An alternative to inflation targeting in Latin America: macroeconomic policies focused on employment

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Abstract :
A fully opened capital acount, a pure floating exchange rate and inflation targeting monetary policy is the macreconomic setting currently recommended in Latin America by the IMF and the othodoxy. In this paper we present an alternative macroeconomic regime proposal focused on growth and employment. A competitive real exchange rate, as an intermediate target, is an essential component of the regime. The paper argues in favor of the proposed policies by showing that they are viable anad manageable and also discusses some possible objections from the mainstream or orthodox approach.

Key words : exchange rate policy, monetary policy, employment.

JEL Classification Codes : E52; F31; O23

Introduction

In the early 1990s, the IMF supported capital account liberalization and fixed exchange rate regimes, two policies that were adopted by the biggest countries in Latin America (Argentina, Brazil, Mexico). Yet, during a boom engineered by capital inflows, monetary policy can not play a significant preventive role. Despite this shortcoming, the orthodox view did not show any concern about the possibility of crises in the first booming phase of the 1990s. The Mexican crisis showed that the lack of concern was grossly unjustified.

Since, the orthodox view and the IMF adopted a preference for floating exchange rate regimes. Yet, the IMF kept its intellectual and financial support to Brazil and Argentina, despite the fact that these countries continued operating with fully liberalized capital accounts and fixed exchange rate regimes. The concern about the possibility of crisis increased in these cases, but the preventive role was assigned to monetary policy: a restrictive policy in the case of Brazil, and a "currency board" in the case of Argentina. Yet, those policies could not avoid the Brazilian (1998) and Argentine (2001) crises.

The adoption of pure floating exchange rate regimes was the main policy change adopted by the orthodox view in the 1990s. The change addressed exclusively the prevention of crises of the kind experienced under fixed exchange rate regimes. But the change was minimal with respect to the regimes previously supported. After the realization that fixed exchange rates were not compatible with capital flows volatility, minimal changes congruent with the orthodox perspective were adopted. The newly adopted regime has been conceived with a defensive attitude: it was meant to preserve the full financial liberalization at all cost in light of the apparent volatility of capital flows.

In a pure floating exchange rate regime there is of course no exchange rate policy. The monetary policy is isolated from the balance of payments. Its focus is on internal targets. According to the orthodox and IMF perspectives, monetary policy should focus exclusively on inflation. Monetary policy should be implemented with respect to quantitative monetary targets or, in recent fashionable policies, with respect to an inflation target.

The pure floating and monetary rule regime performs some crisis prevention functions that are not present in a fixed exchange rate regime. In exchange for performing these functions, however, the full financial openess, floating exchange rate and inflation targeting regime has an important negative attribute: the volatility of capital flows is transmitted trough the volatility of nominal and real exchange rates and relative prices, with adverse effects on growth and investment.

Under this regime, macroeconomic policies completely neglect real objectives, such as employment, activity levels and the real exchange rate, as an intermediate target for real and balance of payments objectives.

The parallel histories of financial globalization – allowed and induced by the liberalization reforms – and orthodox macroeconomic regimes led to a paradoxical situation. On the one hand, the integration into the international financial markets has become an important source of volatility. On the other hand, the macroeconomic policy regime was mainly focused on inflation control and on the prevention of balance of payments crises, in a defensive attitude towards external volatility but giving priority to the preservation of free capital mobility, while other objectives were lost along the way.

In this paper, we present a macroeconomic policy regime proposal focused on growth and employment that represents an alternative to the regime promoted in Latin America by the IMF and orthodoxy. A competitive real exchange rate, as an intermediate target, is an essential component of the policy proposal.[2] The paper is organized in two sections. In section 2, we begin by proposing a brief stylized picture of traditional macroeconomic policies in Latin America followed by a synthesis of the proposed regime. We add a concise exposition of the relationship between the real exchange rate and employment. Section 3 presents the macroeconomic regime proposal and discusses some possible objections from the mainstream or orthodox approach.

2. The tradition of macroeconomic policies in Latin America and a way to overcome it

Macroeconomic policies were originally conceived in developed countries to boost depressed economies and to rapidly increase employment. Macroeconomics itself, as a

separately discipline within economic science, was born with Keynes in the search for theoretical foundations to public policies to fight unemployment.

