Comments on “Monetary Policy in Developing Countries”, by Jeff Frankel

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A tour de force

- Will become a standard reference
- Encyclopedic (193 footnotes, 400+ references)
- Covers the full landscape (EM countries more than LICs), from m policy, to e regimes, to capital flows, to crises, etc.
- Would have liked slightly more formal arguments, some light algebra.

- But leaves policy makers hungry for more
- In the end, how should monetary and exchange rate policy be conducted?

State of play: Hypocrisy and confusion

- Rhetoric. Often:

  Flexible inflation targeting. Interest rate rule.
  Exchange rate only to the extent it affects inflation

- Reality. Often:

  Limit volatility and movements in the exchange rate

  Sterilize to keep monetary aggregate(s) on trend

Result. Confusion, unclear rules, and lack of transparency.

Badly in need of simple principles.

Brazil and capital flows

- Brazil (Chile, Malaysia) confronted with large capital inflows (bonds, equities).

  Likely to amplify for some time.

  How to react?

- Let the e rate appreciate?
- Decrease the interest rate?
- Accumulate reserves, to what extent?
- Combine with fiscal tightening?
- Use capital controls?

Building a model. What major imperfections?

- Terms of trade shocks
- Balance sheet effects
- Imperfect capital mobility
- Shocks to capital flows

- A model (thought organizer, further simplified...)
- IS : $Y = Y(e, r, x)$; Y_e ?
- UIP : $e = e(r, \Delta R, z)$
- Natural output: $Y^* = Y^*(e)$, $Y^*_e > 0$ (FB Y ct)
- Inflation: $\Pi_y = \Pi(Y-Y^*)$

Policy implications?

- IS : $Y = Y(e, r, x)$; $Y_{e\_}$?
- UIP : $e = e(r, \Delta R, z)$
- Natural output: $Y^* = Y^*(e)$, $Y^*_{e\_} > 0$ (FB Y ct)
- Inflation: $\Pi_y = \Pi(Y - Y^*)$

- Optimal policy. If care about (Y-FB Y) and Π_y ?
- If no restrictions on ΔR: Inflation targeting; use of two instruments: r and ΔR:

  with z shocks, constant e, constant r.
- If restrictions on ΔR, then inflation targeting suboptimal with respect to z shocks. No divine coincidence.

In guise of conclusions

- Align theory on practice
- Flexible inflation targeting
- Two instruments, not one: r and ΔR
- A million extensions. (Back to Brazil: expected path of z, degree of capital mobility, use of capital controls...)