South American Monetary and Exchange Rate Policies: Their Implications for the FTAA

William C. Gruben
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I. Introduction.

The implications of participating nations’ monetary and exchange rate policies for trade relations within the Free Trade Area of the Americas (FTAA) involve: (1) the ability of nations to come to and stay functionally within some formalized agreement; and (2) more directly, the ability of participating nations to trade with each other. However, the channels through which monetary and exchange rate policies operate upon nations’ abilities to maintain a formalized and functional agreement are very different from the channels through which these policies may affect trade directly. This paper focuses on monetary and exchange rate policies jointly because in most of the countries in the Western Hemisphere these policies are more explicitly linked than they are in the United States or in most other industrial nations.

In addressing these issues, I shall discuss the implications of alternative exchange rate regimes—including flexible exchange rate regimes, currency boards, formal dollarization, and currency bands or pegs—and what they may mean for a monetary policy focused on inflation stabilization in the context of multilateral trade agreements. However, I shall concentrate this discussion on how currency regime heterogeneity may affect the ability of nations to form and hew to agreements for liberalized trade and how particular exchange rate regimes may affect trade directly.

The broad conclusions of this narrative are that heterogeneous currency arrangements can, under some very common circumstances, impede nations’ abilities to pursue trade liberalizations and that some types of exchange and monetary arrangements facilitate trade much more than some others. Even so, the question remains as to whether the gains in trade of certain monetary regimes—particularly dollarization or common currency areas—are consistent with the sacrifices required in lost seigniorage (dollarization) or in monetary policy independence (dollarization or any other common currency program).

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Although monetary and exchange rate regimes affect trade through several channels, most discussion and training associated with this topic involves how events within these regimes affect trade. The distinction between such narratives and the issues more closely related to the effects upon trade agreements is important to make. In some important cases, however, this difference is so fine that the distinctions are really in perspective rather than in fact. Even so, the difference in perspective is also important.

In the most common discussions of the link between exchange rates and trade, countries devalue their currencies to bring an unsustainably negative current account into balance. Most such discussions of devaluation refer to increases in the number of units of domestic currency (e.g., pesos) that must be paid for a unit of foreign currency (e.g., dollars) after a protracted period of fixed or pegged exchange rates. The idea, of course, is for the prices of the home country’s products as expressed in dollars to fall enough to increase foreign purchases of these products and for the prices of the foreign country’s products as expressed in pesos to go up correspondingly.

These overvaluation-and-crash-cum-current-account-imbalance narratives are part of the explanation for Mexico’s devaluation in 1994, Brazil’s in 1999, and Ecuador’s in 1999. All of these countries seemed either to have large and widening current account deficits or strong expectations that these deficits were forthcoming. In the case of Mexico, for example, the current account deficit of the late 1980s seemed to be based partly on inflows of investment goods that reflected privatizations, liberalizations, and the overall rationalization of the Mexican economy. Mexicans began to note that while they were in fact maintaining a current account deficit, the efficiency of these investment goods was already resulting in increased exports. However, as the 1990s ensued, the composition of Mexican imports began to suggest less of a revolution in productivity through imported equipment and more of an unsustainable boom in consumer goods imports.

Nevertheless, during the 1990s an important part of both the exchange rate overvaluations and sudden devaluations—including in the countries noted in the preceding paragraph—involves dynamics in which trade's role was second to that of capital flows. As will become clear, these factors also may be seen to have important implications not only for trade but also for trade agreements.

At the end of the 1980s, the issuance of Brady bonds began to resolve serious debt problems in developing countries including Latin America. Developing countries' bad debt entries on the books of commercial banks—typically commercial banks in industrial countries—were placed on the capital markets to be traded at discounts from their original value. As the market for these securitized debts—or Brady bonds—developed, the securities markets in general began to acquire a body of knowledge about the Latin American

1. Note that even though the foregoing discussion is the most typical context in which devaluations are discussed, it is easily possible to have a devaluation under a fully flexible exchange rates. The difference is that under a truly flexible exchange rate (the term "truly" will receive more attention later), devaluations and their opposite (revaluations) may happen not only every day, but also every minute. However, the big and really sudden moves one sees when fixed or pegged rate regimes collapses are much less likely to be part of the scenery in a flexible rate regime.
economies. In addition, this increase in knowledge turned out to be applicable to markets for other non-Brady bond securities of Latin American countries (Calvo, 2000).

