
Chile	21.8	9.5	3.7	6.7
Colombia	24.0	20.5	3.5	2.7
Mexico	65.2	18.7	2.5	3.6
Peru	1,117.7	60.1	0.0	4.2
Argentina	724.6	21.4	–1.0	4.3
Ecuador	35.3	43.8	2.4	1.8
El Salvador	19.0	8.4	–0.7	4.9
Panama	2.9	1.2	1.4	4.5
Latin America	462.8	246.1	1.1	3.4

Note: The inflation rates and the GDP growth rates are averages of the period. The numbers for Latin America are weighted averages of these selected countries.

Source: IMF, Economist Intelligence Unit, Inter-American Development Bank

across countries, but the average growth for Latin America as whole more than doubled in the 1990s.

The figures in Table 2 mask the fact that many Latin American economies have not enjoyed clear sailing during the 1990s. The generally optimistic view about Latin America's economic prospects was severely dented by the financial turmoil brought on by the Mexican peso crisis in 1995 and the Asian, Russian, and Brazilian financial crises in 1997 and 1998. Even though Latin America as a whole responded to the crises better than it had during previous episodes, these events highlighted the region's vulnerabilities to international capital market volatility. Consequently, many Latin American countries began looking for alternative economic policies that could provide a degree of discretion to counterbalance external and domestic shocks.

In 1990 Chile began the transition toward an inflation targeting regime and experienced some of the strongest economic growth during the 1990s among Latin American countries. Following Chile's lead, Brazil and Mexico adopted inflation targeting late in the decade, while Colombia and Peru partially implemented inflation targeting systems (see Table 3).

TABLE 3
Chronology of Monetary Policy Regimes in Selected Latin American Countries

Country	Period	Monetary Policy Regime
Brazil	1994–98	*Real* Plan, exchange rate–based stabilization program
	1999–present	Inflation targeting
Chile	1990–present	Inflation targeting
Colombia	1991–present	Inflation targeting (incomplete)
Mexico	1987–91	Pegged exchange rate policy
	1991–94	Exchange rate band
	1995–98	Monetary targeting (incomplete)
	1999–present	Inflation targeting (incomplete)
Peru	1990–92	Stabilization program
	1993–96	Monetary targeting (incomplete)
	1997–present	Inflation targeting (incomplete)
Argentina	1991–present	(Quasi) Currency board
Ecuador	2000–present	Full dollarization
El Salvador	2001–present	Full dollarization
Panama	1904–present	Full dollarization

Source: IMF, Economist Intelligence Unit, Inter-American Development Bank

This article describes the recent history of monetary policy in Latin America, focusing on the alternative policy strategies that have been implemented. The article also suggests some lessons that may be gleaned from the Latin American experience about the relative costs and benefits of such policies and the importance of the underlying economic and political environment in determining the ultimate success of alternative monetary policy regimes.

Monetary Policy Regimes in Latin America

During the past decade, Latin American countries have considered or implemented some combination of policy alternatives: an exchange rate peg, monetary aggregate targeting, or inflation targeting.

In pegging the exchange rate, policymakers fix the value of the domestic currency to the currency of a large country, usually the main trading partner. The exchange rate can be set at a fixed value or allowed to vary at a predetermined rate. The goal is to lower domestic inflation and inflation expectations by "importing" the policies and credibility of the foreign country and by applying sufficient domestic fiscal and monetary restraint to maintain the peg.

Additional perceived advantages of pegging the exchange rate include the potential to reduce the devaluation risk and the default or sovereign risk of domestic interest rates, thereby lowering the cost of borrowing for both the government and the private sector and encouraging greater international trade.[1] But a pegged exchange rate also constrains discretionary monetary policy because it prevents activities such as financing government deficits, thus limiting the ability of the monetary and fiscal authority to respond to shocks. The central bank's credibility in its commitment to the value of the currency is also vulnerable because its credibility depends on having sufficient foreign reserves to support the peg.

