Book Reviews

Rolf J. Langhammer and Lúcio Vinhas de Souza (eds). *Monetary Policy and Macroeconomic Stabilization in Latin America.* Heidelberg: Springer-Verlag. 2005. ix+254 pages. Hardback. Price not given.

Monetary Policy plays a crucial role in macroeconomic stabilisation of a country. Latin American countries have faced successive waves of economic instability causing hyper-inflation and currency and financial crises leading to losses in output. This book is a collection of papers presented at the conference on "Monetary Policy and Macroeconomic Stabilization in Latin America", held at the Kiel Institute for World Economics (IFW), in Kiel, Germany, on September 11-12, 2003. Well-known speakers from major multilateral policy institutions and the monetary authorities of Latin American economies participated in this conference. Graphs and tables throughout the book make for easy understanding of the main findings, as the book focuses on the recent experience of Latin American economies with designing, announcing, and implementing monetary policies with different internal and external anchors. It deals with the exposure of real exogenous shocks, high dollarisation, regulated and segmented labour market, inappropriate policies and monetary institutions, and unrest from deep financial and currency crises. The book draws lessons from European monetary integration for Latin America, and examines the role of financial integration to help reduce the systematic shocks in Latin America.

The first chapter, "Reducing Inflation through Inflation Targeting: The Mexican Experience" reviews the role of monetary policy in the disinflation process that has taken place in the Mexican economy over the last few years. The experience of Mexico is of particular importance as it represents a small open economy with flexible exchange rate regime that reduced inflation in a sustainable way. This conclusion is supported by empirical findings using a vector autoregressive analysis. The chapter shows that inflation targeting framework could not be implemented properly unless the problems of fiscal dominance and the fragility of financial stability were addressed. These require increasing transparency of central banks and a consistent interest rate response to shocks. It shows that the Mexican economy was able to reduce inflation from close to 52 percent in 1995 to around 4 percent by 2003 under flexible exchange rate regime. The measures taken after the 1995 crisis to attain a fiscal position for restoring credibility in the financial system—by stabilising the economy through monetary policy—are analysed in considerable detail.

The second chapter, “How Has NAFTA Affected the Mexican Economy? Review and Evidence”, estimates the “Latent Factor” model that provides an assessment of the impact of NAFTA on the growth and business cycles in Mexico. The authors conclude that the agreement recorded an increase in trade and financial flows between Mexico and NAFTA partners and, resultantly, it affected Mexican economic growth and business cycle dynamics. The chapter provides useful information from Mexico’s NAFTA experience to policy-makers in developing countries in the Western Hemisphere and elsewhere. It shows that bilateral and regional free trade arrangements should be used to accelerate needed structural reform in an increasingly global trading system. The chapter adds to recent research about the impact of increased trade and financial flows on the dynamics of growth and macroeconomic fluctuations in developing countries with special reference to Mexico’s macroeconomic policies during the 1990s.

The third chapter, “Argentina: Monetary Policy by Default”, provides a brief review of the developments that lead to the Argentinean crises of 2001-02. Monetary transmission in Argentina includes interest rate channel, assets channel, wealth effect channel, exchange rate channel, credit channel, bank lending channel, household balance sheet channel, expectation channel, and money channel. The chapter deals with the limited channels of monetary policy, basically the exchange rate, the expectations, and the money channels. An interest rate channel existed with the introduction of various bonds. The assets channel, the credit channel, and the household balance sheet channel were almost irrelevant. The paper shows that there are a number of technical difficulties with implementing inflation forecast targeting in Argentina. The process of recovery of financial markets and the banking system is very slow. Therefore, it concludes that return to normality will take a number of years due to the country’s foreign exchange-dominated debt.

In Chapter Four, “Do Exchange Rates Matter in Inflation Targeting Regimes? Evidence from a VAR Analysis for Poland and Chile”, the author presents alternative monetary policy strategies in flexible exchange rate regimes for Chile and Poland using generalised reaction function. These policies are used as a starting-point for an empirical investigation of the role of the exchange rate in the inflation targeting regimes. Polish monetary policy characterised by a regime change of 1990s shows a clear break where the exchange rate as the nominal anchor is replaced by inflation targeting. In Chile, monetary policy was characterised by using announced inflation targets to gradually reduce inflation. Results show that exchange targeting is not neglected completely in Poland, while in Chile inflation targeting is applied to the entire sample period, and exchange rate policy is used only in international financial disorder situation.

The fifth chapter, “Argentina and Brazil Risk: A ‘Eurocentric’ Tale”, shows that the European experience with earning rather than importing policy credibility,

using the Exchange Rate Mechanism (ERM), is relevant outside of EU or OECD membership, and suggests that it would apply especially to Argentina and Brazil in the context of a regional organisation like the Mercosur. It also suggests that the practical operation of the ERM provides important lessons to authorities in developing countries struggling to implement sustainable exchange rate regimes to support economic convergence. The difficulty is in adapting a code of conduct like that of the ERM to Latin America. The chapter provides useful information on earning credibility through regional surveillance, flexible integration and yardstick competition, and on limiting crisis vulnerability.

In the sixth chapter, titled "Macroeconomic Shocks, Inflation, and Latin America's Labour Market", the author analyses the procedure of macroeconomic volatility transmitted to the labour market. The chapter compares growth and volatility by regions, presents macroeconomic performance, and explains why Latin American wages are so flexible. Employment, unemployment, and wage Okun coefficient are estimated and used to show that Latin American countries adjust more through wages than through employment, if compared with the industrialised countries. It shows that inflation plays some role in explaining the difference between employment elasticities in Latin America and in the industrialised countries. There is a difference between these two regions that cannot be explained by the differences in inflation. Within Latin America, inflation increases labour market flexibility in countries that have a highly regulated labour market and that enforce regulations. In Latin America, crises are particularly costly for workers. The policy prescription is that the disinflation process should be accompanied by labour market reforms—by reducing wage rigidity that will reduce the cost of recessions.

Finally, Chapter Seven, "Monetary Policy Rules in Emerging Market Economies: Issues and Evidence", reviews the recent conduct of monetary policy. The chapter includes a brief review of emerging economies experience; it estimates the reaction functions, applies robustness checks, and tests for non-linear and asymmetric reactions, and show that independent monetary policy and its credibility are of great importance in this respect. The chapter also highlights the central bank's interest rate setting behaviour in selected emerging market economies. Using the standard open-economy-monetary-policy-reaction-function, it tests the reaction of the central banks to changes in inflation, output gap, and exchange rate in a consistent and predictable manner. It finds that in most emerging economies the interest rate responds strongly for some economies and the response is higher than the changes in the inflation rate and the output gap. This result depends on alternative specification and estimation methods, and the outcome highlights the importance of exchange rate as a source of shock, and supports the "fear of floating" hypothesis. The chapter finds some evidence that in some countries the central bank's response to inflation shocks is symmetric.

Each chapter in this book concludes with a critical evaluation of the papers presented in the conference. Discussants' comments facilitate the readers' grasp of the monetary issues.

Kalbe Abbas

Pakistan Institute of Development Economics,
Islamabad.