Monetary Policy Challenges in Latin America: Some General Principles for a Countercyclical Monetary Policy

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When we met just one year ago, in Miami in April 2008, Latin American countries were facing a very different monetary policy dilemma. The period leading up to 2008 represented one of the longest phases of expansion for the region since the early 1970s. Although we were aware that the international financial crisis that had begun in the summer of 2007 would come to affect us, there was some still hope that the crisis would not be severe. At the time, many of us were still growing strongly. Back then, the risk was of tenacious inflation. A persistent sequence of rises in world energy and food prices had pushed our domestic inflation rates above our targets. If these relative price effects were just restricted to first-round, direct effects on inflation, they could have been accommodated. But supported by strong domestic demand and reactivated wage and price indexation mechanisms, they were threatening to spread and grow. The question a year ago was then "How much should we raise interest rates by to contain inflation?"

Then, just six months later, the balance of risks tilted dramatically away from high inflation to low growth o recession. The world financial crisis intensified in early September 2008, about the time that Lehman Brothers went bankrupt. Indicators of consumers´ and businesses´ confidence dived in many countries. Growth forecasts dipped. These new forecasts now acknowledge that all advanced countries and some emerging economies would be in a deep recession in 2009. Other countries would grow but very slowly. Doubts remain about the recovery in 2010.

[1] Governor Central Bank of Colombia. Comments given at the Investor Seminar at the time of the Inter-American Development Bank Annual Meetings.

Official data releases for Latin America will probably reveal a deceleration in domestic demand at around this time, which was probably shaken by the loss on confidence. As a consequence of weakening external demand, Latin American export growth would have slowed down too.

In tandem, the world market prices of oil and other commodities fell off their peak in the summer of 2008. Commodities represent an important share of Latin American exports and so these lower export prices mean lower income at least in dollar terms.

Spreads on our borrowing rose with the Lehmans' bankruptcy and have stayed at higher levels. As the process of repairing balance sheets of advanced countries' banks still has some way to go, it seems sensible to plan for a scenario where there is further tightening in international lending. Cross-border bank lending flows could fall. Foreign direct investment could slow down with the commodity prices. Remittances could also stall.

Taken together, all this means very low growth for the region in 2009, with greater risks to bank finance of investment and consumption. Unemployment has already started to rise, adding to the gloom.

It is also important that the falls in world prices are pushing down on the price of our imports, especially in food and energy items. That pressure was strong enough to override a depreciation of many our currencies against the dollar. Some of us are starting to see those lower prices in falling inflation rates.

In short, since September 2008, inflation became less of a problem and growth has become a much greater risk. The question now for monetary policy is "How much should we cut rates by?"

In this speech I want to lay out some principles for a countercyclical monetary policy in Latin America. I will make these points generally, and draw only from our experience in Colombia. I leave it up to you to apply this across the countries in the region.

My first point is that it is important to recognize that there are some limits to how much monetary policy can respond countercyclically during a slowdown.

If rates are pushed below a level that is compatible with the inflation target then the credibility of monetary policy will be damaged. Credibility about long-run inflation might seem like a luxury in a downturn. But, if policy rates are cut excessively and credibility is lost, there is a risk of causing even slower growth.

The reason why Latin American monetary policymakers cannot hope to buy much more growth by sacrificing inflation credibility is that we still have imperfect indexation mechanisms still operating in the region. Because of these mechanisms, a persistent high inflation is disruptive. High inflation damages the real incomes of consumers and the real profits of firms, especially those without financial access. High inflation also keeps long nominal market interest rates from responding to monetary policy cuts, and raises the income gearing of borrowers. Under these circumstances, there will be little to gain in terms of growth, and very likely a lot to lose, from abandoning the nominal anchor of inflation credibility that many of us have gained in these past years.

Another constraint on a countercyclical policy is when it might trigger an excessive devaluation. We have higher rates in Latin America for a reason: we have to pay a risk premium. Offering too low rates makes lending to us less attractive, and can set off devaluation in the price of our currency.

As I will go on to elaborate, there are some very important reasons why devaluation against the dollar is in general less of a concern in Latin America than it was in the past. Many of us are less exposed to currency risk. Many have accumulated substantial reserves. And finally, the world prices of imported products have been falling fast enough to offset the depreciation up until now.

This less exposure is reflected in that many Latin American countries, like Colombia, now target inflation and that less target the exchange rate. Inflation targeters such as Brazil, Colombia and Chile have been able to accommodate a large depreciation. The pace of the depreciation has now tailed off and has been replaced by a smaller appreciation.

Despite this, central banks in the region will continue to be wary of the risk of triggering large uncontrolled devaluations. The world currency markets are volatile. The purpose of a countercyclical monetary policy is precisely to avoid very sharp falls in real incomes. And at the end of the day, a very sharp devaluation represents a loss in real income for domestic residents. It also means higher payments for domestic borrowers in foreign currency. So some concern for devaluation, which depends on each country's circumstances, should be seen in this context.

So far I have concentrated on monetary policy. What about a countercyclical fiscal policy?