Meanwhile, in partial response to initiatives by the United States and by international lending agencies, many Latin American countries in addition to Mexico began to rationalize their economies by deregulating, privatizing, making efforts towards fiscal balance, and inflation reductions. In 1991, Argentina began a series of such programs underpinned by a currency board that allowed Argentines to officially use either pesos or dollars as media of exchange, stores of value, or units of account. Somewhat later the Brazilians began to rationalize their economy, although they controlled their exchange rate within a band rather than through the much more restrictive system of a currency board.

Finally, between 1989 and 1993, lower U.S. interest rates began to discourage investors from holding their money in the United States. Far more remunerative investments could be found in Latin America. Moreover, while Latin Americans acquired greater market knowledge as the Brady bond market developed less uncertainty in Latin American markets, the rationalization of these economies during the late 1980s and the 1990s lowered risk as well.

As the 1990s ensued, capital flows into Latin American countries doubled and then quadrupled. The bank lending that had been such an important part of capital flows into Latin American countries in the 1970s and 1980s was eclipsed by huge flows of portfolio capital—equities as well as fixed income securities (bonds).

It is useful to distinguish this phenomenon from what has historically been emphasized, for example, in economics textbooks. Certainly in the more basic textbooks of the past, trade has often been seen to play a dominant role in international transactions and the exchange rate relations related to them. The historical concept of these transactions was that if countries ran trade deficits, then capital inflows occurred more or less to offset the difference between foreign exchange income earned from exports and foreign exchange expenditures incurred from imports. The analogy was sometimes made to individuals who, in the early stages of their working lives, spent more money putting together a household than they earned from their work. This deficit would be made up with proceeds from loans. Later in the life cycle, these individuals would pay off their loans and begin to save, providing capital for another generation.

In the case addressed here, however, it is possible to interpret these capital inflows not as occurring to offset the difference between purchases abroad and income earned abroad. In many cases in the 1990s, the capital flows could be interpreted as rushing to remunerative investments that would increase the efficiency of these countries. Instead of capital inflows occurring as a result of a current account (or trade) deficit, it would be possible to interpret the current account or trade deficit to occur so as to offset the imbalance in the other direction that had been caused by net capital inflow.

But to the extent that capital flows dominate and current accounts or trade accounts are the passive reactors, factors affecting capital flows may be seen as having a direct effect on trade. As I shall discuss, they may also be seen as having an effect on how countries pursue and persist with trade agreements.

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2. For a fuller discussion of this issue and of push and pull factors in general with respect to capital flows into Latin America, see Calvo, Leiderman and Reinhart (1996).
In this context, an important aspect of the new capital flows into Latin America in particular and to so-called emerging markets in general in the 1990s has been their profound volatility. Two related aspects are that (1) this volatility is not determined nearly as much by trade imbalances as by issues directly related to capital markets, and (2) one of the most important causes of sudden capital outflows is the anticipation of fiscal problems that will motivate government debt monetizing.

Exchange rate cum financial crises based on what appear to be anticipations of fiscal problems have punctuated international finance with respect to developing countries at a markedly increased rate over the last decade in comparison with previous decades. This is true even though Latin American countries obviously had financial and exchange rate crises in the 1980s as well.

