Comments on “The Impact of the Financial Crisis on EM Regions-The Case of LA” by Molina, Serena and Gallego

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The (usual) sequence for LA

- Good external conditions
- Easy financing
- Outcomes:
  - Overheating
  - Inflation
  - ER Misalignment
  - CA deficit
  - Over borrowing
  - Crisis!!!!

Characterizing the external shock: 2008-2009

- The “exogenous” external shock:
  - Deterioration in international financial conditions (financial shock):
    - Cost of funds increases significantly
    - Reduction in capital flows
  - Reduction in world economic growth and in commodity prices (real shock)
  - Significant increase in uncertainty (real shock)

The impact of the crisis in LA

- Increase in domestic demand for liquidity.
- Significant reduction in exports and growth.
- Depreciation of the local currency.
- Credit conditions became more restrictive

Policy responses: counter-cyclical policies to some extent…

- The final effects of external shocks on the economy depend on the country's ability to implement counter-cyclical macroeconomic policies.

- In LA we have not seen much of these counter-cyclical policies in previous episodes.

- But this time seems to be different:
  - Solid international reserves position allowed rapid, strong and credible reaction
  - Liquidity provision (domestic and foreign) to banking sector
  - Rapid/Strong reduction in domestic interest rates
  - Non pro-cyclical fiscal policy

Good luck, good policies or all the previous?

- Three elements to assess vulnerability:
  - Initial macroeconomic conditions
    - Inflation
    - Fiscal deficit
    - Real exchange rate misalignment
    - CA deficit
    - Beware of structural position…
  - Macroeconomic policy framework
    - Flexible inflation targeting
    - Flexible exchange rate
    - Sustainable fiscal policy

Good luck, good policies or all the previous?

- The role of previous institutional development:
  - Lower pass-through (credibility)
  - Relatively more sustainable fiscal policies
  - More developed financial systems
  - Lower financial risks: balance sheet exposure of the private and public sector (dollarization of liabilities, derivatives position)
  - Solid and well regulated financial system

On heterodox policy…

- Do we need something else? A little bit of heterodox policy in the good times?

  - Multiple objectives or multiple instruments?
  - Financial stability in the objective function?
  - Interest rate is not the only instrument to preserve financial stability. Regulation is key.
  - Exchange rate concerns. Most monetary policy frameworks do include the possibility to exchange rate interventions.
  - The problem of multiple objectives…

Final comments

- Special circumstances require special actions…(pragmatism).
- But pragmatism (flexibility) requires credibility.
- Try to be very conventional in good times to build credibility…
- Macroeconomic policy framework must consider special situations (for example situations that justify foreign exchange rate interventions).
- But keep macroeconomic policy objectives (framework) clear and consistent.