In Latin America two strong forms of exchange rate peg have been implemented: a currency board and full dollarization.[2] In a currency board, the domestic currency is completely supported by a foreign currency. The central bank simply sets a conversion rate to the foreign currency and announces its willingness to exchange domestic for foreign currency according to demand. This exchange rate peg is credible because the conversion rate has a legal support. But under this

1. Default or sovereign risk is the possibility that a country will default on its external debt.
2. The economic analysis of Latin American countries assumes that these are small open economies.

regime there is no room for short-run monetary policy discretion, and the central bank no longer plays the role of lender of last resort to domestic banks. It simply acts as a depository for foreign currency and issues and redeems local money for foreign money.

An alternative exchange rate peg is full dollarization, whereby the domestic currency is completely replaced by the U.S. dollar. Dollarization represents a stronger policy commitment than a currency board because there is absolutely no stabilization role for domestic monetary policy, no possibility of devaluation of the domestic currency, and no role for the central bank as a lender of last resort to domestic banks. Also, even though domestic interest rates may approach those of the United States, there can still be a substantial country risk component to domestic interest rates. Panama became the first fully dollarized country in Latin America in 1904. Ecuador and El Salvador dollarized their currencies in 2000 and 2001, respectively.

One of the requirements for a successful monetary policy seems to be the breaking of fiscal dominance. Chile has made perhaps the greatest strides toward disrupting this pattern.

Exchange Rate Peg Regimes

Argentina. During the 1980s Argentina suffered a severe recession and hyperinflation. Economic growth in 1989 declined 7 percent while inflation soared at a rate of over 3,000 percent per year. In response, the government enacted the Convertibility Law of 1991, which instituted a fixed exchange rate of one Argentine peso to one U.S. dollar. The law also required the central bank to back two-thirds of the domestic monetary base using its large holdings of international reserves. This quasi currency board eliminated the possibility of inflationary financing of the fiscal deficit and limited the central bank's role as lender of last resort.[3] In addition to the Convertibility Plan, further financial system reforms brought increased private bank competition along with stronger supervisory and regulatory institutions. Reductions in trade barriers and the loosening of restrictions on capital flows opened the Argentine economy to international markets. Tax reform and privatization of state-owned enterprises were aimed at generating a more efficient public sector.

Between 1991 and 2000 Argentina enjoyed a degree of renewed prosperity. Gross domestic product (GDP) growth averaged 4.3 percent between 1991 and 2000 notwithstanding two mild recessions, and the inflation rate declined from 172 percent in 1991 to close to zero in 2000.

During the 1990s the Argentine economy was subject to several large external shocks. The Mexican peso crisis in early 1995, which followed Mexico's devaluation of its currency in December 1994, resulted in a widespread series of bank runs, a loss of international reserves, and a recession. Over a period of about five months, bank deposits in Argentina fell by 18 percent, creating a severe liquidity problem. These events spurred policymakers to revise bank regulation and supervision laws, to establish mandatory private deposit insurance, and to open contingent repurchase agreements with international banks. These reforms, along with multilateral commitments, quickly restored investors' confidence.

However, the Russian crisis in August 1998 and the devaluation of the Brazilian *real* in January 1999 raised additional doubts about the sustainability of Argentina's currency board. The perceived slowness of policymakers' response to these events created uncertainty among investors that contributed to substantial capital outflows. The country risk premium increased, hurting the performance of domestic financial markets as well as access to funds in international markets. All these factors contributed to recessions in 1999 and 2000 and a very slow recovery. In December 2000, the International Monetary Fund (IMF) approved a U.S.$39.7 billion financial assistance package. In 2001, Argentina's overall economic performance has been uneven, and the country appears to be having considerable difficulty reactivating economic growth.

In sum, Argentina's economy has experienced low and stable inflation rates along with periods of positive economic growth under a currency board regime. However, the constraints a currency board has imposed on domestic policies may have left Argentina's economy more vulnerable to foreign shocks. While Argentina's currency board has improved policy credibility and facilitated a lowering of inflation and inflation expectations, it has limited the government's ability to respond to financial crises.

Panama. Between 1980 and 2000, despite considerable volatility, Panama's dollarized economy had an average growth rate similar to that of the United States and an average inflation rate some 2 percentage points lower than in the United States. Also, because dollarization obviates the central bank's role as lender of last resort, Panama liberalized its financial system during the 1970s, allowing the entry of foreign banks and eliminating barriers to capital flows.