Fiscal problems and anticipations of them are particularly problematic in Latin America. As a result, development of financial, monetary and exchange rate crises that sometimes result in trade shocks deserve perhaps more interest there than in some other regions. Tax evasion is a common problem in Latin America, and the political causes and implications may easily be understood. Latin American countries typically have markedly more uneven distributions of income than developing countries in other regions. Indeed, Brazil appears to have as uneven a distribution of income as any country on earth. As Alberto Alesina and Dani Rodrik (1994) note, countries with great inequalities in wealth and income are commonly characterized at some points in their histories by high pressures to transfer income from the haves to the have-nots. High nominal rates of taxation are typical in these countries.3

The tax evasion problem appears to result from a lack of national consensus as to appropriate tax or expenditure levels, a problem whose roots are easy to understand in a context of income and wealth inequalities. These problems, however, create a tension or “political fiscal gap (Calvo, 2000, 10),” which politicians promise to close when campaigning for office and often fail to fulfill upon election. When they cannot extract enough taxes to pay for these programs, politicians can paper over the political fiscal gap by printing money. These tensions motivate investors to suspect that under some political circumstances sudden bursts of monetization—the inflation tax—or other surprise de facto confiscations may reduce their rates of return beyond zero.

But that is only one reason why capital market volatility is particularly acute in Latin America. In turn, large capital inflows may incite investor fears about policymakers’ capacities to handle these flows. A well-known adjunct is the Talvi effect (Talvi, 1997). Here, the capital inflow is accompanied by an increase in fiscal revenue and international reserves that create the appearance of improved financial circumstances. But the new availability of funds is only equaled—and then exceeded—by politicians’ impulses to spend, resulting in large fiscal deficits as the capital inflows ebb and then fade away.

An additional determinant of capital market volatility in this context is what has become a classic problem in private financial markets in developing countries. An important detail of private financial markets anywhere is that the liabilities of deposit-taking institutions (recall that deposits are liabilities to a bank) are often seen as contingent liabilities of the government. That is, if capital inflows result in investment or building

3. For reasons well developed in Alesina and Rodrick (1994), these inequalities and high tax rates are also negatively correlated with subsequent economic growth.
booms that are inconsistent with market realities, the resulting banking—or other financial crisis—will result in financial market assets (e.g., loans) whose market value plunges to levels far below their original or book value. Ultimately, the result is that bank liabilities are worth a great deal more than bank assets, which is the definition of technical bankruptcy. When this happens, political pressures typically result in the government’s accepting responsibility for making depositors whole. When bank losses as a percentage of gross domestic product edge into double digits and then climb farther, the fiscal implications are easy for investors to appreciate. Massive capital outflows and ensuing hard exchange rate devaluations have been seen not only in the Latin American financial crises of the 1990s, but also in those in Thailand and other Asian countries in the summer of 1997 and in Korea in the following fall.

As a consequence of all of these factors, certainly Latin America has been characterized by numerous episodes of capital outflows and devaluations including Argentina in 1991, Mexico in 1994, Brazil and Ecuador in 1999, and periodic devaluations and associated financial disturbances in Colombia and Venezuela.

Although I have noted the common perceptions of the impact of devaluation upon a country’s trade, the impact of these episodes on trade agreements are perhaps less widely appreciated. The problem with devaluations is that they increase the rate of return to expenditures by special interest groups on trade protectionism in the devaluing country’s major trading partners. In the context of a trade agreement, the impediments the injured parties may use to damage either the agreement or its effects can easily be appreciated.

To frame the above conclusions, consider a common sense notion called the compensation effect (Brock, Magee and Young, 1989), which may represent a response to a political disequilibrium. Under the theory of the compensation effect, a factor turns to politics for relief when its economic fortunes decline because the return to expenditures made on this relief increases in inverse proportion to the magnitude of the decline in fortunes (Id.).

In the context of a trade agreement, a palpable example has been the increasing strains upon the MERCOSUR Agreement—whose members include Argentina, Brazil, Paraguay, and Uruguay—in the wake of Brazil’s devaluation. Brazil and Argentina are major trading partners. As noted above, Argentina has remained in a currency board arrangement with the U.S. dollar since 1991. Prior to Brazil’s devaluation in January 1999, the Brazilian currency’s high valuation against Argentina’s peso motivated Brazil to impose import quotas on Argentine products, provoking anger amongst Argentine exporters. In the wake of Brazil’s devaluation, the Argentine currency was high in relation to the Brazilian real. The devaluation, of course, caused Brazil’s products suddenly to become cheaper in Argentine pesos and caused Argentina’s products suddenly to become more expensive in Brazilian reals.

