# How to Manage a Sustainable and Stable Competitive Real Exchange Rate

Roberto Frenkel

## Introduction

The conference organizers have suggested that my paper answer the following question: "Is it possible to manage the exchange rate so as to avoid its overvaluation in developing countries?" Obviously, the organizers know that my answer to this question is positive. In a number of papers on the subject my associates and I have argued that to avoid currency appreciation is not only possible but also necessary both to promote growth and employment and to prevent financial instability and crises. So, I interpret the suggestion as a request to present a synthesis of our ideas about the policies that should be implemented to preserve a non-appreciated real exchange rate (hereinafter called competitive real exchange rate CRER). Consequently, I take as a starting point that some emerging market country adopts a CRER and devote the paper to discuss the appropriate measures to achieve that goal.

The paper is presented in four sections. Following this Introduction, Section 1 discusses the stability and sustainability of the CRER target. The conclusions of this section provide the framework for the analysis of the appropriate macroeconomic policies in the following sections. The paper focuses mainly on exchange-rate and monetary policies, presented in sections 2 and 3. The analysis points out the crucial importance of fiscal policy in the implementation of a CRER, but we not develop a detailed analysis of fiscal policy in this paper. Conclusions are presented in section 4, which include a set of guidelines of a macroeconomic policy regime, which includes a CRER target.

---

2 Principal Research Associate at CEDES and Professor at Buenos Aires, Torcuato Di Tella and FLACSO-San Andrés Universities.
3 Our most recent contributions are Frenkel and Rapetti (2011), Damill and Frenkel (2012) and Frenkel (2011)
1. Stability and sustainability of the CRER target

In order to discuss the implementation of the RER target we think that other attributes need to be added the RER goal besides its competitiveness. The first attribute we add is the stability of the CRER.

Adopting a RER target seeks to orient the allocation of real and financial resources in the economy. The formation of agents' expectations of future real exchange rates is crucial to that end. Actually, the main focus of the policy should be the agents' expectations. The agents must not only perceive that the current exchange rate is competitive but they should also believe that competitiveness will last in the future. In other words, agents must be convinced that the government has the tools and the will to prevent the RER from appreciating as much as to significantly reduce the profitability of the (financial, real investment and employment) decisions assumed in light of the current relative prices. The government's announcement that economic policy aims to preserve the CRER certainly helps that expectations are geared in that direction. But the main source of learning for the formation of expectations is the agents’ experience: the observation of the actual behavior of the RER and the repeated success of the measures taken by the government to keep the RER in the competitiveness range. Consequently, the goal considered in this paper is a competitive real exchange rate stable in the sense defined in this paragraph (SCRER).

Sustainability is the second qualification, which we think needs to be added to the definition of the RER target. A sustainable SCRER target means that its implementation should not generate trends that end up making it unfeasible. The most obvious example of these potential trends is inflation. If the measures required to implement a SCRER target induce the persistent acceleration in inflation, or impede the implementation of measures to keep it under control, the goal must necessarily be abandoned at some point. Inflation is not the only example; the evolution of other variables may also affect the sustainability of the target. For example, if the implemented policies induce an explosive trend in the quasi-fiscal deficit of the central bank or the fiscal deficit, the goal will become unfeasible at some point and the policy should be abandoned. With the addition of the sustainability attribute the target that has to be discussed in this paper is a SSCRER: a sustainable stable competitive real exchange rate. In what follows we analyze the threat to sustainability posed by an
inflationary trend. The sustainability problems related to the sterilization policy are discussed in Section 3.

The control of aggregate demand and inflation

The transmission channels of the competitive real exchange rate imply the rapid growth in private demand in the markets for locally-produced tradable goods, in the labor market and in the market for investment goods. The combined effect results in a rapid growth in private demand in all markets, tradable and non-tradable. This induces the acceleration of growth, but can also establish a sui generis inflationary pressure, generated by the rapid growth in aggregate demand induced by the SSCRER.

The boost given to aggregate demand by a competitive exchange rate is hard to pin down and quantify. Among the mechanisms involved are the relative prices it influences. It is very difficult to arrive at an accurate appreciation of the magnitude and evolution of these effects. Although the effect on aggregate demand may be difficult to identify and quantify, we do know that the higher growth experienced by economies which adopted a depreciated RER is partly due to this effect, although we cannot judge its relative importance or how this varies from one country to another or over time. It seems reasonable to assume, for example, that the expansionary effects of a depreciated RER differs from one country to another and also varies over time in each.