For a long time now, fiscal and monetary policies conserved their original features. When they became a permanent practice of governments in developed countries after the Second World War, the objective of these policies was to preserve full employment, preventing the economies from recessions and the rise in unemployment. Macroeconomic policies were then named stabilization policies, emphasizing the anti-cyclical function that they had to accomplish – cushioning the real cycle of activity and employment.

The anti-inflationary function of macroeconomic policies was incorporated later as a new objective, in addition to the stabilization of employment. In turn, monetary policies started to gain weight as the main policy instrument. Two trends developed since then: one in the field of targets and the other in the field of instruments. The anti-inflationary target moved the employment objective to a secondary position, while monetary policy became established as the macroeconomic policy *par excellence*. Both trends are universally verified in developed countries, although there are differences in the relative importance attributed to the different objectives and instruments according to countries and circumstances. In the current version of inflation targeting, stabilization macroeconomic policy limits itself to one sole anti-inflationary goal and is exclusively performed by the monetary policy.

In contrast to developed countries, there is no tradition of macroeconomic policies focused on employment in Latin America. Generally, balance of payments stabilization and inflation control were always the main goals of those policies. Inflation, which used to accelerate as a consequence of currency devaluations in the balance of payments' adjustment phases, became the main goal when the external restrictions were loosened. In most cases, the employment target of macroeconomic policies was subordinated to the achievement of the more pressing goal of curtailing inflation and stabilizing the balance of payments.

Employment targets not only lack of tradition in Latin America, but also lack legitimacy. They are simply discredited. Some experience with explicit employment and income redistribution targets that resulted in inflationary and balance of payment crises, which then gave rise to tough adjustment policies, originally contributed to this bad

reputation. Quite frequently, expansionary fiscal and monetary policies that would initially give good results in terms of economic activity and employment, soon would result in poor performance in terms of the external sector and inflation, thereby ending up in crisis.

Those populist experiences paved the way for the discrediting of policies focused on employment. But this only led to false rhetoric. Indeed, other failed experiments that had nothing to do with populism nor were focused on employment simply contributed to this view. For instance, the IMF and analysts with neoliberal perspectives have systematically attributed the frequent crises during the financial globalization period – commonly associated with exchange rate appreciation and high external deficits – to othodox fiscal policies that were not sufficiently orthodox. The difficulties in stabilizing the Latin American economies during the period of external debt renegotiations and financial rationing of the 1980s were also attributed to similar causes. In this way, all crises are grouped together and are explained by the lack of discipline, impotence or irresponsibility of governments – populism. According to this vision, all crises and macroeconomic instabilities in the end are the result of governments that either do not accept or are unable to implement the bitter orthodox remedies – i.e. more unemployment.

There is also a highly simplified and mistaken interpretation of macroeconomic policies – widespread among opinion makers and politicians – that make the formulation of policies focused on employment difficult. This interpretation is consistent with the false rhetoric mentioned above. Macroeconomic policies in favor of employment are trivially associated exclusively to expansionary monetary and fiscal policies.

This interpretation is false since it ignores exchange rate policy. The macroeconomic instruments are the fiscal and monetary policies and the exchange rate policy. All three instruments interact and affect the balance of payment, the prices, the activity level and employment. Moreover, a consistent policy focused on employment does not assume that the constraints and objectives related to the balance of payment and inflation should be left aside. Macroeconomic policy must be consistently formulated in its three components and, certainly, taking into account the coherence of objectives.

The influence of the evolution of both macroeconomic theory and policies in the developed countries must also be mentioned among the difficulties in formulating a policy focused on employment. This influence operates throughout the views that prevail in the

international financial organizations and throughout the economic ideas of the political leaders in the developed counties – who have significant influence in the orientation of those organizations On the other hand, the theory also contributes to define the vision of the economic opinion makers at the international level, such as the private sector analysts and specialized journalists. Lastly, the prestige of academic centers and technical organizations in the developed countries has a significant direct influence over the views of local economists.