However, Panama has also experienced one of the potential costs of full dollarization—increased vulnerability to shocks. For example, during 1987 and 1989 political tensions between the governments of Panama and the United States resulted in a major financial crisis. Panama's real GDP decreased 15.6 percent in 1988, and the country experienced substantial capital outflows because of the heightened uncertainty (see Moreno-Villalaz 1999). Yet Panama weathered the Asian and Russian crises in 1997 and 1998 somewhat better than most Latin American countries, perhaps in part because of the relative flexibility and integration of the Panamanian financial system.

Of course, dollarization does not guarantee fiscal discipline. In Panama, fiscal deficits were large during the 1980s, with most of the debt externally financed since it could not be bought by the central bank. However, during the 1990s this trend has been reversed as part of funding agreements with the IMF.

Ecuador. In Ecuador the decision to dollarize in 2000 was prompted by large-scale and persistent economic crises during the 1990s. Earlier attempts to open Ecuador's economy to international trade and capital markets had mostly failed. Large fiscal deficits and increasing external debt led to imbalances that became unsustainable following the decline of world oil prices and the devastating impact of El Niño in 1998. These external shocks weakened economic performance, accelerating inflation and liquidity problems in an already fragile banking sector.

In response to the worsening economic environment, Ecuador's government decided to devalue the sucre in February 1999, freeze bank deposits in March, and default on external debt payments in September. Real GDP declined by over 7 percent in 1999, the inflation rate was more than 50 percent, and the currency depreciated some 200 percent. In January 2000, amid growing social unrest, the newly appointed President Gustavo Noboa introduced a set of broad-based economic reforms that included full dollarization. In addition, the IMF signed a standby agreement with the Ecuadorian government to support economic stability and recovery. This agreement also helped attract additional funding from other international development agencies.

As an apparent sign of enhanced credibility following the dollarization announcement, the release of the frozen bank deposits in March 2000 did not result in a large-scale withdrawal of bank deposits (Quispe-Agnoli 2001). The deceleration in the inflation rate during the second half of 2000, combined with a mild economic recovery, supported the stabilizing effect of full dollarization. However, the persistent large spread between Ecuadorian and U.S. interest rates suggests that a substantial country risk premium is still present in Ecuador and reflects continued political uncertainty and concerns about Ecuador's long-term commitment to further fiscal and financial reform.

El Salvador. On January 1, 2001, the U.S. dollar also became official legal tender in El Salvador at an exchange rate of 8.75 colons per U.S. dollar. Unlike Ecuador, which adopted the dollar as a policy alternative to bring economic stability, El Salvador was already enjoying relative economic stability and low inflation rates during the 1990s. The decision to dollarize in El Salvador was largely an attempt to reduce domestic interest rates and improve foreign investor confidence.

On the other hand, fiscal discipline remains a major challenge for Brazil and the viability of its inflation targeting strategy and for Argentina and the sustainability of the quasi currency board.

Mixed Monetary Policies

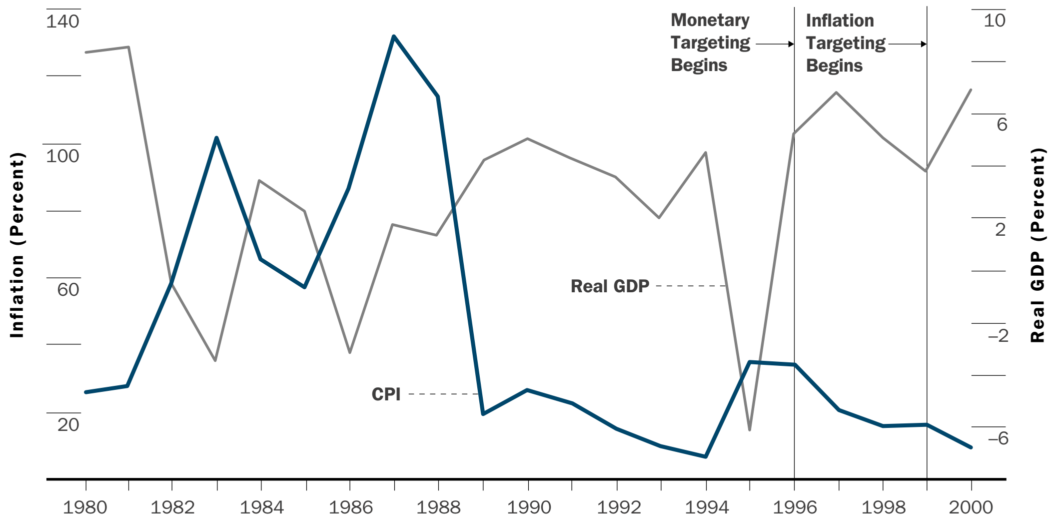
As an alternative to direct exchange rate management, other Latin American countries have implemented monetary policies under flexible exchange rate regimes by managing their domestic money supplies or by targeting their inflation rates.

