Ending Instability

How monetary policy reforms helped propel five major Latin American countries from recurrent crises to economic stability

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A LITTLE over two decades ago, much of Latin America faced financial instability, currency crises, and even hyperinflation. These painful developments became recurrent and the social and economic impact was grave—production was disrupted and many people lost jobs and sometimes a lifetime's worth of savings. Social frustration was high.

Today, though, things are different—especially in five of the biggest Latin American countries, which account for about 80 percent of the region's gross domestic product. Brazil, Chile, Colombia, Mexico, and Peru—what we call the Latin American Five (LA5)—have set the pace for a region that has weathered the global financial crisis to become one of the strongest emerging markets. How did they manage to achieve this radical change that 20 years ago most would have thought unreachable?

Although many factors—including some luck—played a role, two crucial elements were central bank institutional reforms and changes to the monetary policy frameworks. These far-reaching reforms did not take place overnight and were effective mainly because for somewhat more than a decade the LA5 countries maintained responsible fiscal and financial policies that kept vulnerabilities to adverse developments in check. Together, those policies reinforced the ability of central banks to preserve price stability and build credibility—which in turn enhanced their capacity to guide the inflation expectations of citizens and businesses. This strengthening of the central bank role arose not only from a clear mandate to fight inflation, but also from the central banks' increased autonomy and accountability, from better policies, and from enhanced communication and transparency. The improved policies helped insulate these economies from the worst effects of the global financial and economic crisis (see "Sustaining Latin America's Transformation" in this issue of *F&D*).

Increased autonomy and accountability

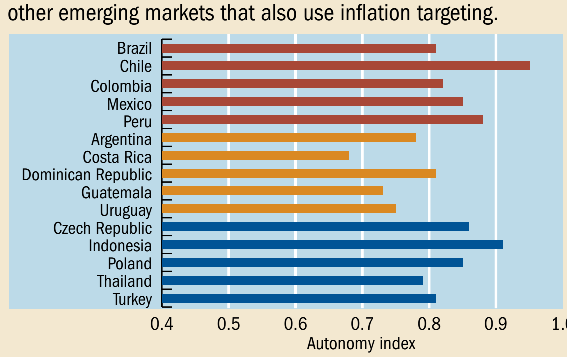
In most cases, new laws gave LA5 central banks the primary mandate of preserving price stability. Central banks were granted broad autonomy to carry out their mandate and resist political and interest-group pressures. A milestone in the reform in most countries was the removal of the link between monetary policy decisions and the political cycle—by creating central bank board member terms that exceeded, or overlapped, the presidential term. Other key legal provisions included vesting central banks with the power to manage the policy interest rate and forbidding or limiting direct lending to the government. In exchange for giving central banks this autonomy, the legislation strengthened central bank accountability to the markets and society at large by requiring them to disclose and explain their policies, goals, and results through frequent communication.

Today, LA5 central banks are among the most autonomous central banks in Latin America and are slightly better than many other important emerging market central banks (see Chart 1). But that does not mean there isn't room for further change. For example, Brazil could enshrine central bank autonomy in legislation—although in practice the central bank has enjoyed de facto autonomy during the past 16 years. Central banks in Colombia and Peru could further insulate the selection of their central bank board members from the

Chart 1

Independence reigns

The LA5 central banks are among the most autonomous in Latin America and compare favorably with central banks in other emerging markets that also use inflation targeting.



Source: Canales-Kriljenko and others (2010).

Note: The autonomy index ranks a central bank's independence from the political process using many criteria, including its legal mandate, how it formulates policy, whether it lends to the government, and its accountability to the society. The index ranges from zero to 1, with zero the least independent and 1 the most. Other Latin American countries are Argentina, Costa Rica, Dominican Republic, Guatemala, and Uruguay. Other emerging markets are the Czech Republic, Indonesia, Poland, Thailand, and Turkey.

political cycle, while Mexico and Chile could require governments to maintain adequate levels of central bank capital.

Better policies

With a clear mandate on price stability, the LA5 central banks adopted inflation targeting as the basis of their monetary policy—setting a rate of consumer price inflation as the primary goal. The new policy regime anchored inflation expectations and increased monetary policy flexibility, including on the exchange rate front. To deliver on their mandate more effectively, the LA5 central banks revamped their operational techniques. They all eventually chose a short-term interest rate (the "policy rate") as their operational target to achieve the inflation goal. Central banks use the policy rate to signal changes in the stance of monetary policy, increasing the policy rate when inflation pressures build and decreasing it when they ease. LA5 central banks also expanded and refined their toolkits to conduct open market operations, which allowed them to keep demand and supply for domestic liquidity in equilibrium and market rates close to the policy rate. This required improving their capacity to forecast the main factors that affect domestic liquidity—such as demand for currency and government cash flows.