As an example of this influence we can quote the modern policy of inflation targeting. This policy implies the extreme reduction of the macroeconomic policy – monetary policy – to one sole anti-inflationary objective. Regarding the evolution of monetary policy, inflation targeting represents one step forward with respect to the quantitative monetary targets policy, since the latter faced implementation difficulties due to the emergency of unpredictable monetary innovations. The most general theoretical foundation of the monetary policy exclusively focused on inflation, both of inflation targeting and its precedent, is the hypothesis that the labor market spontaneously tends to the 'natural rate of unemployment'. Yet, Latin American central banks could hardly cite that argument as a base for the application of that policy, since the hypothesis is clearly false in the region[3] Nonetheless, inflation targeting is still promoted.

Alltogether, the lack of tradition, the bad reputation and the influence of both the mainstream theory and policies from developed countries amount to a colossal obstacle for the formulation of macroeconomic policies focused on employment. The accomplishment of this objective requires a deep conviction by the political authorities as well as the concentration of the capacity of analysis, formulation and control of the exchange rate, monetary and fiscal policies at a high level of decision-making power.

A pro-employment macroeconomic policy in brief

The challenge is to develop a macroeconomic policy regime focused mainly on employment and growth, capable of performing precautionary functions against crises and macroeconomic instability. It must be consistent with financial globalization – it is neither possible nor desirable to completely close the economy to capital flows – and its precautionary functions must take into account the volatility of capital flows.

The preservation of a competitive and stable real exchange rate – as an intermediate target of macroeconomic policies – focuses these policies on the employment and growth objectives, although they also focus on the balance of payments. In this respect, it performs precautionary functions against unsustainable current account and external debt trends. Certainly, to reach and sustain a competitive real exchange rate does not exhaust the policies' objectives. Inflation control must be added, since the objective of reaching the highest growth rate must be consistent with the available resources. The highest feasible growth rate and a competitive real exchange rate make up the objective of employment growth. Thus, the set of objectives that macroeconomic policies must follow in this regime is complete. This is a macroeconomic policy regime focused on multiple objectives with a stable real exchange rate (RER) as an intermediate target.

Obviously, there is some conflict between the objectives. The intermediate target and the objective of controlling inflation are placed in order of importance, and they set the stage for restrictions of the exchange rate, monetary and fiscal policies. There is no segmentation of objectives and instruments in this regime. The policies must be formulated as a whole so as to guarantee the consistency of the intermediate target and the objectives. The demands that the simultaneous achievement of the real exchange rate target and the inflation control imposes on fiscal and monetary policies warrant that the latter carry out preventive functions against undesirable trends – recessive or expansionary – in the financial sector and aggregate demand.

The real exchange rate and employment

The preservation of a competitive RER plays a central role in the proposed regime. We do not have the space here to fully justify it, but a brief explanation deserves to be presented.[4] The real exchange rate affects the employment throughout three different channels. The first is the macroeconomic channel, which results from the role played by the real exchange rate in the determination of the activity and employment levels in the short run. A competitive real exchange rate leads to higher net exports and consequently to higher demand on local activities and higher output and employment levels.

The second is the development channel. This results from the influence of the real exchange rate on the economic growth and, consequently, on the speed of new job creation. A competitive real exchange rate involves the distortion of domestic relative prices in favor of tradable activities against non-tradable activities: the combination of higher protection for local activities that compete with imports with a higher competitiveness for export activities. Consequently, the real exchange rate affects the employment growth rate in the long run due to its influence on the output growth rate, through its incentive on investment in tradable activities that accelerates productivity growth and generates positive externalities in other sectors.

The third is the labor intensity channel, which refers to the influence of the real exchange rate on labor intensity in the economic processes; i.e. the influence of the real exchange rate on higher job generation, given a certain activity level or output growth rate. A competitive real exchange rate increases the labor intensity of output, mainly in the tradable sector – but also in the non-tradable sector. This channel is singularly relevant in countries where most capital goods are imported, as is the case in Latin America.[5]

A macroeconomic policy regime with a stable RER as an intermediate target

In this section we present the basic features of a macroeconomic policy regime with a stable RER as an intermediate target. We argue that such a policy is viable and manageable. But we also believe that orthodox objections are also worth taking into explicit account, because of the weight these ideas have in the academic mainstream, the IMF and many countries. The confrontation with such views contributes to the presentation and defense of the proposed regime. In order to do so, we present first the orthodox arguments against RER targeting. Then, we present the exchange rate and monetary policy components of the regime and discuss the orthodox objections.

