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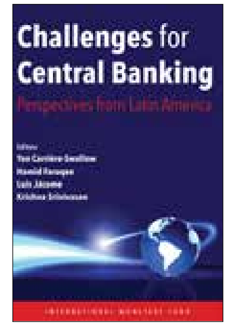

BOOK REVIEW

"CHALLENGES FOR CENTRAL BANKING: PERSPECTIVES FROM LATIN AMERICA"

by Yan Carrière-Swallow, Hamid Faruqee, Luis Jácome, and Krishna Srinivasan, editors
International Monetary Fund, 2016.

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In the wake of the 2008-09 global financial crisis (GFC), central banking and monetary policy in all regions of the world came under intense pressure as they entered unchartered waters. Since the crisis the breadth and scale of central bank operations have been modified or expanded in unprecedented and even unimaginable ways. Accordingly, a fundamental rethinking of central banking and its policy framework has been taking place.

This edited volume reflects a multilateral effort by experts and policymakers from Latin American central banks and the IMF to help close the knowledge gap required to meet the critical challenges of modern central banks, particularly in Latin America. A significant, ever-growing literature focuses on post-GFC challenges of central banking in general and in advanced economies (AEs) –the epicenter of the crisis– in particular. A much smaller literature addresses the particular challenges facing central banks in emerging-market and developing economies (EMDEs), including Latin American ones. In a not-so-recent monograph (Schmidt-Hebbel, 2011), I review central banking in Latin America, focusing on pre-GFC changes and successes, policy conduct during the GFC, and post-GFC challenges. More recently, Chinn (2016) reviews the challenges of central banking in EMDEs at large. Both papers identify several constraints that make central banking in Latin America (and in EMDEs) different from that in AEs: less developed financial markets, weaker banks, currency and debt dollarization, greater exposure to foreign shocks and domestic supply shocks, weaker policy credibility, weaker monetary independence, fear of floating. Against the latter features found in many (but certainly not all) EMDEs, both papers underscore how well central bank policies were generally conducted in most EMDEs during and after the GFC.

Yet important new analytical and policy issues for central banking in Latin America remain unsolved, which is the focus of this book. It comes in three parts. The first part provides an overview of the policy progress of central

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banking in the region and the challenges that lie ahead. Jácome analyzes the historical evolution of central banking since the opening of (most) central banks in the region during the 1920s. After a very long period of price instability and episodes of hyperinflation, finally central banks were able to conquer inflation in the 1990s, as a result of attaining political and operational independence, as well as of adopting institutional and policy frameworks inspired by the world's leading central banks in AEs.

Carrière-Swallow, Magud, Jácome, and Werner discuss central banks' current challenges to strengthen their capacity to attain price and financial stability. This requires institutional reforms to ensure central bank independence where it has not been granted, adopting inflation targeting where it has not been adopted yet and making it more effective where it has, making forex intervention more rule-based and transparent, and– as a post-crisis lesson–establishing an effective macroprudential policy function without impairing independence and the primacy of price stability. While it is generally easy to concur with most of the latter recommendations, one of them is potentially dangerous for monetary policy independence: the institutionalization of forex intervention by adopting rules. If rules are adopted to assure markets that interventions are limited only to exceptional episodes of exchange-rate disequilibria (like the Reserve Bank of New Zealand's intervention rule), monetary policy independence may survive relatively unscathed. However, if rules enshrine the large and daily interventions conducted by many Latin American central banks, they institutionalize fear of floating and erode monetary independence.

The volume's second part is on spillovers and monetary independence. Carrière-Swallow and Gruss analyze the latter issue by assessing correlations between Latin American and US interest rates. Although they are large, this fact can be attributed to common cyclical conditions and therefore not necessarily to domestic monetary dependence. Further strengthening of floating and inflation-targeting regimes contributes to more monetary policy independence. In a related chapter, Naudon and Yany assess the influence of long-term US rates on long-term rates in nine small open AEs and EMDEs (including three Latin American countries), reporting that the US term premium has a significant effect on long-term rates in all economies and that this effect is larger in Latin America.

Extending previous models, Parra Polanía addresses analytically two frequent questions faced by central bankers since the GFC. First, does forward guidance in the form of a public unconditional commitment to a future path of interest rates improve welfare? The answer is positive only in the most extreme case of zero–lower-bound conditions; not in normal times. Second, how should a prudent central bank react to demand shocks under conditions of measurement errors in activity, in comparison to a non-prudent central bank? The answer is: a more (less) aggressive response when market expectations are (not) forward-looking; less aggressive when the variance in the measurement error of demand shocks is higher.

The last part of the book is devoted to the key issue of the design and interaction between monetary policy and macroprudential frameworks, with applications to three Latin American economies. Roldán-Peña, Torres-Ferro, and Torres address the key question about how macroprudential policy goals should be attained in Mexico. They conclude that expanding the policy objective function by adding a macroprudential objective (volatility of a financial variable, consistent with "leaning against the wind") to the conventional monetary-policy objectives (minimization of output and inflation volatility), reduces attainment of the latter objectives. This unsurprising result leads to conclude that attainment of both monetary and macroprudential policy objectives requires separate objective functions and instruments, as predicated by the Tinbergen principle. This has been the view of many policymakers and researchers, and is reflected in the adoption of new counter-cyclical policy tools, including pro-cyclical bank provisions and capital buffers.

De Carvalho and De Castro assess actual and hypothetical combinations of monetary and macroprudential policy tools in the case of Brazil. They find that certain combinations of the monetary policy rate, reserve requirements, and risk-weight factors yield good results for the attainment of the central bank's policy goals. Finally, Castillo, Vega, Serrano, and Burga assess the interaction of monetary and macroprudential policies in Peru, an economy with significant financial dollarization, currency mismatch, and derived exposure to liquidity and credit risks derived from exchange-rate shocks. In this context, Peru's macroprudential policy, defined in a wide sense, includes forex interventions, large holdings of reserves, and higher reserve requirements on foreign currency liabilities. The authors conclude that the latter reserve requirements and other potential incentives for de-dollarization, if successful, would enhance attainment of monetary-policy and macroprudential policy objectives.

I strongly recommend careful reading of this excellent volume on the frontier practice of central banking in Latin America and the policy challenges that central bankers face under very different national conditions. What I take home from the book is that the region's central banks face serious challenges in attaining conventional monetary and new macroprudential policy objectives in countries beset by the growing pains of EMDEs. The latter pains are due to the structural (but not unmovable) features that I mentioned in this review's first paragraph. The implication of the latter is simple to state but hard to achieve: attaining deeper financial markets, strengthening domestic banks, de-dollarizing fully, over-coming fear of floating, and strengthening inflation targeting (as discussed in Schmidt-Hebbel and Carrasco, 2016). This would bring the region's countries and central banks closer to what is found in advanced commodity-exporting countries like Australia, Canada, New Zealand, and Norway.

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