As Argentine demand for Brazilian products increased as a result of the devaluation, the rate of return on competing Argentine industries’ lobbying or political pressure efforts for trade protectionism accordingly increased. In response to these political pressures, Argentina announced its intention to levy import quotas on textiles, clothing, and shoes. All of these products are important Brazilian exports, and they have been gaining market share in Argentina. In return, the Brazilian authorities suspended bilateral talks on automobile industry integration. Access to the Brazilian market is important to the Argentine automobile industry. Argentina then backed down from permanent imposition
of the quotas against its MERCOSUR trading partners, but insisted on temporary import quotas or export caps within the trade grouping. A MERCOSUR summit meeting in Montevideo, Uruguay failed to resolve the dispute. The Brazilians remain adamant that the imposition of any import quotas within MERCOSUR is unacceptable, even though they themselves had imposed quotas prior to their devaluation, when the Brazilian real was more distorted in international currency markets than was the Argentine peso.

Seeing these signals that pressures for trade protectionism had become *au courant*, Brazilian rice farmers from the southern state of Rio Grande do Sul in turn blocked Argentine rice imports at the border. The farmers complained that cheap rice from Argentina (where there had been a record harvest) and Uruguay (which borders on the state of Rio Grande do Sul) was undercutting their own products. Meanwhile, in response to shoe industry pressure, Argentina introduced new regulations requiring that all shoes bear "country of origin" labels. This move was seen as an effort to hinder imports of Brazilian footwear (Latin America Monitor, 1999).

An important determining factor of these clear erosions of the MERCOSUR Agreement is the relationship between the exchange rate, monetary policy, fiscal policy, and trade policy. Brazil's devaluation occurred in response to capital outflows. These outflows occurred because obvious actual current (rather than anticipated) fiscal problems had been mounting persistently and because investors had begun to suspect that they were not going to be resolved. These complications were seen as triggering fears that monetary policy would also ultimately loosen. Holders of Brazilian debt were said to fear that capital outrushes and devaluation would cause the value of their securities to drop, resulting in investors attempting to beat each other out of the country (Gruben, 1999).

The lesson these events hold for FTAA is that when heterogeneous monetary and exchange rate policies trigger currency market distortions, political pressures toward protectionism may arise. In the case above, Argentina's currency board system, in which monetization of debt under fiscal pressures would result in the destruction of the entire system since parity with the dollar would be unsustainable, had made Argentina less susceptible to sudden outrushes of capital than Brazil. In contrast to Argentina's currency board arrangement, Brazil's Convertibility Plan used a much less durable, early-nineties-Mexican-style currency band. Ultimately, Brazil's combination of a softer fiscal policy and a softer exchange rate regime resulted in a devaluation that was not matched by Argentina and had obvious consequences for trade liberalization within MERCOSUR. While Argentine and Brazilian national policies differed in many ways, their differences in exchange rate regime and behavior obviously had important impacts on the viability of MERCOSUR.

But as noted above, this was not the only episode in which MERCOSUR's trade liberalization goals were abridged by monetary and exchange rate policy heterogeneity between Argentina and Brazil. Recall that prior to Brazil's 1999 devaluation it was Brazil that imposed import quotas in response to exchange rate distortions. Similar heterogeneity in exchange rate regime, coupled with fiscal pressures, could abridge the progress of any trade agreement.
III. Common Currencies, Dollarization and Trade.

Investor suspicions of what governments might do and the capital market volatility associated with these suspicions have motivated a great deal of talk about the establishment of so-called commitment technologies to convince markets to be less skittish. A monetary/exchange rate topic that has received much discussion in this context is the common currency area and, still more narrowly, official dollarization. In a common currency area, nations by definition share one currency, perhaps one such as the Euro, which is not the currency of any particular participating country. Under dollarization, a country would exchange its foreign-currency reserves for cash dollars, trade the dollars for all domestic currency in the country, destroy the domestic currency, and use only dollars. Empirical examinations (Rose, 2000) strongly suggest that common currency arrangements (including dollarization) have strong implications for trade, and that trade in turn (Frankel and Rose, 1996) has strong implications for the viability of a common currency arrangement.