The orthodox arguments against RER targeting

It is worth mentioning in the first place that a stable and competitive RER target does not attract too much criticism by itself. Few people in both the mainstream and heterodox

thinking deny the beneficial aspects of stable and predictable relative prices and the positive development role of competitive exchange rates (Frenkel, 2004). In some cases, welfare arguments against public intervention in the exchange market are raised. But the optimality of the free market determination of the exchange rate and the argument that the public sector has no informational advantage over the private sector are not very appealing ideas in the specialized discussion over exchange rate regimes and policies. The apparent volatility of capital flows and the instability and unpredictability of free-floating exchange rates greatly lessen the relevance of those ideas (Frankel and Rose, 1995).

Moreover, the free-floating exchange rate indeterminacy and unpredictability is precisely the deeper foundation of both the need for managing the exchange rate and the government ability to do it (Blecker, 2005; Taylor, 2004, chapter 10). This is particularly true in countries in which the real exchange rate plays a crucial role in economic performance.

Given the lack of theoretical foundations and empirical evidence on the RER determination in the short run, the orthodox objections that are relevant for economic policies formulations are based on the impossible trinity argument (or trilemma).[6] It says that it is impossible for a country to simultaneously maintain free capital flows, active monetary policy and an ability to control the exchange rate. One of these features is necessarily impossible.

The impossible trinity is a logical argument, a textbook theorem lying behind the orthodox objections. As a general conjecture valid in every circumstance the trilemma is obviously false. The conclusion that the central bank cannot determine both the domestic interest rate (or determine the monetary base) and the exchange rate in a free capital flows context (provided that domestic and foreign financial assets are not perfect substitutes) is derived from the hypothesis that the central bank does not (can not) implement changes in the composition of its own portfolio (the assets and liabilities of the central bank) in compensation for the changes in the domestic portfolio caused by private capital flows (Lavoie, 2001 and Taylor, 2004; chapter 10). The hypothesis is not valid in many cases. For instance, in a developed country, a central bank holding a substantial amount of foreign and domestic assets, able to easily sale or buy foreign and domestic assets in the local and

international markets (i.e. the US Federal Reserve) can normally perform the mentioned compensatory operations.

Developed countries' central banks other than the US Federal Reserve enjoy similar policy degrees of freedom, although they differ in cases of capital inflows and outflows. The degrees of freedom in compensating for capital inflows are higher because in this case the central bank has a practically unlimited capacity of selling government bonds or issuing central bank papers in the domestic market (although the operation's fiscal or quasi-fiscal costs have to be taken into account) (Bofinger and Wollmershäuser, 2003). On the other hand, the compensation of capital outflows is more limited because it could be constrained by the stock of foreign reserves or by a limit in the amount of bonds that the central bank can sell in the international market.

So, the trilemma is false as an assertion valid in every circumstance. But even developed countries' central banks cannot always perform the compensatory operations. For instance, the distinction between inflows and outflows points to that limitation. We can imagine that even the US Federal Reserve – hypothetically pursuing both exchange rate and interest rate targets – could be forced to devalue the dollar or raise the interest rate if confronted with huge capital outflows.

With respect to the ability to perform operations intended to compensate for the effects of capital flows, the central banks of emerging market economies – developing countries open to capital flows – generally have less degrees of freedom than central banks in developed countries. One reason for that difference is that in developing countries the amount of central bank assets – foreign reserves and domestic assets – and the size of the domestic financial market – in a broad sense, including money and bank liabilities, as well as other financial assets – are relatively small vis-à-vis the size of capital flows. It should also be mentioned that in Latin America the opening of the capital account in many cases has been implemented as part of structural reforms and stabilization policy packages, after financial and external crisis and/or high inflation periods that caused the shrinking of both the domestic financial market and the assets and foreign reserves of the central banks[7] (Frenkel 2002, 2003).