Mexico. Between 1987 and 1991 Mexico's monetary policy included the use of a pegged exchange regime. During that period, government spending was substantially reduced, inflation rates fell from 132 percent to around 23 percent, and output grew from 1.7 percent to 4.2 percent (see Chart 1).

To allow greater policy flexibility, the Mexican central bank began to use exchange rate bands instead of a fixed exchange rate in late 1991. But in December 1994 there was a speculative attack on

3. In a currency board the monetary base is fully supported with international reserves. In Argentina domestic government bonds can be used to back one-third of the monetary base. These bonds must be purchased at market prices and cannot increase more than 10 percent in a year (see Hanke and Schuler 1999). By 1991 Argentina was already a highly dollarized economy with a substantial amount of private debt and bank deposits denominated in U.S. dollars.

CHART 1
Mexico: Inflation Rate and Economic Growth



Source: IMF, Economic Intelligence Unit, Inter-American Development Bank

the peso brought on by political and economic uncertainty, and the central bank widened the bands considerably. This widening amounted to a sharp devaluation of the peso.

In early 1995 Mexican authorities abandoned the pegged exchange rate and announced a new monetary program that used targets for the monetary base as the policy instrument. At the time, a goal for an annual inflation rate was set at 19 percent, but shortly afterward the target was raised to 42 percent because of the peso's apparent instability. The announced projection for the increase in the monetary base during 1995 was 17 percent, or the equivalent of 10 billion pesos. This monetary target was achieved, but the annual inflation rate was 10 percentage points higher than the announced target.

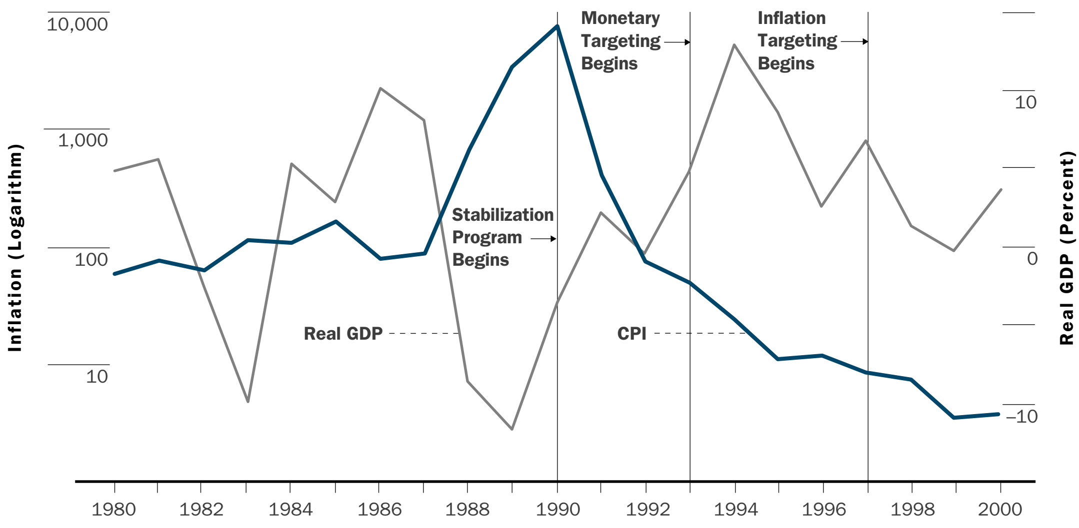
For the next two years Mexico's central bank continued to announce monetary and inflation targets, but these targets were often missed, sometimes by wide margins. In 1998, inflation exceeded the year-end objective by 7 percentage points even though base money grew 1.5 percent less than its forecast. The Bank of Mexico announced in 1998 that controlling inflation was its primary monetary policy objective despite the apparent unreliability of the short-term relationship between the monetary base and inflation. The central bank continued to publicly release its forecasts for the daily monetary base and explained its monetary policy in terms of liquidity management.