It is much more difficult to generalize here. But speaking very broadly, although there is scope for a countercyclical fiscal policy in the region, we should realize that it is limited for some countries. It is limited where fiscal revenues are very procyclical and where insufficient saving has been made during the past years. On top of that, our governments will be competing with a greater stock of sovereign debt from advanced economies.

Because of its limited scope, discretionary fiscal policy should be targeted carefully and provisioned for risks. Fiscal policy can help provide guarantees for bank liabilities in the event of financial crisis. It can support liquidity provision. It can be used on safety nets for the vulnerable in region. In short, it can be used to keep the worst effects of the crisis at bay.

It is also important that fiscal and monetary policies act in unison during the downturn. Fiscal policy should not limit the scope for a countercyclical monetary policy, for example by trying to claw revenues through raising regulated prices. Also, an excess of spending above revenue should not damage the sustainability of the fiscal plan. Otherwise this will push up risk premia and act against efforts to stimulate growth.

Let me return to monetary policy. Having established that there are some limits to a countercyclical monetary policy during a downturn, I now want to emphasize how

structural improvements can alleviate this dilemma and give us the scope to cut rates by more.

Those structural improvements have to be made in good times. Essentially how much we can lower rates now during the downturn depends on how we were able to tighten policy and maintain control during the boom years that came before.

First, it is important to reach the downturn with monetary policy credibility undamaged. As I explained earlier, the combination of high inflation and low growth is particularly lethal for the region.

Second, it is crucial that spending is not allowed to grow much faster than income during the boom. An unsustainable build up of debt comes back to haunt us during the downturns. In harsher times, foreign investors dislike debt more and so the presence of a large debt stock heightens the vulnerability to devaluation, currency crisis and income loss. On the other hand if we reach the crisis with debt at sustainable levels, we have scope to cope with losses without cutting spending. That is especially important in this current crisis because our debt will be competing with massive new emissions of sovereign debt from richer countries.

Third we have to make sure that our balance sheets are kept healthy in other aspects during booms. For example the maturity and currency composition of liabilities should match those of our assets. This should apply across the public and private sectors, as in a crisis, liabilities are shared. The greater share of accumulated foreign direct investment in the region's external liabilities is welcome in this sense, as it implies a longer maturity.

Fourth, policies have to recognize that banks are the engine of this expansion. It is banks which translate flows of external income and finance into a growth in nontradable demand through issuing credit. Of course a healthy growth in domestic private credit is welcome in Latin America as it opens access to the financial system. But that growth must be sustainable. The quality of banks' portfolios must not be allowed to deteriorate too much during the good times. Otherwise in the bad times that will surely follow, banks will cut lending drastically and indiscriminately to recoup a history of bad

investments. By being prudent we also make sure that our standard monetary policy instrument will have some effect on market rates during the slowdown. To sum up, there is a lot to gain from promoting financial stability during the boom.

How difficult is it to lean against the wind during the boom? The answer is that is very difficult because the wind against which we have to lean is very strong. Real private sector credit in Argentina grew at 23% in 2006, in Brazil at 21%, in Chile at 12%, in Colombia at 33%, in Mexico at 27%. This regional credit boom was related to strong inflows of capital and high prices for our exports. We have to act against these powerful forces.

How does one lean against the wind in booms? There is a debate underway now about how this should best be done for advanced countries. I can only add to this by telling you what we did in Colombia in the boom that preceded this slowdown.

- First we accumulated international reserves to offset the effect of capital inflows. We kept our reserves to in between 11 and 12% of nominal GDP since 2005. Since 2008, our purchases of reserves are made through rules-based mechanisms so as not to compromise the credibility of monetary policy.

- We raised our policy interest rates by 400 basis points since April 2006. It is important the monetary policy is tightened when we see the early signs of inflation pressure and unsustainability. But it also became apparent to us that standard monetary policy actions by themselves were not going to be enough.

- So we also imposed marginal reserve requirements on deposits. Capital controls were introduced to alleviate the appreciating pressure on the currency at the same time.

- We already had limits on the net foreign currency- denominated asset position of Banks and other financial institutions as a fraction of their net worth..

- We require banks and other financial institutions to have a positive net “cash” foreign currency-denominated asset position of as a fraction of their net worth. There is also an upper bound for the net “cash” foreign currency-denominated asset position.

- Last but not least, our financial supervision authority increased provisioning requirements on commercial and consumer loans, and adopted a tougher system of administration of credit risk for both types of loans.

As a result, Colombia´s financial sector is much healthier than in past episodes of low world growth. Since September 2008, we have been able to cut interest rates sharply, as well as provide liquidity and weaken the reserve requirements.

Let me draw to a close by claiming there have been improvements across the whole region in our management of our financial sectors. It is important that, for example, supervision is more closely focused on sustainability; that instruments are used more actively to achieve this; that policy is better coordinated across institutions and that those institutions are less dependent on the economic and political cycle. Perhaps it was the recent memory of past crises that made us take financial stability more seriously and seek it more actively here.

This will shortly be put to a stern test. In the worst scenario, international bank flows to Latin America will be sharply reduced over 2009 and 2010. If that happens, I expect that monetary policy will work more effectively and the recovery will be quicker where financial stability is stronger in the region.

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