The objections raised by the orthodoxy in the discussion of RER targeting policy in developing countries have the the local financial markets as its implicit setting. So,

although the objections are incorrectly based on the trilemma, they point to true problems in the management of exchange rate and monetary policies posed by an open capital account in the financial globalization context. The objections point to the implementation difficulties that exchange rate and monetary policies confront in such setting.

One way to express the orthodox argument is the following. Targeting the exchange rate implies a central bank intervention in the exchange rate market. In doing so, it is argued, the central bank losses its ability to control the money supply. So, targeting the exchange rate and controlling the money supply can be simultaneously pursued only if capital flows are regulated (the trilemma). However, the regulation of capital flows is undesirable and probably ineffective, because the private sector innovative capacity is greater than the public sector regulatory ability. The orthodox conclusion is that central banks have to avoid intervening in the exchange market.

Another way to reach the same conclusion is by focusing the argument on controlling inflation. If the interventions in the exchange market target the RER (instead of the nominal exchange rate), no nominal anchor remains for the public to configure inflationary expectations. Since the central bank cannot control the money supply, the inflation rate is completely out of control.

As we mentioned above, the exposed orthodox arguments do not involve logical necessity. But they actually point to practical implementation possibilities. Leaving aside institutional constraints on the central bank ability to perform compensatory operations, the practical possibilities depend on the magnitudes of the quantities involved. For instance, central bank exchange interventions are a source of money creation, but central banks have other instruments to control money supply. The control ability of the central bank depends on the size of the intervention vis-à-vis the practical limits of sterilization and other compensatory instruments.

On the other hand, the size of the central bank’s intervention depends on the magnitude of international currency excess supply or demand in the exchange market. International currency flows depend on the capital flow volume. The flows also depend on exchange rate expectations and consequently, can be influenced by the monetary authority’s behavior and signals.

Also the ability to control capital flows is a matter of degree. Some capital flows are easier to regulate than others. Regulations do not need to be implemented once and for all; they may be implemented only in certain periods or can be made contingent to transitory circumstances. Besides, it is simply not true that capital flow regulations are always ineffective.

The degrees of freedom of a RER targeting policy is a practical matter that has to be assessed in each case, taking into account the context and circumstances of the policy implementation. We will go beyond the general considerations and discuss more in depth the orthodox objections while presenting our exchange and monetary policy proposals.

The exchange rate policy

Central bank interventions in the exchange market are intended to maintain a stable and competitive RER. The main objective is to signal the stability of the RER in the medium and long term. The emergence of appreciation trends should be avoided for two reasons. Firs, it is to avoid self-fulfilling bubbles that increase the monetary “costs” of buying interventions. Second, the effects of expected trends in the RER are not symmetrical. Some countries have experienced long appreciated RER periods that harmed the profitability of tradable activities, and made many of them non-viable and forced many firms to close. Investment in tradable sectors is mostly irreversible. Consequently, there are reasons to give high weight to the appreciation risk. To reduce the perceived risk of appreciation is crucial in order to incentive investment and employment in tradable activities.

The preservation of RER stability does not mean the short run indexation of the nominal exchange rate to domestic prices. The flexibility and advantages of floating nominal exchange rate in the short run should be also preserved. So, central bank interventions in the market have to achieve two conflicting targets: they have to prevent the formation of RER appreciation expectations and they have to allow the nominal exchange rate to float in order to de-incentive short term speculative capital flows. The interval of interventions has to be narrow enough to perform the first function and wide enough to perform the second.

The so called “crawling-bands” policy rule – implemented in Chile in the early nineties – attempts the conciliation of the two mentioned targets by issuing long term RER stability signals while preserving short term nominal rate uncertainty.[8] Its implementation is possible. But the recent experiences of exchange rate rules leading to disasters have surely impaired the credibility of any exchange rule. Taking recent histories into account, it seems better to avoid rules announcements and commitments and deliver signals in implicit ways, throughout the central bank interventions in the market. Nevertheless, in order to contribute to the expectations formation, it is important that the central bank and the government make clear the important role given to the competitive RER in the country’s development strategy, even if it does not imply any formal commitment.