In 1999 and 2000, Mexico's monetary policy performance improved as measured by its ability to come close to the announced inflation target. In 1999, annual inflation fell slightly below the target rate of 13 percent, and the economy grew by more than 3 percent. In 2000, the economy expanded by almost 7 percent, its best performance since 1981, and year-end inflation was 1 percentage point below the target of 10 percent. Also in 2000, the Bank of Mexico announced a multiyear target for inflation—2 percent to 3 percent by 2003. For 2001, the target inflation rate is 6.5 percent, but weakening global economic conditions are making it increasingly difficult for Mexican policymakers to maintain the relatively tight fiscal and monetary conditions. Nonetheless, its seems clear that the Bank of Mexico has improved its credibility because of its success in controlling inflation.

Peru. In Peru a series of economic policies implemented between 1990 and 1992 were successful in lowering inflation rates from over 7,000 percent in 1989 to about 74 percent in 1992. These programs involved a drastic reduction in government expenditures, taxation reform, privatization of state-owned enterprises, and trade liberalization. In 1993 Peru's central bank was given independence from fiscal authorities, and it began implementing monetary policy via targets for the money base. However, the central bank did not announce these base targets to the public, thereby giving itself some discretion.

The rate of inflation fell from almost 50 percent in 1993 to about 12 percent in 1996 whereas output increased at an average rate of 7 percent over

CHART 2
Peru: Inflation Rate and Economic Growth



Source: IMF, Economic Intelligence Unit, Inter-American Development Bank

this period (see Chart 2). Mishkin and Savastano characterize Peru's monetary policy strategy as "one of discretionary monetary policy with an increasing focus on price stability, not too different from the approach to monetary policy followed by many non-inflation-targeting industrial countries (including the U.S.)" (2000, 30).

In 1994, Peru's central bank began announcing explicit inflation target ranges but continued to keep the money growth targets confidential. Inflation continued to decline, falling from 24 percent in 1994 to 4 percent in 2000. Since 1997, actual inflation rates have been consistently below the lower band of the target range. At the same time real output increased an average of 5 percent between 1994 and 2000 despite a steep recession in 1999.

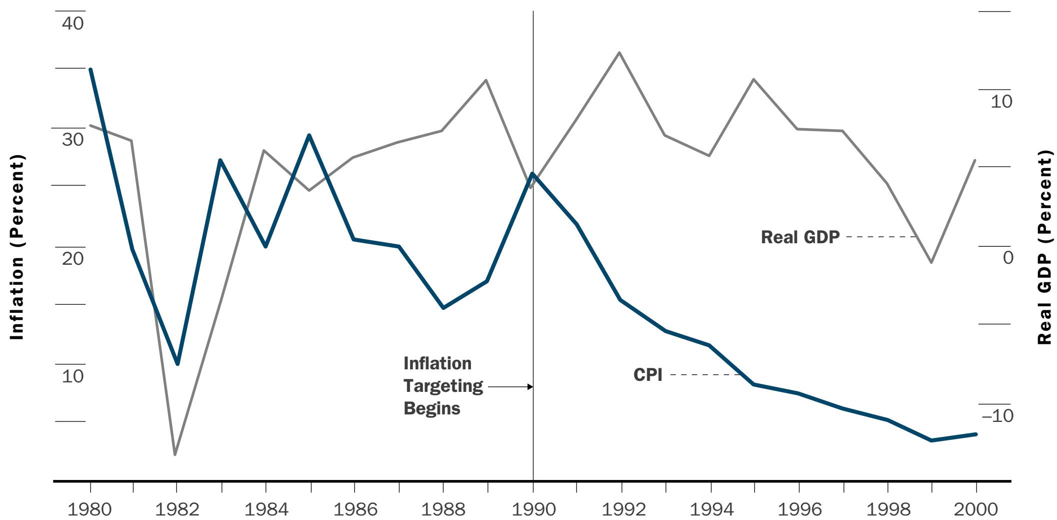
In comparison with Mexico, Peru's monetary policy is somewhat less transparent because of both the wider range of policy instruments employed and the limited extent to which the central bank's decisions have been communicated to the public.[4]