The virtues of both more general common currency areas and dollarized areas are that a country no longer risks devaluation. Investors who may try to beat each other out of a country in which they fear devaluation will not try to beat each other out of a dollarized or currency union country. One major cause of capital market instability disappears.

Moreover, the country that enters a common currency area or dollarizes surrenders its monetary policy. Dollarizing countries surrender their monetary policies to the United States Federal Reserve System. Members of a common currency area, as in the case of the Euro, give over their monetary sovereignty to a group to which they all (at least in the case of the Euro) send representatives.

In the observed cases of dollarization, and also for many currency union participants, the sacrifice of monetary sovereignty results in lower inflation and lower interest rates. Countries cannot collect inflation taxes. Because investors know this, the interest rates at which they are prepared to part with their funds tend to be lower. In addition, shared currencies seem to have marked impacts on trade between countries. After adjusting and conditioning for a large number of other factors—including, but not restricted to, common colonial histories, a common language, relative magnitudes of population, relative income factors, distance between countries, and participation in a regional trade agreement—participation in a common currency area still raises trade between two countries by more than 300 percent. While this seems large, note that McCallum (1995) quantifies the size of the intra-national bias (the bias towards trading with other political units in the same country) at twenty, far larger than Rose's effect of a common currency (Rose, 1999).

Among the problems of dollarization is that under normal circumstances nations would have to sacrifice seigniorage, the income they earn by printing paper to convert it into money, and then spending it. Common currency arrangements allow for sharing of seigniorage. Indeed, the chief argument in a Latin American context against engaging in a common currency area instead of dollarization is Hausmann and Gavin's (1998) contention that investors may not be much less skittish about the common currency of a collection of countries whose monetary policies have some histories of hyperinflation within our lifetimes than these same investors would be with the original currencies. That is, the

4. Note, however, that Sims (1999) offers theoretical circumstances under which dollarization could result in higher rather than lower interest rates.
monetary policy of the aggregation of countries may not be substantively different than the policy history of the individual countries.

An additional difficulty of both dollarization and common currency areas is that the countries that dollarize or join a common currency area may benefit at some times from monetary policies that are very different from what the United States (in the case of dollarization) will pursue or from what the central bank of the common currency area will pursue. This optimal currency area argument (Mundell, 1961) in which countries ought to join a currency union or dollarize only if their business cycles are consistent with the rest of the currency union (or the United States in the case of dollarization), suggests that many countries are not candidates for such currency sharing. However, Frankel and Rose (1996) suggest that in fact currency area optimality is endogenous, that joining a currency area will result in increased trade (Rose, 1999) and that increased trade between any two countries will result in greater harmony of their business cycle fluctuations.

IV. Flexible Exchange Rates.

Despite the virtues of currency unions, which have been proposed by Brazil for MERCOSUR, and dollarization, which has been proposed for Argentina by former Argentine President Carlos Menem as well as by current Argentine central bank President Pedro Pou, recent moves in currency regimes have been in the direction of flexible exchange rates rather than currency unions, dollarization, or currency boards, although Argentina still has a currency board. While Ecuador is moving legislatively towards dollarization and Panama has long been officially dollarized, Mexico adopted a flexible exchange rate in 1995, while Chile and Brazil adopted flexible rates in 1999. Colombia also maintains a flexible exchange rate regime.

Moreover, of all the larger Latin American economies, Mexico has enjoyed the longest period of uninterrupted growth. Since moving to a flexible exchange rate regime in 1999, Brazil and Chile have also mentioned turning around their economies.

While these countries are pursuing a flexible exchange rate policy because exchange rate flexibility allows for monetary policy independence, there are also some sacrifices particularly endemic to Latin America. Rose’s (1999) evidence suggests that flexible exchange rate regimes are not as amenable to trade as currency unions are, but this result only applies to trade with the countries that share your country’s currency. The Rose model does not address the issue of any particular nation’s overall trade. This detail is important because increased trade between two nations may not imply growth in overall trade for either country. Instead, the two countries may simply be diverting trade they used to have with another country.

