Monetary and Exchange Rate Policy for Mexico: Key Issues and a Proposal

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Abstract
In these notes I lay out basic considerations which I believe are relevant for the design of monetary/exchange-rate policy, MEP, in Mexico. In my view, there are no ‘magic’ formulas. For some countries, an iron-clad currency board may be a desirable arrangement, while for others flexible exchange rates would be appropriate. This is so because ‘money’, unlike regular goods like bread, derives its value from convention, institutions and, more than any other good, from expectations. Thus, a key consideration in the design of MEP is the credibility of policymakers - the latter being heavily determined by history and institutions which are, by necessity, countryspecific. Section II discusses some traditional goals of MEP, while Section III examines the role of credibility and flexibility to ensure its effectiveness. Section IV studies the recent experience in Mexico and shows that the proximate case for the 1994 financial debacle was a failed attempt at interest-rate smoothing, coupled with having ignored the role of external factors. Moreover, this section briefly examines MEP after the crisis. It concludes that MEP is highly accommodative and may have contributed to the existence of a “peso problem.” The latter, in turn, may give rise to further real appreciation of the currency. Section V presents a brief summary of the pros and cons of different MEPs. This is complemented in Section VI with a discussion of other policies and considerations that are essential for the sustainability of any MEP. More specifically, I will discuss the role of fiscal policy, management of domestic public debt and the role of the financial sector. Section VII offers some ideas for a MEP for Mexico based on previous considerations. In a nutshell, I propose adopting a system of flexible exchange rates, much like the present one, but with a longer horizon and complemented with a sliding floor on the nominal exchange rate to prevent large and sudden currency appreciation. Furthermore, I argue in favor of free-floating interest rates and no controls on capital mobility, except for reserves requirements aimed at preventing sudden and sizable growth in bank credit. Comparison with present MEP and some criticisms are discussed in Section VIII. Questions about long-term goals and transition are presented in Section IX. Appendix I examines a simple formal model to rationalize the effect of the MEP after the December 1994 crisis, while Appendix II analyzes some technical implications of the proposed exchange rate rule.

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2. Exchange rates and monetary policy: how to respond? References. BIS Working Papers. No 178. Research on exchange rates and monetary policy: an overview. by Jeffery Amato, Andrew Filardo, Gabriele Galati, Goetz von Peter and Feng Zhu. Monetary and Economic Department. June 2005. Abstract. Secondly, an issue that has received little attention is the potential asymmetry in exchange rate pass-through effects between appreciations and depreciations. Work at the Bank of Italy points out that the. 7. pass-through appears to be complete following an appreciation but incomplete after depreciation. This issue is likely to receive more attention from both a theoretical and an empirical point of view.