Chile. In 1989 the Chilean government enacted legislation that established an independent central bank and set price stability as a primary objective. However, it also maintained a managed exchange rate regime to the extent that the peso was allowed to fluctuate within a certain range before foreign exchange intervention would take place. The central bank emphasized that the exchange rate band was intended to keep real exchange rates consistent with medium- and long-term external equilibrium and not to control inflation. In late 1990 the Chilean central bank announced an inflation target range for 1991 of between 15 and 20 percent; the actual inflation rate was around 19 percent. The range was gradually lowered in subsequent years, and the actual inflation rate generally fell within 50 basis points of the target. With inflation contained below 5 percent since 1998, in September 2000 the central bank announced a target range of 2 to 4 percent for 2001 onward. Over time, as inflation has declined, the exchange rate band has been adjusted to allow the Chilean peso to depreciate to maintain a relatively stable real exchange rate.

Between 1991 and 2000, Chile's average output growth was almost 7 percent, the highest of any Latin American country during that period. However, in 1998 output growth fell below 4 percent, and in 1999 the economy entered a mild recession during which output declined by around 1 percent (see Chart 3). The recession ensued following a sharp decline in 1998 in the price of Chile's main

4. The policy instruments Peru has employed include intervention in the money market (through auction of certificates of deposit), intervention in the foreign exchange market (direct transactions of foreign exchange), and several other secondary instruments such as rediscounts, reserve requirements on the sizable foreign currency deposits, and the interest paid on those reserves (see Mishkin and Savastano 2000).

C H A R T 3
Chile: Inflation Rate and Economic Growth



Source: IMF, Economic Intelligence Unit, Inter-American Development Bank

export, copper, that prompted the central bank to increase domestic interest rates and narrow the exchange rate band in an attempt to maintain the real exchange rate. But realized inflation fell 2 percentage points below the targeted rate in 1999, and the central bank reversed course; it began lowering interest rates and dropped the exchange rate band policy.

Chile's experience provides a good lesson in economic policy. In the face of a demand shock, prices and output tend to move in the same direction. This tendency gives the central bank some discretion in the short run to target output stability without necessarily deteriorating the inflation outlook.[5] The Chilean experience is an example of implementing inflation targeting as a strategy for achieving gradual disinflation. It also demonstrates the support fiscal discipline and a sound financial system can provide in inflation targeting. The transparency of Chile's inflation targeting policy has increased in recent years; in May 2000 the central bank began producing an inflation report that includes the baseline inflation forecast. The inflation report, the adoption of a floating exchange rate in late 1999, and the elimination of restrictions to capital flows should further strengthen the credibility of Chile's inflation targeting policy.

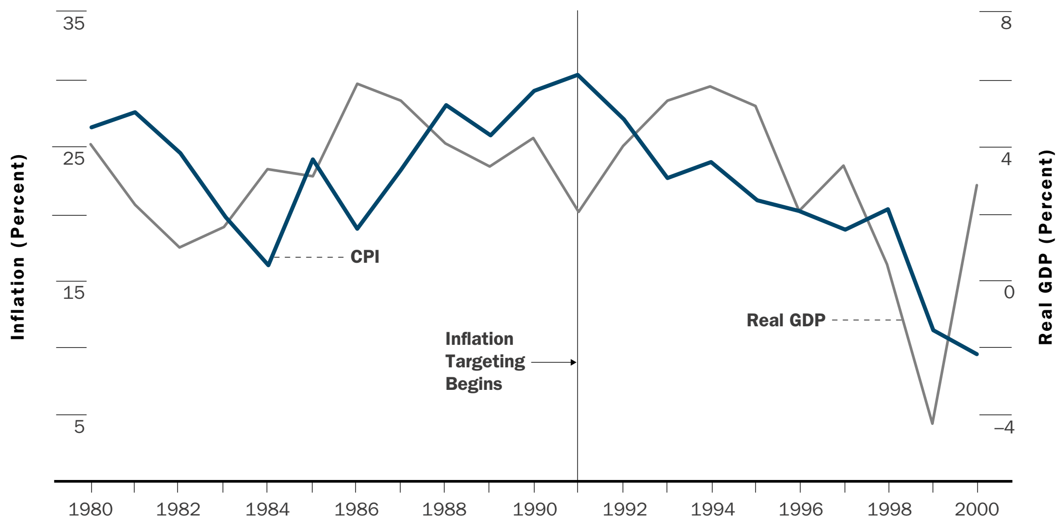
Colombia. During the 1980s Colombia was one of the few Latin American countries that avoided the populist economic policies that often resulted in hyperinflation. The new constitution in 1991 and supportive legislation in 1992 made the central bank independent from the government. The central bank had strong limitations on its ability to finance government deficits, however, and it was prohibited from funding private sector activities. In 1991 the central bank began announcing explicit numerical targets for the next year's inflation rate. As in Chile, initially a crawling peg exchange rate regime was maintained.