Enhanced transparency

These reforms and policy innovations benefited from enhanced communication and transparency. They proved to be critical to boosting the effectiveness and credibility of monetary policy. Over time, LA5 central banks got better at explaining their policy strategy and individual policy decisions. For about a decade now, LA5 central banks have been preparing and publicly disclosing inflation or monetary policy reports three or four times a year. They decide the level of the policy rate during preannounced meetings and disclose the rationale behind their rate changes and other policy decisions; some publish the minutes of their board meetings. LA5 central banks also constantly communicate with the market and issue press releases as needed. Those central banks also make available data on market views about key macroeconomic variables—in particular, about expectations on inflation and economic activity—as well as their own forecasts. This ample availability of data has helped build public trust, because market participants can verify, at a reasonably low cost, that the monetary policy authorities are acting consistently with their stated objectives.

Together with far-reaching monetary reforms, significant improvement took place in government tax and spending policies and in banking supervision and regulation. Taking advantage of a commodity price boom and easy global financial conditions during 2003–07, the LA5 countries were able to build fiscal and external buffers—reducing the risk from public debt burdens and boosting international reserves—to provide a cushion against outside economic shocks. At the same time, the countries improved regulation and supervision with the aim of avoiding large bailouts of insolvent institutions. These changes contributed to reduced economic and financial vulnerabilities in the LA5 countries and helped central banks conduct consistently credible and flexible monetary policy.

Tapping the war chests

When external financial conditions were favorable and export prices high, the LA5 central banks built up considerable international reserves.

When external conditions turned bad, the LA5 central banks used those reserves to smooth out depreciation of their currencies. Brazil and Mexico sold almost 10 percent of their international reserves, but they still experienced the largest currency depreciation—about 30 percent between August 2008 and February 2009. The central bank of Peru used close to 20 percent of its international reserves over a couple of months, letting its currency slide by only 11 percent.

In contrast, Chile and Colombia allowed their currencies to depreciate more than Peru's and sold fewer international reserves. In addition, some LA5 central banks secured additional external support for their reserve positions for extra peace of mind given the uncertain magnitude of the global financial crisis. Colombia and Mexico got access to a new IMF facility, the Flexible Credit Line—reserved for countries with strong policies and institutional frameworks—which would allow them to borrow from the IMF if needed. Brazil and Mexico also had the ability to swap domestic currency with the U.S. Federal Reserve for up to $30 billion.

The LA5 central banks used other techniques as well to improve foreign exchange availability in their economies, for example through foreign exchange swaps (Brazil and Chile).

Testing under fire

Then two major events hit the world back to back. In 2007 food and oil prices skyrocketed, and in September 2008 the global financial crisis began in earnest, after the failure of the Wall Street investment firm Lehman Brothers.

Soaring commodity prices in combination with demand pressures in some countries pushed inflation above targets. With the aim of limiting spillovers into core inflation (from which energy and food prices are removed), central banks tightened monetary policy by raising interest rates, which peaked by mid-2008. As a result of capital inflows and favorable terms of trade, domestic currencies tended to appreciate, which helped moderate inflation pressure by keeping import costs down. Official foreign exchange intervention and reserve accumulation varied across the LA5 countries.

In contrast, the global financial crisis came with a sharp increase in risk aversion, which caused a sudden stop in domestic and foreign investment. Global trade also collapsed and a worldwide recession ensued, reducing inflation pressures. In the past, such sudden stops associated with global recession and debt shedding fueled domestic currency and banking crises in Latin America. This time, the new monetary policy approaches—together with stronger overall economic conditions and better fiscal policies—enabled the LA5 central banks to maintain stability while handling the associated large swings in real exchange rates.