Because of the uncertainties mentioned, it is very difficult, if not impossible, to carry out fine-tuning with exchange-rate policy to regulate aggregate demand growth by altering the real exchange rate. There is known to be a positive association between the real exchange rate and growth, but it is not known if this relationship is non-linear, if there are thresholds, or how it differs from one country to another and over time. The basic knowledge required to carry out fine-tuning with exchange rate policy is thus not available. Furthermore, experimenting with exchange-rate policy seems wholly unadvisable in the absence of the knowledge needed to implement a fine-tuning exchange-rate policy whereby a new real exchange-rate target could be set from time to time with reasonably accuracy. The main objective of the SSCRER policy is to reduce uncertainty in agents’ investment and employment decisions. Thus, experimental and uncertain changes in the exchange-rate target would have adverse effects on the main policy objective.
To sum up, the adoption of a SSCRER target makes the policy context different from others in one crucial aspect: exchange rate policy is a permanent driver of demand growth which can give rise to inflationary pressure, and it is unlikely that this stimulus can be regulated by fine-tuning exchange-rate policy. Consequently, the monetary and fiscal policies required to accompany the adoption of a SSCRER target must also have special features: the permanent expansionary stimulus that is part and parcel of the SSCRER heightens the importance of the restraining role to be played by fiscal and monetary policies.

As can be seen, the sustainability criterion of the RER target broadens the range of policies that are involved in its implementation. The sustainability of the RER target imposes requirements and restrictions on fiscal and monetary policies. The exchange-rate policy needs to be part of a wider framework that includes fiscal and monetary policies consistent with it. Exchange-rate, monetary and fiscal policies are interconnected and have to be designed and implemented consistently. For these reasons, the adoption of a competitive real exchange-rate target needs to be understood as a component of a macroeconomic policy regime capable of pursuing multiple conflicting objectives in a consistent way. This SSCRER regime pursues growth, employment, activity level and inflation objectives simultaneously. The SSCRER is an intermediate target of the regime, as a given interest rate might be for monetary policy, or a given primary surplus for fiscal policy.

The adoption of a RER target is a singularity of the proposed macroeconomic policy regime. In addition to the standard policy objectives of any macroeconomic regime; namely, inflation and employment and activity levels, the SSCRER regime also pursues economic development as an objective. Once a determined trend for the RER is adopted, exchange rate policy focuses exclusively on both granting short-term volatility of the nominal exchange rate (NER) and preserving the long-term stability of the RER. Thus, in normal times the NER cannot be oriented towards any other macroeconomic objective such as inflation or inflation expectations. The control of aggregate demand, inflation and inflation expectations rests on monetary and fiscal policy (an also on other policies not discussed here, such as wage and incomes policies)\(^4\). The role of these policies in a SSCRER regime is crucial at moderating the pace of aggregate demand and inflation pressures, because the SSCRER –by enhancing employment growth and

\(^4\) See on that matter Rapetti (2011)
capital accumulation in the tradable sector- has by itself an expansionary bias on aggregate demand. So, in the SSCRER regime the three macroeconomic policies are active.

In the SSCRER regime the coordination of macroeconomic policy is essential. In the first place, the intermediate targets of fiscal and monetary policies and their design should be consistent with the stability of the RER trend target. For instance, it is difficult to preserve the stability of the RER trend in a context of accelerating inflationary expectations. This is the problem that the Argentine authorities could not resolve as from 2007 and finally led to a significant RER appreciation. On the other hand, as was already mentioned, a SSCRER has a permanent expansionary effect on aggregate demand. Monetary and fiscal policies must take into account that effect and must be consistently designed and implemented in order to attain the multiple real and inflation objectives.

The management of policies in the SSCRER regime is not simple. On the one hand, there is a tension between the preservation of the SCRER target and the aggregate demand and inflation control. On the other hand, the braking role that monetary and fiscal policies should normally play in this context demands a sophisticated political leadership. Both observations stress the importance of macroeconomic policies coordination at the highest level of the economic policy administration.

