

## The Impossible Duo? Globalization and Monetary Independence in Emerging Markets

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### Summary

Once upon a time it was the *impossible trinity*: countries could not have capital mobility, an independent monetary policy and fixed exchange rates all at once.<sup>1</sup> Now, according to the conventional wisdom that has emerged after the Mexican, Asian, Russian and Turkish crises, it is the *impossible duo*: you cannot enjoy free capital movements and a counter-cyclical monetary policy, regardless of your exchange rate regime. The culprit, allegedly, is *original sin*: past misbehavior keeps the country from being able to borrow in its own currency, causing a pervasive dollarization of liabilities. In that context, pundits argue, a monetary expansion accompanied by a real depreciation can do more harm than good, causing debt-service costs to shoot up while bankrupting local banks and firms. Sinful nations that suffer an adverse shock are therefore simply advised to *turn the other cheek*. Many have, from Hong-Kong in 1997 to Argentina today, with predictably painful consequences.

So much religion is allegedly uplifting, but the economics behind the emerging orthodoxy is not always clear. This paper argues the impossibility of the duo is much less clear-cut than the post-Asia discussion suggests. There are indeed situations --particularly if the economy is in the midst of a speculative attack, caused by a bout of pessimism that could be self-fulfilling-- in which a policy-induced depreciation may turn out to be lethal. But there are many others --for instance, if the economy suffers an adverse export shock-- when not allowing a depreciation may be just as lethal. An active monetary policy and a weaker exchange rate may be just what the doctor ordered if the economy is to avoid a collapse in investment and growth.

I analyze these policy options using an extremely simple model of a small open economy in which real exchange rates play a central role in the adjustment process, wages and prices are sticky,

liabilities are "dollarized," and local capitalists' international borrowing capacity is limited by their net worth. Hence all the basic building blocks are there for unexpected real exchange rate movements to be financially dangerous. The model does yield circumstances in which self-fulfilling devaluations and financial crises are possible, but also yields a potentially constructive role for exchange rate flexibility and countercyclical monetary policy.

One recurrent theme of the analysis is that a monetary expansion and the associated real devaluation affect net worth --and hence borrowing capacity, investment and growth-- through varied and possibly offsetting channels. In a nutshell, net worth depends negatively on the home output value of debt repayment, and through that channel an unexpected real devaluation reduces entrepreneurs' wealth and creditworthiness. But current net worth also depends on the total current return to capital, which is increasing in current output. Through that channel a monetary expansion increases net worth and creditworthiness. Which effect prevails depends on initial conditions --for instance, on how large accumulated debt stocks are relative to current exports.

Another recurrent theme is that the appropriate monetary response may be quite different in different circumstances, and that money may or may not be a useful tool depending on the problem it is trying to address. Advocates of the doctrine of original sin<sup>2</sup>, I argue below, are right in claiming that monetary policy -whether contractionary or expansionary-- is not too useful when debt stocks and export levels are such that bad equilibria are possible, and when the task at hand is preventing investors from panicking and heading for the exits. But that is not the same thing as arguing that monetary policy is useless in all circumstances. In fact, precisely the same mechanisms that render money useless in dealing with runs render it extremely effective in dealing with some kinds of real adverse shocks, even when debts are in dollars and financial constraints bind.

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<sup>1</sup> A recent exposition is in Frankel (2000).

<sup>2</sup> The term was coined by Hausmann and Eichengreen (1999). Calvo (1999), (2000) was the first to warn about the dangers of dollarization of liabilities.

The paper is structured as follows. Section 2 lays out an extremely simple model, and section 3 shows that, depending on initial conditions and expectations, the model can yield a wide variety of equilibria, including ones with massive depreciations and investment collapses. Section 4 considers the role of monetary policy in dealing with real shocks, and section 5 asks whether money can help forestall an incipient run on the currency. A quick review of the empirical evidence on some of these matters is contained in section 6, while 7 summarizes and concludes.