

Nominal anchors: fixing expectations

Monetary and exchange rate policy

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Course outline

Nominal anchors:
fixing
expectations

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Policy discussion

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Economic and financial crises are very often crises of confidence

- in the value of a currency
- in the value of savings

Anchoring expectations is essential for macroeconomic stability:

- to facilitate transactions and contracts
- to encourage savings and investment
- to avoid long and costly financial crises

And monetary / exchange rate policy can also support growth

- indirectly by helping build confidence
- and directly by supporting the export sector.



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Purpose of this sequence 2/3

Selected indicators – Vietnam

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Table 1. Selected Economic Indicators, 2008–13

	2008	2009	2010	Est. 2011	Projections 2012	2013
Output						
Real GDP (percent change)	6.3	5.3	6.8	5.9	6.0	6.3
Saving and investment (in percent of GDP)						
Gross national saving	27.8	31.6	34.9	29.3	33.5	33.1
Private	20.8	26.8	30.0	24.4	30.0	29.3
Public	7.0	4.7	4.9	5.0	3.5	3.7
Gross investment	39.7	38.1	39.0	29.9	34.3	33.8
Private	30.5	24.6	27.9	21.4	26.8	26.6
Public	9.2	13.6	11.2	8.5	7.5	7.2
Prices (percent change)						
CPI (period average)	23.1	6.7	9.2	18.7	10.8	7.4
CPI (end of period)	19.9	6.5	11.7	18.1	8.2	6.0
Core inflation (end of period)	16.3	6.1	8.8	12.7
General government finances (in percent of GDP) 1/						
Revenue and grants	28.9	27.3	27.8	27.8	27.9	27.7
Of which: Oil revenue	6.0	3.7	3.5	4.4	3.9	3.6
Expenditure	29.4	34.5	33.1	30.3	31.3	30.3
Expense	20.3	21.0	21.9	22.0	23.9	23.1
Net acquisition of non-financial assets	9.1	13.4	11.2	8.4	7.5	7.2
Net lending (+)/borrowing(-) 2/	-0.5	-7.2	-5.2	-2.6	-3.4	-2.6
Public and publicly guaranteed debt (end of period)	42.9	51.2	54.2	48.3	48.2	46.6
Money and credit (percent change, end of period)						
Broad money (M2)	20.3	29.0	33.3	12.1	21.6	18.1
Credit to the economy	25.4	39.6	32.4	14.3	16.8	14.4
Interest rates (in percent, end of period)						
Nominal three-month deposit rate (households)	8.1	10.7	11.6	14.9
Nominal short-term lending rate (less than one year)	11.5	12.7	14.0	16.4
Balance of payments (in percent of GDP, unless otherwise indicated)						
Current account balance (including official transfers)	-11.9	-6.6	-4.1	-0.5	-0.8	-0.7
Exports f.o.b.	69.4	61.3	69.7	79.0	81.7	84.2
Imports f.o.b.	83.6	70.2	74.7	79.3	83.5	86.2
Capital and financial account	14.0	12.2	4.4	3.0	4.1	3.5
Gross international reserves (in billions of U.S. dollars, end of period) 3/	23.0	14.1	12.4	13.5	19.0	25.7
In months of prospective GNFS imports	3.8	1.9	1.4	1.3	1.6	1.9
Total external debt (end of period) 4/	32.4	41.6	43.8	40.9	41.0	40.4
Nominal exchange rate (dong/U.S. dollar, end of period)	17,483	18,479	19,498	21,034
Nominal effective exchange rate (end of period)	92.0	80.8	81.0	67.5
Real effective exchange rate (end of period)	125.7	115.8	117.0	121.3

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The “supplementary document to the action fiche and payment dossier” requires that you

- identify and describe the aims and the tools of the monetary and exchange rate policy (part 1)
- establish its success in providing macroeconomic stability and discuss further possible policy improvements (part 2)

Furthermore

- this sequence should help you discuss the monetary / exchange rate stance in supporting the development process, an important element of the policy dialog with local authorities.

