## Monetary Policy in Developing Countries – Silvana Tenreyro

This is a very incomplete summary of the Monetary Policy Workshop in London, October 22, 2011. The material builds on contributions from participants in the open discussion and in the presentations (for the latter, see in particular the material presented by Paolo Pesenti and Chris Adam).

The design of appropriate monetary policy builds on two critical ingredients: 1) a representation of the economy, characterizing technology, market structure and behaviour of different actors (households, firms governments); and 2) a normative dimension, which relies on a welfare function that summarizes the social costs and benefits from different policy actions.

A natural question is whether the current framework and methodological approach used for the analysis of monetary policy in developed countries (i.e., New Keynesian DSGE models) can be exported to the analysis of policy in developing countries. A consensual view emerged that there are important new dimensions of that need to be taken into account in the evaluation of monetary policy in developing economies. There was a healthy discussion on whether one needs to “start from scratch or whether part of the existing framework can be employed in the analysis of monetary policy in LIC”. Towards the end, agreement was reached on what are some of the ingredients or considerations that have to be part of the framework needed to study monetary policy in LIC (some might think of this as ‘starting from scratch, or fundamental deviations from canonical New Keynesian DSGE) framework/approach follows:

1. High Volatility

DSGE techniques typically focus on small perturbations from non-stochastic steady state in (log-) linearized versions of the model. But LICs are subject to high volatility related to both supply and demand shocks. There may be important theoretical non-linearities. Large movements in spreads and risk premia

1. Nature of Shocks and growth effects

A common practice in macroeconomic analysis of developed countries is to isolate the cyclical component of fluctuations. However, in LIC the trend is far from stable and can be hardly separated from the cycle. The current crisis in East Africa is a case in point: a seasonal drought has killed a sizable part of the cattle (a key asset in this economies), which will have repercussions for growth in years to come.

An important issue is whether monetary policy should factor in that countries are still far below their longer-term steady states.

Supply shocks are at least as important as demand shock (the key shock in NK models to which monetary policy optimally reacts).

1. Non-homotheticities: subsistence level

Many households in LIC live at or near subsistence levels. Contractionary monetary policies are then particularly problematic in these economies and have to be thoroughly though-through. Redistributionary measures may have to be taken along with monetary contractions.

Inequality is an important dimension in the conduct of monetary policy in LIC, both because it is much higher than in developed economies, and because a large fraction of the population is at subsistence levels.

1. International dimension

Critically, economic models for LIC should feature the international dimension, with the inherent exposure to terms-of-trade shocks, financial flows, changes in interest rates, etc.

1. The sectoral composition of the economy

Many LIC are highly concentrated in agriculture, an inherently high volatile sector, with little scope for prices to adjust to supply shocks.

1. Choice of exchange rate regime---by the economy and all other economies in the world seems critical.
2. Central banks are not necessarily independent. Fiscal dominance

The political economy of the decision making and the interaction between the fiscal authority and other interest groups deserve special attention.

1. Credibility of policy is crucial. How to build credibility is an important consideration.

Domestic debt position raises the classical incentives to inflate. Similarly, seignioriage is important in LIC.

1. Banks are the key mechanism for transmission policy. Financial repression (with interest rate caps on banks) is not uncommon. Monopolistic structure of banking system/ government-owned banks.

A rethinking of the transmission channel is needed.

A second mechanism operates through the exchange rate and it’s critical the extent of pass-through as well as the balance-sheet effects. It is not obvious that exchange-rate depreciations are expansionary, given the balance-sheet effects.

1. Credit-constrained consumers.

Financial constraints are very important and can play a key role in the transmission mechanism.

1. Partially open capital account

Most LIC have quite closed capital accounts and hence they operate under conditions of near financial autarky---in big contrast with the literature and assumptions in the international business cycle literature.

1. Data

Data on LIC are of much lower quality. Many people stress the need to improve the data collection process---and the publication of data.

1. Growth and monetary policy

Can monetary policy be part of a growth strategy? Can it play a role in the provision of credit? There were many divided views on this issue, with the ones against pointing the infeasibility of monetary policy to affect long-term growth through credit; those in favour stress the role of exchange-rate policy for exploiting potential increasing returns to scale.

1. The transmission mechanism revisited

Another important issue is the dilemma that is created when lending rates do not respond to changes in the policy rate or in monetary aggregates. This is a failure of the transmission mechanism. Work on the banking system (with its particular characteristics) was highlighted as important.

1. Related to the above, the Mobile banking revolution deserves attention. The implications it might have for monetary policy are not well understood.