The exchange market behaves like an asset market. Buying and selling decisions are mostly based on expectations. If central bank interventions and signals stabilize expectations around the stable RER – a necessary condition for that is the consistency of monetary and fiscal policies and the robustness of the external sector accounts – the market forces by themselves will tend to stabilize the rate. The monetary “costs” of central bank interventions will be lower and fewer interventions will be required. For this reason, the central bank market interventions should be firm, in order to clearly show to the market the willingness and strength of the monetary authority.

The exchange market and the capital flows

It is implicit in the above presentation of the exchange policy that the buying and selling flows of international currency are manageable. This means that the central bank can manage the compensation of the money contraction or expansion resulting from the exchange market interventions, in order to maintain the money stock fluctuations between tolerable limits.

In the discussion of this issue, it is convenient to analyze situations of excess supply and demand of international currency separately.

The orthodox argument against RER targeting focuses mainly on an excess supply situation that makes exchange interventions unmanageable.[9] If capital inflows are massive – up to the point to make monetary policy unmanageable – the orthodox argument is right.

But in this situation it would have little sense to risk macroeconomic stability in order to preserve the capital account full openness principle. The preservation of the macroeconomic policy regime requires in this case capital account regulations, intended to restrict capital inflows and facilitate the management of exchange and monetary policies. There is a menu of measures able to accomplish this function.[10] The orthodox argument about the lack of effectiveness of restraining policies is not true. They do not work perfectly well, but they contribute to soften capital inflows in a booming situation. The need for restraining policies is not permanent, they have to do their job only in a booming phase, and we now know well that booming phases do not last forever.

Let us consider the excess demand situation. There is an excess demand for international currency that is not manageable with the normal exchange and monetary policies. In order to sustain the exchange rate, the market intervention would cause an excessive monetary contraction and the rise in the interest rate - triggering recession. The defense of some nominal exchange rate may risk a speculative attack on the central bank reserves. The situation has similarities with a fixed exchange rate regime crisis. But there is also an important difference. If there are no fundamental reasons[11] to expect devaluation – generated, for instance, by an important balance of payments deficit expectation – then fiscal and monetary policies are consistent with the targeted RER, and inflation is under control. In this sense, the macroeconomic policy regime should be preserved. This would only be possible in this situation if exchange controls and restrictions on capital outflows were imposed[12] If, as we assume, there are no fundamental reasons inducing the excess demand for international currency, there is no need for the controls and regulations to last for long.

The orthodoxy and the IMF reject capital outflow regulations with particular emphasis. There is an implicit argument lying behind this rejection that is deeply rooted in the orthodox view about the way markets operate. A priori, this view does not consider the possibility of a foreign currency run that is not motivated by fundamental reasons. In such a situation, there should be fundamental reasons explaining the agents' behavior, even if the authorities and the IMF officials do not detect those reasons. But it is evident that runs without fundamental motivation can take place. For instance, the bankruptcy of an important bank or the uncertainty generated by a political crisis may trigger runs. The

financial globalization context has broadened the possibilities of capital outflows triggered by international contagion.

Monetary policy

In a stable and competitive RER macroeconomic regime, monetary policy could no be exclusively focused on inflation. Monetary policy has to be simultaneously focused on RER, the control of inflation and the activity level.

To propose a monetary policy with multiple objectives conflicts with the orthodox and IMF orientations, according to which inflation should be the only objective of monetary policy (with a preference for inflation targeting) and it has to be managed by an independent central bank with a narrow inflation control mandate.

The technical orthodox reason for the independence of the central bank is to enhance the credibility of monetary policy. To prescribe an exclusive inflation focus for monetary policy is not a direct consequence of the orthodox impossibility argument, discussed above. With controls on capital flow, or in a pure floating exchange rate setting, the trilemma says that an independent monetary policy is viable. Why should it be exclusively focused on inflation? There are different technical arguments justifying an exclusive focus on inflation, but in essence they are all based on the "non-accelerating inflation rate of unemployment" (NAIRU) hypothesis.

Beyond the orthodox technical arguments, within the foundations of an exclusive inflation focus for monetary policy and a narrow mandate for an independent central bank, lies a deep distrust about the ability of governments to take care of inflation and submit themselves to monetary discipline.

It may be true that an independent central bank with a narrow mandate enjoys more credibility in the eyes of the average market opinion. But the cost of reaching the highest credibility in shaping inflationary expectations is the loss of monetary policy as an instrument for attaining other targets, such as the RER and the activity level.