Introduction: External vs. domestic peg

Mundell's incompatibility triangle

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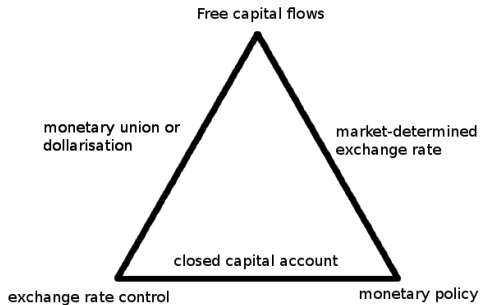
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Inflation and monetary policy

Vietnam – graph from Art IV

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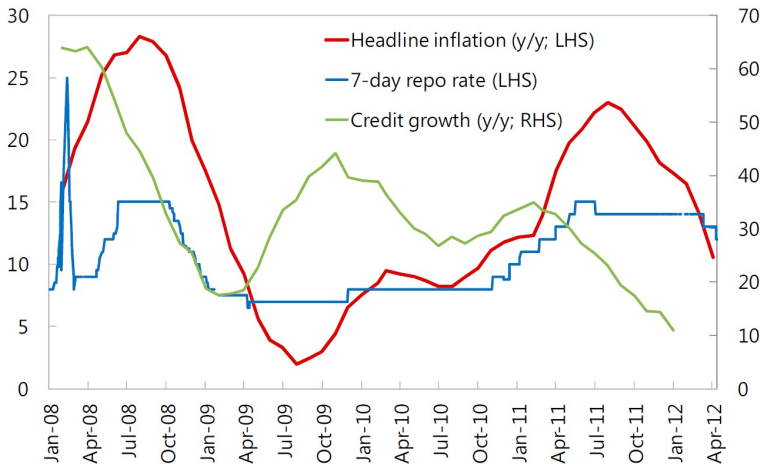
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Hyperinflation

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Defined as episodes of inflation over 50%

- usually follow chronic price instability
- long and protracted crises
- shrinks the size of the financial sector
- Argentina ended the episode thanks to
 - full currency convertibility (currency board)
 - strict institutional constraints on monetary policy
 - major fiscal adjustment

Hyperinflation

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Fiscal and monetary policies

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Fiscal and monetary policies have common motivations

- both may be used to pilot aggregate demand in the ST

... as well as different ones

- different time-horizon
- and a conflict of interest (little support for effective policy-mix)

Which generally advise for an insulation of the two categories of policies

- a straightforward economic recommendation
- which implies difficult political engineering

Monetary policy in DCs

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Complex monetary dynamics

- price stickiness (monetary inertia)
 - imperfect information about policy implementation
 - contract rigidity
 - menu costs
 - partial dollarization
- combination of monetary and prudential and financial regulation
- building credibility and communication skills



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Inflation targeting in Brazil

Source: F&D, Canales-Kriljenko, Jácome, Alichí, de Oliveira Lima 2011

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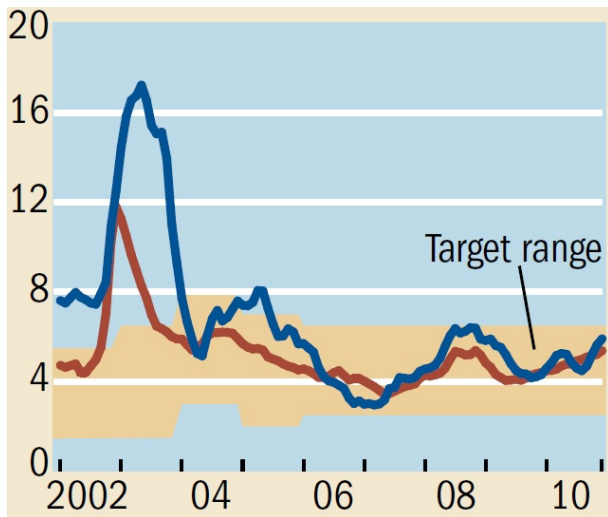
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The tools of monetary policy

Transmission mechanisms

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- The IR channel
- The wealth effect
- Wide and narrow credit channels
- Portfolio reallocation



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Implementing IT in DCs

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- need for very good institution-building – difficult policy to implement
- helps build institutions and encourages fiscal conservatism
 - \implies Threshold effect
- less vulnerable to external shocks
- domestic determinants of the value of the currency

Outline: exchange rate policy

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The exchange rate

Back to Vietnam

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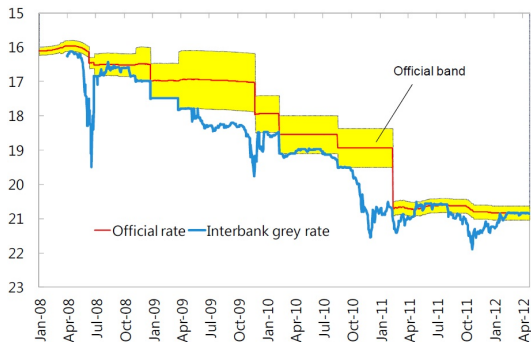
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The exchange rate is the price of a currency expressed in another currency:

- higher ER \iff weaker currency
- undervaluation \iff favorable to exporters



Getting the fundamentals right

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The exchange rate is usually set so as to reflect certain fundamentals

