

General Discussion: How Should Monetary Policymakers Respond to the New Challenges of Global Economic Integration?

Chair: Anne Krueger

Ms. Krueger: Thank you all. We now open up the floor for discussion, and in this group I can't imagine we won't have lots. Morris Goldstein?

Mr. Goldstein: I had a question for Guillermo Ortiz. He talked about the positive experience that Mexico has had with the floating exchange rate regime. In this connection, it's relevant to note three arguments that one often hears about dollarization in Latin America. One is that if you don't dollarize, it is very difficult and expensive to hedge. Here, Guillermo mentioned the development of the future's market for the peso. The two other arguments are that private capital markets won't give you loans in your own currency at any reasonable price and, perhaps, more fundamentally, that if you don't go to dollarization, you will not be able to get long-maturity finance, that is, you will not be able to develop capital markets at home for longer maturities. I would be interested in Guillermo's reaction to those latter two arguments and possibly also why Mexico's experience is different than that of some of its neighbors.

Ms. Krueger: Ignazio.

Mr. Visco: I have another question for Guillermo Ortiz. He said that the risk of exchange volatility discourages pure speculators, those who deal with short-term capital flows. But if this works ante,

i.e. it is successful, one might expect that actual volatility might turn out to be rather low. This was, indeed, the experience after the 1992-1993 ERM crisis in Europe for both those countries that went to floating as well as those that increased their fluctuation bands. The question is whether a similar experience should not also have been expected for Mexico, while Guillermo said, instead, that exchange rate volatility in Mexico is still relatively high.

Ms. Krueger: Ric Mishkin.

Mr. Mishkin: One of the things I think that is very important—and Guillermo Ortiz mentioned it—was this issue of pass-through as a result of exchange rate movements. It has been used as an argument for paying tremendous attention to the exchange rate, or even, in fact, fixing it. I think something that Guillermo did not emphasize—but I think that he would agree with—is that the pass-through is very regime dependent. And, in particular, we have seen that, in fact, the pass-through can vary very much, depending on the credibility of your regime and the actions taken. Indeed, one of the surprises of the Brazilian experience with their devaluation is the low degree of pass-through. Part of the elements there were, in fact, replacement of one nominal anchor, the exchange rate, with another nominal anchor and also not only saying this but actually taking the actions to do this.

With regard to Mexico, one of the things that has happened in recent years is that the credibility of Mexican monetary policy has been increasing and they have been moving to a new nominal anchor of using the inflation target; although, they've been doing it gradually. And the successes in that direction, I would suspect, will mean that the pass-through in Mexico will, in fact, decrease over time. Indeed, I have a feeling that there's some limited evidence in that direction already and, indeed, one of the reasons why this is important is that thinking that the pass-through is what it was in the past and using that as an argument not to allow the exchange rate to fluctuate I think is a terrible mistake.

Ms. Krueger: Stan Fischer.

Mr. Fischer: Both Don and Guillermo have touched on or talked about the dilemma of exchange rate appreciation occurring when you want to tighten monetary policy and getting the wrong reaction on the current account as a result. And looking around the audience here, I've counted at least four central bank governors who are dealing with that issue right now.

What I didn't hear so clearly from you all was what your conclusions were. If I can make it more specific: Have there been occasions on which you moderated what you wanted to do on interest rates to deal with domestic inflation because of current account concerns? And in the light of the answer to that, what would you advise your colleagues who are struggling with that issue right now?

Ms. Krueger: Okay. Next, back over here, Mr. Goodhart.

Mr. Goodhart: I have a question for Mr. Solans, which is that he states, perfectly reasonably, that the objective is to try to achieve a medium-term control of inflation. But in pursuit of transparency, and, indeed, accountability, I'd like to know exactly what he means by medium term. Would he quantify it? Is his horizon two years, three years, four years, "n" years, whichever number of years he wishes to choose or what?

Ms. Krueger: Okay. Mr. Berner.

Mr. Berner: Don Brash raised a question but didn't really answer it and that is that perhaps global economic integration and convergence have imparted a disinflationary bias to the world. Do you really believe that that is true? And for all of you, do you find that global economic integration does that and makes monetary policymaking easier for you?

Ms. Krueger: Roger Ferguson.

Mr. Ferguson: I have a question for Don Brash. He ended up focusing a bit on, not the market integration as being talked about, but rather banking and the fact that his banking system is so heavily

penetrated by banks from other countries. It leads to two questions. The first question is whether or not having a banking system that is so heavily penetrated by foreign banks has had any impact on the ability of the Reserve Bank of New Zealand to have monetary policy transmitted through the banking channel? And the second question is whether or not having that degree of penetration seems to have any impact, as far as you can tell, with respect to that sometimes explicit and sometimes implicit role with respect to financial stability in your country?

Ms. Krueger: David Hale.

Mr. Hale: I have a couple of questions for Guillermo. Would you elaborate more on what role the health of the Mexican banking system plays in the conduct of your monetary policy? Your banking system was devastated in 1994-1995 by the big devaluation and the interest rate shocks of that period. As we go forward, have the movements in the currency had any impact on the health of the banking system and, therefore, the freedom of monetary policy to adjust interest rates in response to changing economic circumstances?

And, again, for Don Brash, could you elaborate a bit more on how the change in your banking system ownership affected monetary policy during the last fifteen years? You had banking problems in the late 1980s that partly set the stage for the foreign takeover bids. Do you really feel less constrained now because of the change in the capital position and the ownership?

And, finally, for Mr. Solans, could you elaborate a bit more, given your exposition on the role of exchange rates in particular, in shaping your inflation target and monetary policy? You spoke in very broad terms and I think it would be helpful for us, given the nature of discussion, to get a better sense of when the exchange rate should matter, as opposed to more purely domestic inflation variables.