So, in the proposed regime, the central bank should have a broad mandate. Monetary policy has to be formulated jointly with the rest of macroeconomic policies and

the implementation frequently coordinated. In any case, central bank independence should help strengthen the credibility of both exchange rate and monetary policies.

Let us add two other comments before focusing on the management of monetary policy, both related to inflation. The first point is to show that the proposed regime performs a preventative role with respect to inflation acceleration. In Latin America and in other developing economies, the exchange rate is the main transmission mechanism of monetary impulses to the inflation rate.[13] The RER target precisely encourages the central bank to implement monetary policies that avoids fluctuations that affect primarily the nominal exchange rate and cause RER fluctuations. In contrast, for the same reason, an exclusive inflation focus of monetary policy generates incentives towards RER appreciation.

The second comment relates to the contexts in which the proposed regime would be implemented. For instance, in Latin America as in other parts of the world we are fortunately far from the high inflation contexts that justified the primacy of inflation controls. These contexts helped give inflation control a hierarchy similar to the other objectives of monetary policy.

Let us now turn our attention to monetary policy management. This refers to the normal operations that the monetary authority can implement to compensate for the interventions in the exchange market, if necessary. Out of the extreme situations discussed above, the monetary authority can manage different instruments for that purpose.
The most common is the sterilization operations. They consist in the selling of public sector or central bank papers with the objective of money absorption. They imply a financial cost to the treasury or the central bank, proportional to the difference between the interest rate of those papers and the interest rate earned by the central bank's international reserves. But the net result of the sterilization operation also depends on the effects of prices and interest and exchange rates on the values of the assets and liabilities of the central bank. For instance, if the nominal exchange rate increases at a rate equal to the difference between the local and the international interest rates, the net result is nil (Bofinger and Wollmershäuser, 2003).

In more general terms, the set of instruments that the central bank can manage depends, on the one hand, on the particular institutional setting and, on the other hand, on

the relative size – vis-à-vis the size of the financial market – and structure of the central bank assets and liabilities. For instance, a central bank in possession of a significant amount of bank debt can manage it as an instrument for monetary control (Lavoie, 2001). The public sector deposits in the central bank can be used in analogous way.

Some prudential regulations can be oriented to the same target, particularly when the problem is to constraint money expansion. For instance, the central bank can raise the cash requirements of the banking system. Higher cash requirements imply a lower expansionary effect of the central bank basic operations in the exchange market. Other prudential regulations can be directly focused on smoothing the selling pressure in the exchange market. For instance, if local banks are not allowed to back credits in domestic currency with liabilities in international currency and credits in international currency are limited, there are fewer incentives to the banks procuring of international funding.

The existence of public banks with a significant share of the financial market can facilitate the monetary management. The public banks can be coordinated in order to help the central bank in both the management of the liquidity and the exchange market interventions.

Central bank operations oriented to neutralize or attenuate the monetary expansion resulting from its exchange market intervention may have incremental effects on the interest rates. In occasions, those effects may constitute an additional incentive to capital inflows, frustrating the main purpose of the sterilization operations. In this regard, the effectiveness of sterilization policies obviously depends on the exchange market selling pressure magnitude. If the above-mentioned operations do not suffice – given the size of the supply in the exchange market – they should be reinforced with restrictions on capital inflows, or other measures intended to directly reduce the selling pressure in the exchange market.[14]

The management of these instruments should allow the central bank to keep money expansion under control. But there is another crucial problem: the demand for money is usually highly uncertain. This is particularly the case in developing countries. In these cases the evolution of money demand may be particularly uncertain because money demand is growing at an unknown pace along the development process. Other situations in which the demand for money is highly uncertain are not unusual in developing countries. For

instance, when a remonetization process is taking place in a recuperation phase following a crisis.

It should be emphasised that the same problem also affects monetary policy that focuses exclusively on inflation and implemented by quantitative money targets. This uncertainty about the money demand is precisely the main motivation to abandon the traditional money quantities policies and adopt fashionable inflation targeting policies[15]
In the proposed regime, monetary policy has multiple objectives, as was mentioned above, and it falls victim to the same uncertainty problem suffered by other monetary policies. So, in accomplishing its ample mandate, the central bank requires frequent assessments of the country macroeconomic evolution and enough policy discretion – in opposition to rigid rules - to operate throughout all its instruments. Even if it is an independent institution, the central bank measures should be coordinated with other governmental policies.