In most years during the 1990s, Colombia's realized inflation exceeded the announced inflation target. The average inflation rate between 1991 and 2000 was 21 percent, not too different from the 1980s' average of 24 percent. Colombia's average output growth of 3.5 percent between 1980 and 1990 slowed to an average of less than 3 percent between 1991 and 2000 (Chart 4).

In 1998 a large decline in Colombia's foreign reserves was attributable to growing political and economic uncertainty, fed by a substantial fiscal deficit and a large official external deficit. The central bank responded by raising domestic interest rates and shifting the exchange rate bands to accommodate a 9 percent depreciation in the peso. These actions did not calm deteriorating expectations, and Colombia experienced its first recession in seven decades during 1999. By mid-1999 it was apparent that the inflation target of 15 percent would be undershot by a large margin. In September the exchange rate band was abandoned in favor of a floating exchange rate, and Colombia requested its first IMF program in more than 30 years.

In 2000 Colombia's real output grew almost 3 percent largely because of higher world oil prices,

CHART 4
Colombia: Inflation Rate and Economic Growth



Source: IMF, Economic Intelligence Unit, Inter-American Development Bank

which represented a positive terms-of-trade shock, and an expansionary fiscal policy. In the past two years, although an inflation target is still announced, the disinflationary objectives of the 1991 policy initiatives have been replaced by a greater attention to short-term output stability.

Brazil. As part of a broad set of economic reforms instituted in 1995 under the *Real* Plan, the Brazilian central bank maintained a managed exchange rate regime. The *Real* Plan was extremely successful in reducing inflation from over 2,000 percent in 1993 to a little over 3 percent in 1998 (see Chart 5). However, the government's inability to achieve fiscal discipline and the gradual increase of the public debt made the *real* increasingly vulnerable to speculative attacks, and the exchange rate system collapsed in January 1999.

In June 1999 President Fernando Henrique Cardoso issued a decree announcing multiyear inflation targets, assigning the responsibility for setting inflation targets to the National Monetary Council, and giving the central bank full responsibility for implementing the policies needed to attain the inflation targets. The decree also established procedures to delineate the central bank's accountability and to improve the transparency of monetary policy (Schaechter, Stone, and Zelmer 2000). In July 1999 the first inflation report discussed the economic conditions and the prospects for inflation as well as the probabilities of different inflation paths.

The inflation target was set at 8 percent for 1999 with a tolerance of plus or minus 2 percent, and realized inflation was slightly below 9 percent. The target midpoint was reduced to 6 percent for 2000, and actual inflation in 2000 was close to 6 percent. The target was set at 4 percent for 2001. Economic recovery started in 1999 and continued in 2000 as output grew 0.8 percent and 4.3 percent, respectively. For 2001, analysts predict that inflation may exceed its target. This result would not indicate a lack of commitment by the monetary authorities to inflation targeting but instead would reflect shocks from financial market instability and the country's energy crisis.