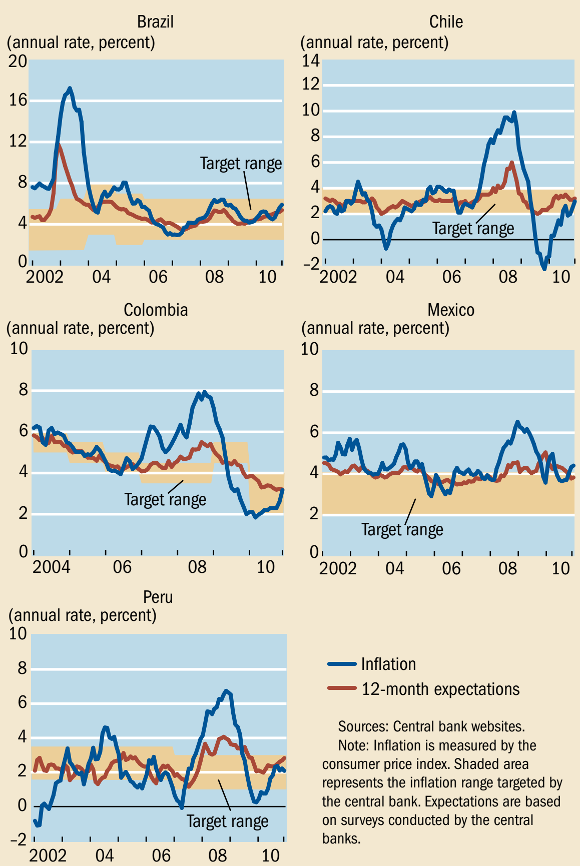
Because of confidence in monetary policies, inflation expectations remained within target levels, which meant the LA5 countries could allow declines in the nominal exchange rate, to different degrees, to do much of the job of coping with the global crisis without worrying too much about the inflation effects. But they did not totally abandon exchange rates to the market. They maintained a trading presence so that markets did not get carried away, given the considerable uncertainty in global financial markets. The LA5 central banks sold in the foreign exchange market significant amounts of the international reserves they had built up, and reversed earlier measures to absorb foreign exchange liquidity (see box).

Despite sharp declines in exchange rates, which raised import prices, the public expected inflation to remain low. In particular, surveys showed that 12-month inflation expectations stayed within the target bands during most of the crisis period—even when actual inflation missed the target range (see Chart 2). This suggests that central banks' credibility led markets to distinguish between cyclical short-term inflation and long-term trends.

Chart 2

Confident about inflation commitments

Business and consumer expectations about inflation remained within, or close to, the target ranges set by the LA5 central banks, even when rising commodity prices gave consumer price inflation a boost in 2007 and 2008.



Sources: Central bank websites.
Note: Inflation is measured by the consumer price index. Shaded area represents the inflation range targeted by the central bank. Expectations are based on surveys conducted by the central banks.

Softening the recession's blow

By early 2009, when the global financial crisis had become a global recession, LA5 central banks started to cut policy rates to help economic recovery. The pace of monetary policy loosening varied, depending on inflation projections and each country's position in the business cycle. Because policy rates were high before the Lehman failure, most LA5 central

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banks could cut them significantly—in contrast to advanced economies, where central banks had policy rates already close to zero. Like their counterparts in advanced economies, LA5 central banks adopted various measures to ease the shortage of cash in their economies, such as loosening access to central bank facilities for liquidity provision and cutting reserve requirements. On the other hand, considering the lagged effect of monetary policy, the high domestic interest rates before the (unexpected) global crisis could have exacerbated the recessions in these countries.

Communication was crucial. Central banks explained their policy decisions and goals to the markets. They stressed that prospects for low inflation and economic recession warranted an unusually aggressive cut in policy rates. They noted that expansionary monetary policies were needed to preserve normal liquidity conditions—an implicit reference to financial stability. Nevertheless, while explaining their decisions to ease monetary policy and ensure financial market functioning, LA5 central banks clearly delivered the message that, as soon as inflation pressures emerged, monetary policy tightening would start, which has happened in Brazil, Chile, and Peru.

Still, despite their recent success, there is no room for complacency. These countries are already facing another challenge. Having recovered smartly from the global downturn while advanced economies sputter, these economies are again among the darlings of foreign investors. How the LA5 deal with this new capital surge will be another test of how well they manage risks to financial and economic stability. ■

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This article is based on IMF Working Paper 10/292, "Weathering the Global Storm: The Benefits of Monetary Policy Reform in the LA5 Countries," by Jorge Iván Canales-Kriljenko, Luis I. Jácome, Ali Alichi, and Ivan Luís de Oliveira Lima, published in December 2010.