Conclusion

The combination of a fully opened capital acount, pure floating exchange rate and inflation targeting monetary policy is the set of policies recommended in Latin America by the IMF and the othodoxy. This combination has two important negative attributes. Firstly, the volatility of capital flows is transmitted trough the volatility of nominal and real exchange rates and relative prices. Secondly, the inflation targeting sets a bias towards exchange rate appreciation, with negative effects on employment and growth.

We have shown that an alternative macroeconomic policy regime focused simultaneously on employment, inflation and growth is viable and manageable. This is a multiple-objectives regime with a competitive real exchange rate as an intermediate target.

The apparent volatility of capital flows and the instability and unpredictability of free-floating exchange rates greatly lessen the validity of the "equilibrium" exchange rate notion. Given the lack of theoretical foundations and empirical evidence on the RER determination in the short run, the orthodox objections against RER targeting that are relevant for economic policies formulations are based on the impossible trinity argument (or trilemma). The trilemma is false as a general assertion valid in all circumstances.

Particularly, in a capital inflows context the central bank should not confront severe difficulties in simultaneoulsy managing the exchange rate and the short run domestic interest rate (or the monetary base). Those targets can be attained by implementing compensatory operations in the money market and regulations on the domestic financial system, reinforced, if neccesary, by regulations on the capital flows.

1 The author thanks the comments by Martín Rapetti and Julia Frenkel.

2 Similar proposal are promoted by other economists in the region. See, for instance Ocampo (2004), Galindo and Ros (2005), in the case of Mexico and Barbosa (2005), in the case of Brazil.

3 Labor markets in the region are segmented and heterogeneous. Many countries show permanent high rates of open unemployment and underemployment. These characteristics make the natural rate of unemployment hypothesis clearly inappropriate as a description of the labor market behavior.

4 For a detailed presentation of the growth and employment roles of the competitive RER see Frenkel (2004) and Frenkel and Taylor (2005).

5 A formal model and empirical evidence are presented in Frenkel and Ros (2005).

6 For a recent presentation see Obstfeld, Shambaugh and Taylor (2004)

7 We should emphazise that our discussion in mainly focused on the problems posed by capital inflows. It should be mentioned that most of the discussion about the management of exchange rate and monetary policy in a context of capital mobility is centered around capital outflows, while capital inflows deserve much less attention. See for instance Canales-Kriljenko (2003) and Canales-Kriljenko, Guinaraes and Karacadag (2003).

8 This is similar to "the BBC rules" proposed by John Williamson (2000). (BBC: band, basket and crawl).

9 The argument originated in the early nineties capital inflows boom.

10 Measures like those applied by Chile and Colombia in the nineties did not completely restrain capital inflows, but affected their amount and composition (see Ocampo and Tovar,

2003; and Le Fort and Lehman, 2003). See also Palma (2002) and Epstein, Grabel and Jomo (2003).

11 “Fundamental reasons” or “fundamentals” refer to the information about the economic performance as seen from the conventional perspective prevailing in the market.

12 Argentina, for instance, successfully managed exchange controls and capital outflow regulations in mid-2002, when a run into foreign currency was mainly caused by a self-fullfiling bubble in the exchange rate. The measures were gradually softened when the buying pressure in the exchange market diminished. On other experiences see Epstein, Grabel and Jomo (2003).

13 Not only in developing countries, but also in developed countries such as the United Kingdom. See UK Parliament (1999).

14 For instance, a tax on foreign currency sales collected by the bank system and reimbursed to the exporters preserves the exchange rate for exports while de-incentive other foreign currency inflows.

15 In this sense, inflation targeting is a way to ample the central bank discretion. More discretion is needed because the uncertainty problem makes quantitative money targets impractical. We also believe that central bank should have enough degrees of freedom to pursue its targets. But we question inflation targeting because of its exclusive inflation focus. Our proposal targets comprise the inflation rate, the RER and the management of aggregate demand.

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