“Choosing the Right Approach to Monetary Stabilization”

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Panel Macroeconomía:

- Cajas de Conversión
- Dolarización
- Uniones Monetarias

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Choosing the Right Approach to Monetary Stabilization
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• In most cases there is one fundamental cause for instability: FISCAL IMBALANCE

• Monetary Arrangements are necessary but not sufficient conditions for stability. Consistent and credible fiscal adjustment must occur.

• No Monetary Arrangement can succeed with an undefined fiscal setup.

• The Monetary System defines the NUMERAIRE of the economy and should be stable and predictable.

• Only in extreme circumstances is instability so great that it may pay to combine the unavoidable FISCAL adjustment with a redesign in the Monetary Arrangements.
Floating and Fixed Rates Strategies Differ in:

1- **Preconditions**: Available Reserves and Credibility

2- **Short Run Effects**:
   - Fixed Rates: Initial boom with lower interest rates and real appreciation
   - Floating Rates: Initial recession with higher interest rates and real appreciation.

3- **Costs of Abandoning the System later on**:
   - Small: Flexible Rates
   - Larger: Fixed Rates (devaluations gradually add to credibility loss)
   - Huge: Currency Boards
FIXED Exchange Rate Arrangements

1- Prefixed Rate: Tablita system used in Chile and Argentina in the 70’s. Allows for the coexistence of inflation tax and fixed rates at a preannounced rate of devaluation. Devaluation = Velocity * Deficit – Growth – Int. Inflation

2- Fixed Rate: Incompatible with inflation tax: only seignorage from growth.

3- Currency Board: Strong institutional framework.

4- Dollarization: Planned (Panama) or de-facto (in L.A. under a variety of regimes)

5- Cooperation Agreement: Adds credibility to the Currency Board by including stand-by credit lines in FOREX. It may include some seignorage sharing clause.

6- Monetary Union: Strong institutional setup includes a single monetary authority and shared bank regulation.

Options 1-4 are unilateral, options 5 and 6 require agreement between the two countries.
Lender of Last Resort

Needed when there is an increase in demand for cash under a fractional reserve system. The Central Bank can provide the cash and avoid an unnecessary contraction in secondary bank credit.

If the demand for cash is the result of a run for foreign exchange, the LoLR arrangement collapses since printing the local cash is like pouring gas on a fire.

In a bi-monetary economy, the LoLR function has to be provided by Reserves and stand by credit lines denominated in foreign exchange negotiated with foreign banks, governments or international institutions.

In most unstable EC’s, the Central Bank is the BORROWER OF FIRST INSTANCE rather than Lender of Last Resort.
Currency Boards as the Panacea for Macroeconomic Instability

A CB gives needed credibility to an adjustment plan that MUST include fiscal consistency both present and future. Is is, however, costly:

• CB’s start with a meltdown of domestic assets: The 100% reserve backing requires a large initial devaluation in order to make reserves equal to the Monetary Base.

• It probably needs also to freeze secondary bank deposits with a forced government bond in order to prevent an initial run against the lower stock of reserves that would collapse banks.

• Since the costs of abandoning the CB are huge, some risk evaluators raise the sovereign risk premium for the country in times of crisis. This may be due to a lack of experience with Currency Boards. Since the Asian Crisis, Boards have done well.

• Those that believe exchange rate flexibility is better at times of crisis do not consider the history of monetary abuse that led to the use of the Currency Board.

• The result of exchange rate flexibility may be the total abandonment of the local currency and full de facto dollarization that may raise country risk.
Currency Boards and Hyperinflation

• Boards may deal well with hyperinflation when there is a collapse in tax collection (Olivera-Tanzi effect) and no credibility.

• A Currency Board can buy the credibility required to stop inflation and implement fiscal adjustment.

• Unless there is foreign help, credibility does not come cheap: The initial meltdown of money supply must be large to bring it to the low level of available international reserves.

• The meltdown comes about through three mechanisms:
  - Hyperinflation reduces demand for money
  - Initial devaluation further reduces the dollar value of money
  - If needed, a bond may refinance bank deposits