2. Exchange rate policy

Managed floating is defined as a regime under which the authorities are not committed to defend any particular rate, but nevertheless intervene in the FX market at their discretion. It seems to be the best exchange rate arrangement to implement a SSCRER policy in present times. Managed floating provides the same flexibility to absorb unexpected shocks as a pure floating regime, while also entitling the monetary authority to intervene in the FX market and influence the determination of the NER. It allows the monetary authorities to intervene and accumulate reserves to prevent an appreciation trend when the conditions of the current account or capital flows lead to selling pressures in the foreign currency market. Because of the effects of the competitive real exchange rate on the current and capital accounts results, selling pressures in the foreign exchange market tend to be the norm under normal conditions in a SSCRER regime.
The managed floating regime shows its best virtues when the central bank holds a sizeable amount of international reserves. The availability of significant amounts of foreign reserves, under any exchange rate regime, reduces the risk of default on public and private debts due to insufficient international liquidity in the occurrence, for example, of a sudden stop of capital inflows. But the combination of abundant reserves and managed floating has other beneficial effects. Faced with a negative external shock, exchange rate flexibility leads to exchange depreciation, and this contributes to the adjustment of the economy to the new external conditions. In this case, the availability of reserves allows the intervention to control the devaluation, avoiding overshooting and bubbles and limiting the negative balance sheet effects on banks and companies. On the other hand, the exhibition of large reserves gives greater strength to the central bank's ability to guide the foreign exchange market and thus large-scale selling interventions may not be required.

Central bank interventions in the exchange market are intended to maintain a SSCRER trend. Once the RER target has been defined, the NER should follow a stochastic path around a PPP trend. The main objective is signaling the medium and long-term RER stability in order to stimulate employment and investment decisions in existent and new tradable activities. Particularly, the emergence of RER appreciation trends should be avoided to impede the formation of self-fulfilling appreciation bubbles, in the first place, but also because the effects of expected appreciation or depreciation RER trends are not symmetrical. Investment in tradable sectors is mostly irreversible. Consequently, in tradable activities there are good reasons to give high weight to the appreciation risk. To reduce the perceived risk of RER appreciation is crucial to promote investment and employment in tradable activities.

On the other hand, the advantages of the short run exchange rate floating should be preserved. In that regards, the central bank interventions in the FX market have to achieve two conflicting targets: they have to prevent the formation RER appreciation expectations and allow the NER to float in order to de-incentive one-way bets and short term capital flows.

Signaling the stability of the RER trend is important to optimize the real objectives of the exchange rate policy, but flexibility is worth to be preserved. It seems advisable to avoid rules, announcements and commitments and deliver signals in implicit ways, throughout the central bank interventions in the FX market. Nevertheless, in order to contribute to the expectations formation, it seems important that the central
bank and the government make clear the important role given to the SSCRER within the development strategy, even if it does not imply any formal commitment.

The FX market is an asset market. Buying and selling decisions are to a great extent based on expectations. Thus, as was argued above, expectations about the future exchange rate should be the main target of central bank interventions. If central bank interventions and signals stabilize expectations around the SSCRER – a necessary condition for that is the consistency of monetary and fiscal policies and the robustness of the external accounts – the market forces by themselves will tend to stabilize the NER trend. The monetary “costs” of central bank interventions will be lower and fewer interventions will be required. For this reason, the central bank market interventions should be bold, in order to clearly show to the market participants the willingness and strength of the monetary authority.

3. Monetary policy

To discuss the monetary policy in a SSCRER regime we need first to show that the adoption of a real exchange target leaves enough monetary autonomy to conduct an active monetary policy.

Monetary autonomy in a SSCRER regime

A common objection to central bank interventions in the FX market is that they would entail a loss of monetary autonomy. This criticism is based on the well-known “trilemma” of economies open to capital movements. The “trilemma” asserts that the central bank cannot simultaneously control the NER and the interest rate in a context of free capital movements. The “trilemma” is false in some circumstances, and is thus false as a general characterization of open economies.

A condition for the simultaneous control of the NER and monetary autonomy is the existence of an excess supply of FX at the NER and interest rate targeted by the central bank. In these circumstances, the monetary authority can set the NER by purchasing the excess supply in the FX market and can control the interest rate by sterilizing the monetary effects of this intervention, which it does by issuing treasury or central bank bonds in the money market. The central bank has two instruments for
achieving its two goals: intervention in the FX market to set the NER and intervention in the money market to determine the interest rate.

A simple explanation is the following: An excess supply of FX, at the NER targeted by the central bank and current interest rate, implies an excess demand for domestic assets. A fully sterilized intervention can be seen as a policy that is implemented in two stages. First, central bank intervention in the FX market leads to an increase in the monetary base. As a result, there is a larger monetary base, an unaltered stock of domestic assets and an interest rate lower than initially. In the second stage, full sterilization completely offsets the change in the private-sector portfolio that occurred in the first stage. The central bank absorbs the increase in the monetary base and issues an amount of domestic assets equivalent to the initial excess demand for these assets (the excess supply of foreign currency), returning the domestic interest rate to its initial level (Bofinger and Wollmerhäuser, 2003).