However, a complication of exchange rate flexibility in the Latin American context is also an issue raised by Calvo (2000) and Calvo and Reinhart (2000). Recall the causes discussed above of exchange rate and capital flow volatility in Latin America. That is, investors are suspicious of what the government might do fiscally or monetarily. Because of investor skittishness with respect to Latin American fiscal and monetary policies, Latin American countries with flexible exchange rates typically do not pursue independent monetary policies even though the point of maintaining a flexible exchange rate is to allow them to do it. Even with exchange rate flexibility, exchange rates in Latin America are not allowed to vary much.
In addition, and very interestingly, Latin American countries with flexible exchange rates (e.g., Mexico) tend to maintain large stocks of foreign currency reserves. Under normal conditions with a flexible exchange rate, there would be no need to accumulate and maintain such stocks. After all, the chief purpose of foreign currency reserves is to use them to purchase your own domestic currency when pressures for devaluation materialize. When large capital outflows occur under fixed exchange rates, the central bank will defend the currency by using the dollar reserves to buy the domestic currency at the fixed exchange rate. Under a flexible exchange rate, that is not only necessary, but is not supposed to happen. Otherwise, how would it be possible to argue that the exchange rate was flexible?

V. Latin American Monetary and Exchange Rate Policy Overall.

The most important detail to understand of Latin American monetary and exchange rate policy is, despite its heterogeneity not only at points in time, but over time, its overall result has been marked reductions in inflation and marked increases in economic stability. The serious monetary problems of the 1980s are gone. In this context, certainly the stability that monetary policy has brought will facilitate international economic relations of which goods and services trade is clearly among the most important parts.

VI. Conclusion.

In sum, the most important aspects of monetary and exchange rate policy in Latin America with respect to FTAA are: (1) the enormous increases of monetary stability in Latin America since the 1980s, and (2) continued exchange rate policy heterogeneity across countries over time. These have resulted in exchange rate distortions that result in trade pressures that motivate protectionist pressures. As these protectionist pressures mount during distortionary periods, efforts at trade liberalization are abridged and sometimes serious. Even if the exchange rate and monetary policies on a per country basis all turned out to be optimal in the long run, the distortionary impacts they collectively turned out to have on trade liberalization in the recent past certainly suggests problems in the future for a FTAA.

On the other hand, it is clear that some types of monetary arrangements facilitate trade far more than others in any case. Common currency areas or dollarization, regardless of other types of sacrifices they impose on participating countries, seem to facilitate trade far more than other types of exchange rate arrangements, or at least seem to when we look at countries within the monetary areas. This does not prove, however, that overall trade is increased under such unions, but only that trade is increased among monetary partners.

By heterogeneity over time I refer to the propensity of Latin American countries to change their exchange rate regimes. In 1994, Mexico had a pegged exchange rate system in which the exchange rate was permitted to fluctuate within a band. Brazil adopted a similar program in 1994. In 1995, however, Mexico adopted a flexible rate system that it continues to apply as of this writing. Brazil adopted a flexible rate system in 1999. Throughout the 1990s, until 1999, Chile maintained a very unusual system under which the exchange rate was pegged in real terms and not (as in the cases of Brazil and Mexico before they went flexible) in nominal terms. Now, Chile uses a flexible rate system. Colombia followed a peg during certain parts of the 1990s and now has a flexible rate system.
Finally, in the case of Mexico, it is clear that trade has flourished despite the use of flexible exchange rates. However, it is also useful to note that the so-called flexible rates operate under a system of flexibility that is abridged by interest rate intervention on behalf of the Mexican government. Also, it should be noted that Mexico's concerns about becoming extremely flexible might be inferred by the large stock of foreign currency reserves that the country maintains. Flexible exchange rate systems do not typically have much need for large stocks of such reserves. This is to say that it is hard to argue that flexible exchange rates are optimal or close to optimal within a free trade agreement on the basis of the Mexican experience, inasmuch as Mexico's flexibility is so abridged.

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