- Purchasing-power parity
- Goods, services, and factor income: balancing the current account
- Models with 3 goods
- Portfolio of assets and income flows

All made even more difficult by theories of ER volatility

The challenge of sustaining a given exchange rate “peg”

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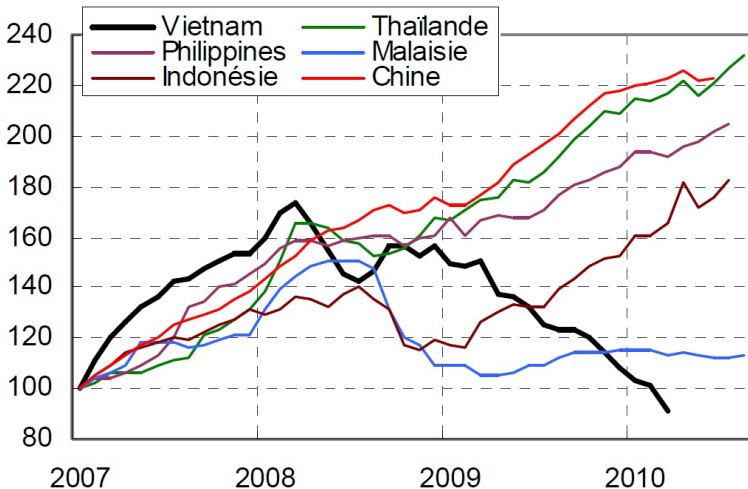
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Simplest model of financial crisis

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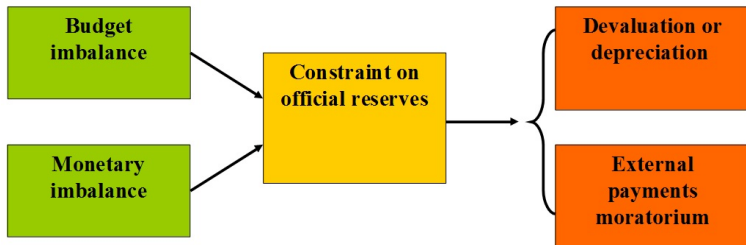
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Financial crises

The consequences of breaking a fixed ER

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Reinhart Rogoff (2009)

- unemployment rises 7 pp, over 4 years
- GDP declines 9%, roughly over 2 years
- equity prices decline 55% over $3\frac{1}{2}$ years
- real housing prices decline 35% over 6 years
- real value of government debt doubles

Several categories of exchange rate regimes

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- dollarization / adoption of another currency
- monetary union
- currency board
- fixed / crawling exchange rate
- managed float
- free float

Monetary or Exchange rate policy?

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- fine-tuning is illusory in DCs (importance of ER regime sometimes overstated)
- but different ER regimes have different benefits
 - fixed ER \rightarrow reduces the impact of financial shocks
 - floating ER \rightarrow avoids the transmission of real shocks in output
- and create different challenges
 - fixed ER: needs a conservative fiscal stance, and its failure has enormous consequences
 - floating ER (\implies inflation targeting): cannot be successful except with excellent institutions

Monetary or Exchange rate policy? Poland

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- 1990: fixed ER
- 1991: devaluation and introduction of a crawling peg
- 1995: OECD accession, partial capital account liberalization and crawling band system
- 1998: inflation under control, first inflation target
- 2000: free float

- Overvaluation of a currency detrimental to growth
- Undervaluation favorable to growth:
 - favorable to sectors which face international competition
 - tradable sector has more spillovers and returns to scale
 - tradable sector needs help when in a context of weak institutions
 - as well as in a context of market failures

- Stabilization policy – anchoring expectations
 - Inflation targeting: threshold effect
 - Pegged ER: maintain the external liquidity
- Supporting growth
 - favor the price- and cost-competitiveness of tradable sector
 - protect infant industries, ISI
 - don't worry about the nontradable sector
- do not exaggerate the importance of an ER regime
- do not underestimate the importance of
 - a sustainable fiscal policy
 - good institutions

Operational conclusion

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Part 1 of the “supplementary document to the action fiche and payment dossier” organizes ‘key indicators’

- Monetary (prices, inflation, credit, monetary stance)
- Exchange rate regime
 - Pegged ER: external liquidity
 - Non-fixed ER: depreciation / devaluations
 - terms of trade, evolution of the RER

Part 2 must include a discussion on the success of the monetary / exchange rate policy

- as a tool for stabilization
 - LT view of inflation fighting - credit containment
 - LT view of institutional capacity building
 - ST shock absorption
- as a tool for growth
 - external price-competitiveness – Dutch disease