The model used above to present the sterilization operation in simple terms assumed a greatly simplified financial structure. Agents’ investment portfolios include only base money, domestic assets and external assets. There are only two interest rates, the domestic and the international rates. The foregoing analysis of sterilization is based on the following reasoning. Given a certain configuration of investment portfolios and a certain interest rate structure, it is assumed an increased preference for domestic assets, for whatever reason. At the prevailing interest rates, this change leads to an excess demand for domestic assets and the corresponding excess supply of external assets. Since the central bank issues the very domestic asset that is in excess demand (the only interest-bearing domestic asset in the model), a monetary policy of maintaining the domestic interest rate implies full sterilization of the monetary base issued as a result of interventions to purchase FX in the market. With this model, maintaining the interest rate is equivalent to full sterilization or, what comes to the same thing, to keeping the stock of base money unchanged.

How is the above analysis affected by the existence of a wider range of domestic assets? To examine this point, a somewhat more complex model with two interest bearing domestic assets is considered here. It is assumed that the range of domestic assets consists of base money and two interest-bearing assets: short-term assets and long-term assets (bonds, for example). It is also assumed that the central bank operates only in the short-term assets market. Now let we also assume that the excess demand for domestic assets resulting from the change of preferences posited above is distributed in
some way between short- and long-term domestic assets. The first step in the central bank operation (the purchasing of surplus FX to maintain the exchange rate) would result in lower short- and long-term domestic interest rates than the starting rates. In this case, if the central bank fully sterilized the base money it issued via the placement of short-term assets, the resulting short-term interest rate would be higher than the starting rate. This is because the long-term rate would be lower than it originally was and, if the elasticity of substitution between base money and short- and long-term assets were significant, the demand for base money would be higher than at the start. To keep the amount of base money equal to the original amount, the short-term interest rate would have to be higher than its starting level to compensate for the effects of a lower long-term interest rate.

The rise in the short-term interest rate in the above exercise comes about because the central bank, which operates exclusively with short-term assets, carries out a full sterilization of its FX market interventions. Conversely, if the central bank wishes to restore the short-term interest rate to its starting level (because this is its monetary policy instrument, for example), it can do so. This will involve conducting a partial rather than a full sterilization, allowing the supply of base money to adapt to a higher demand via the influence of a long-term rate that is lower than the starting rate.

The example using three domestic assets illustrates the more general case: a large quantity of domestic assets, including land and real estate, which are in excess demand as a counterpart to the excess supply of external assets. The monetary autonomy exercised through the sterilization policy needs to be understood as the capacity of the monetary authority to control the instrument rate(s) of its monetary policy. The variable(s) targeted by the sterilization policy ought to be the interest rate(s) of the assets with which the central bank operates and not an underlying quantitative variable (base money or other monetary variable).

There have been cases in practice (and this is often brought up) where sterilization policies have induced higher domestic interest rates. The foregoing analysis offers a possible explanation for these cases. If the central bank pursues quantitative monetary targets (e.g., for base money or other monetary variables) and fully sterilizes its currency market purchases to meet them, the interest rate of the asset class with which the bank is operating is likely to rise. In this case, the problem lies not in the nature of the sterilization policy but in the goal it is pursuing.
The sustainability of sterilization policy

Sterilized FX interventions to purchase foreign currency are possible at any point in time. But can this policy be applied continuously? Not in every circumstance. The sustainability of the policy depends on the interest rate earned by FX reserves, on the domestic interest rate, on the NER trend and on the evolution of the variables determining the supply of and demand for base money. In Frenkel (2007 and 2008), we show that there is a maximum domestic interest rate below which the policy of sterilization is sustainable. Under conditions of excess supply of FX at the targeted NER, the central bank can set the NER and is free to set a domestic interest rate no higher than that maximum without generating unsustainable trends.

More formally: at any point in time, the unit cost of sterilization is \( s = i - r - e \), where \( s \) is the cost of sterilization, \( i \) the domestic interest rate, \( r \) the international interest rate and \( e = \frac{dE}{E} \) (\( E = \text{pesos} / \text{US\$} \)) the rate of increase in the price of FX. The sterilization cost \( s \) is nil if \( i = r + e \), i.e., if the domestic interest rate is equal to the sum of the international interest rate and the rate of increase in the exchange rate. Or (what comes to the same thing) if the uncovered interest parity condition is strictly met.