Ms. Krueger: At this stage, I'm going to let each of the panelists have about four minutes to respond to questions in turn, starting with Don Brash.

Mr. Brash: Let me just comment briefly on the question Ric Mishkin made about the pass-through from exchange rate movements to inflation being to some extent regime dependent. I suspect that may be right. Certainly, New Zealand, Australia, and Canada have all found less exchange rate pass-through in the last five or six years than earlier evidence would have suggested. Whether that is regime dependent or whether it's some other factor, I'm not entirely clear but certainly we have had much less than what we would have expected.

Secondly, Stan Fischer asked whether the concern about big exchange rate swings had moderated our monetary policy stance in some way. I think the answer to that is no. Certainly when we had a high real exchange rate in the mid-1990s, we also had quite a strong upward movement in property prices, which we felt was feeding through into inflation so we didn't feel able to ease up a bit. Looking at the moment where the exchange rate is very weak, the kind of Lipskey/Wadhvani paper would suggest that perhaps we should be running monetary policy a bit tighter. But I'm bound to say recent experience would suggest that tightening monetary policy in this circumstance might actually reduce the exchange rate, not in fact support the exchange rate. Certainly the increase in official rates in May seemed to have that effect.

Third point and I'll answer a couple of questions together about the impact of foreign bank ownership. Certainly, I don't think it has had any impact at all on the effectiveness of the monetary policy transmission mechanism with a floating exchange rate. The monetary base is pretty well insulated and whatever the ownership of the banks, we appear to be able to run monetary policy without much reference to the ownership of the banks.

Ms. Krueger: Okay, Guillermo.

Mr. Ortiz: With respect to the question of advocates of dollarization—that you will not get long-term financing in your own currency—let me say this, I had not mentioned this in my presentation but it's in the paper. We have been trying to develop a longer-term

capital market in Mexico. In fact, since 1995 we've issued index bonds—five-, ten-year index bonds—and recently this year we started issuing three- and five-year cetes. So, I think this is in the process of being developed.

Obviously, there are two things that help a lot. One is having a more credible inflation target so people can actually look three to five years into the horizon. And, second, is having a domestic capital market that is at least in the short-run institutionally well set. The institutional part I think is very important.

In terms of the pass-through, I think that, in the case of Mexico, the fact that the exchange rate moved only in one direction for many decades created a natural reaction. The exchange rate depreciation was just a signal that inflation was coming and so people anticipated and rose prices immediately.

Now, since the exchange rate can move in two directions, that has changed the psychology of the people tremendously. And to the extent that we are able to meet our inflation targets, we have been doing it for two years in a row, there's a little bit more credibility being gained. I suspect we really don't have a long enough statistical series to do any kind of econometric testing. But, for example, we had a spike prior to the elections in Mexico—the peso went to 10 for a few weeks—but we got absolutely no reaction. I sent the people who do the price indexes to see if they were reacting in the supermarkets, but there was zero, nothing. So, this is obviously a very anecdotal evidence, but we may be getting to a situation where the pass-through is actually getting lower.

Stan Fischer asked a very difficult question. What we have been doing, Stan, is we are trying, when we tighten monetary policy, not to give the signal that we are trying to appreciate the exchange rate to use it as an anchor, to bring inflation down and inflationary expectations down. This is something that we have been trying hard to do because one of the criticisms that we have been subject to is that—as you know, the peso has been quite strong for about a year and half now—we are, in effect, substituting anchors and going back to the

exchange rate. And this is obviously not the case. When we had the shocks in 1998, the Russian and Brazilian shocks, remember that the peso went at some points to 11 per dollar and then it appreciated when the shocks reversed.

So, the answer is that we look, of course, at the current account and we have those concerns. But, on balance, you have to be consistent. And, although, there is a cost of possibly worsening the current account in the short term, you have to send the right signals. If you want to gain credibility over time, there is no choice but to be consistent on what you are doing with monetary policy and inflation. And if the exchange rate is really floating well, let the market decide when the adjustment is needed and, hopefully, as you bring credibility and the pass-through is lower, you will achieve good results. This is the way we see it now.

Finally, with respect to banking system and monetary policy, about half of the Mexican banking system is foreign owned now. The situation is very different, so we really have no concerns whatsoever in raising interest rates as affecting the health of the banking system. The banking system has pretty much shrunk. It's half of what it was in 1994. So, this is not a concern.

Ms. Krueger: Thank you. Eugenio.

Mr. Solans: Professor Goodhart, I did not mention medium term in developing the definition of stability in our strategy, but I certainly should. I agree with you that this is an important point to take into account when considering the objectives and strategy of the ECB.

I understand by medium term a trend that has consolidated over time. One should not react mechanically if inflation goes above the definition of stability (of 2 percent in our case) for a short period of time. Furthermore, within the medium term one should consider the causes of the departure from the definition. The reaction of monetary policy should not be the same if the cause is due, for example, to overheating or to an external shock in the supply side, as is happening now with the increase in oil prices. I would prefer not to define

medium term on the basis of a specific period of time. We can agree on some conventional period, but I prefer not to refer to a specific period of time because it will depend on the circumstances.

Relating to the role of the exchange rate, the situation for the ECB is clear: we have two pillars in our strategy. The first one is the monetary pillar. The second pillar has to do with an assessment of the risks for stability and the prospects for inflation. The exchange rate obviously plays an important role in this second pillar through the impact of exchange rate on inflation, but also on other variables such as growth, etc. Of course, no central bank neglects the exchange rate and certainly the ECB does not neglect the exchange rate because it is used in our analysis in the second pillar. Thank you.

Ms. Krueger: Okay. Thank you very much.