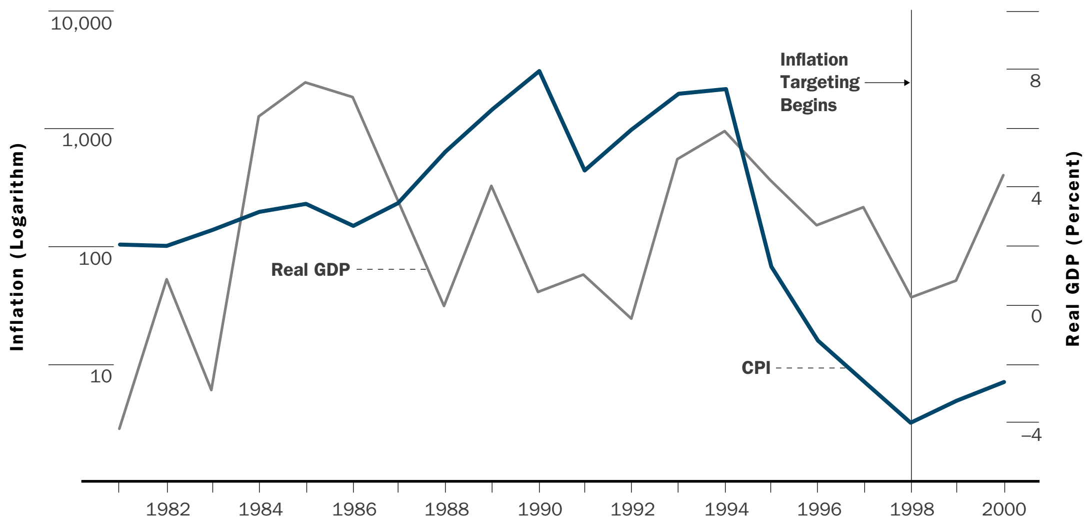
Conclusion

This article examines the recent history of monetary policy in Latin America, focusing on the various policy strategies that have been implemented. Comparing the experiences of Latin American countries under different monetary regimes suggests several lessons concerning the implementation of monetary policy.

First, none of the monetary regimes imply or guarantee fiscal discipline, and without fiscal discipline monetary regimes are unsustainable in the long run. Because of the experiences of Latin American

5. In Australia, which faced a similar negative demand shock, policymakers reacted by easing monetary policy and allowing the currency to depreciate. This action resulted in relatively strong output growth without violating the inflation target.

CHART 5
Brazil: Inflation Rate and Economic Growth



Source: IMF, Economic Intelligence Unit, Inter-American Development Bank

countries in the 1980s, the public began to identify large fiscal deficits with high inflation rates. The common practice of financing the debt with increases in the money supply became embedded in the inflation expectations of individuals. Thus, one of the requirements for a successful monetary policy seems to be the breaking of fiscal dominance. Chile has made perhaps the greatest strides toward disrupting this pattern. On the other hand, fiscal discipline remains a major challenge for Brazil and the viability of its inflation targeting strategy and for Argentina and the sustainability of the quasi currency board.

The role of the exchange rate has also been particularly important for monetary policy in Latin America. Changes in the exchange rate can affect inflation directly through import prices and indirectly through changes in inflation expectations. There is a perception that Latin American policymakers have overridden inflation objectives on occasion to avoid fluctuations in the exchange rate. Also, in countries such as Peru, which has a substantial share of its long-term debt denominated in U.S. dollars, a large and sharp depreciation can increase the risk of financial crisis. This increased risk can raise policy concerns about maintaining exchange rate stability.

Past experiences under highly populist governments have made policy credibility another important issue in Latin America. The currency board in Argentina represents a commitment to the exchange rate peg that has contributed to credibility. However, even in Argentina monetary policy has been under pressure recently because of the currency board regime's inability to respond to financial and external shocks. The credibility of full dollarization comes from the strong commitment required to adopt the U.S. dollar as domestic currency given the difficulty of reversing the commitment. However, Panama's experience in 1987 has shown that full dollarization may deepen output instability during a financial crisis. The credibility of an inflation targeting strategy is supported by transparency and accountability. The inflation reports in Chile, Mexico, and Brazil represent positive steps toward enhancing the credibility of monetary policy in these countries.

Latin America's experience offers a very important lesson. Under any monetary regime or exchange rate arrangement, fiscal discipline, policy credibility, and the role of the exchange rate are important factors that should be addressed to ensure the sustainability of economic policy.

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