A policy of sterilization is obviously sustainable if the cost of sterilization is nil or negative. If this were the sustainability condition, the policy of sterilization would only be sustainable if \( i \leq r + e \); i.e., \( r + e \) would be the maximum value of the interest rate needed to keep the policy of sterilization sustainable. Interest rates higher than this would make the policy unsustainable.

In Frenkel (2007), we show that the condition referred to is not necessary for sustainability. The paper demonstrates that the policy could be sustainable with domestic interest rates higher than \( r + e \) and calculates the maximum rate at which sterilization remains sustainable. This conclusion is arrived at by simply considering the stock of central bank liabilities and taking into account the seigniorage received by the bank. In conditions of relatively high rates of growth and moderate but significant (say 4-5%) inflation rates, the seigniorage perceived by the central banks of EMEs amounts a considerable magnitude. In the mentioned article, we develop a simple model, which takes into account the fact that, in addition to interest-bearing financial assets, the public demands and the central bank issues monetary base which does not bear interest. Note that if the intention were to determine the maximum interest rate at which the cost of sterilization operations was nil or negative, the seigniorage could not be added. Since
what is to be demonstrated, however, is not a nil cost but the sustainability of all central bank monetary and financial operations taken together, the seigniorage should be included in the calculation, as indeed could other revenue items, such as returns on commercial bank debt and public bonds. In the above-mentioned article, we only take into account the seigniorage.

The degree of monetary autonomy is defined as the difference between the maximum domestic interest rate at which sterilization is sustainable and \( r + e \). Thus, \[ g = \text{imax} - (r + e), \] where \( \text{imax} \) is this maximum sustainable rate and \( g \) the degree of monetary autonomy. Given the international interest rate and the rate of increase in the exchange rate, the higher the domestic interest rate that can be set without rendering sterilization unsustainable the greater the degree of autonomy. We briefly present the model below.

It is assumed that the central bank has FX reserves as its only asset and that it issues two liabilities, base money and sterilization bills, yielding domestic interest rate \( i \).

\[ P = B + L \]

where \( P \) is the total stock of central bank liabilities, \( B \) the outstanding monetary base and \( L \) the stock of interest-bearing liabilities. At interest rate \( i \) and exchange rate \( E \) there is an excess supply of international currency \( C \) in the FX market, which the central bank purchases. \( R \) is the central bank’s stock of international reserves (in international currency) and \( RE \) is the peso value of these reserves. The international reserves yield \( r \), the international interest rate. With interest rate \( i \) determined, the increase in the demand for base money is \( dB = B \beta (p + y) \), where \( p \) is the inflation rate, \( y \) the real GDP growth rate and \( \beta \) the GDP-elasticity of the money base demand.

The sustainability condition of the sterilization policy is defined as \( dP \leq d(RE) \). The condition means that the sterilization policy is sustainable if the ratio between total central bank liabilities and the domestic-currency value of international reserves \( P/(RE) \) does not increase. In Frenkel (2007) we show that the set of sustainable interest rates is restricted by the following inequality:

\[ i \leq (e + r) / IR, \]

where \( IR = L/RE \) is the quotient between the stock of interest-bearing central bank liabilities and the domestic-currency value of international reserves.

If \( IR < 1 \), the domestic interest rates required to preserve the sustainability of the sterilization policy can be greater than \( e + r \), and the lower the \( IR \) quotient is, the higher they can be. As noted above, central bank operations determine the domestic interest rate and the NER at any point in time. The sustainability of these operations depends on
domestic and international interest rates, on the IR ratio and also on the trajectory of the NER over time. The maximum domestic interest rate at which the sterilization policy remains sustainable is \( \text{imax} = (r + e) / \text{IR} \). Consequently, the degree of monetary autonomy is
\[
\text{g} = \text{imax} - (r + e) = (r + e) (1 - \text{IR}) / \text{IR}.
\]
The lower IR is, the higher the degree of monetary autonomy, i.e., the difference between the highest sustainable domestic rate and \( r + e \).

**The sustainability of sterilization policy in the long run**

The IR ratio varies over time, altering the range of sustainable interest rates and the degree of monetary autonomy. If IR increases over time, the degree of autonomy tends to diminish, and vice versa. This consideration indicates that it would be advisable to analyze the trend of the sustainability condition to establish whether the highest interest rate consistent with a sustainable policy of sterilization tends to rise or fall over time. Or, what comes to the same thing, whether the evolution of the monetary variables and the FX market tends to increase or reduce the degree of monetary autonomy.

In Frenkel (2007) we define the permanence condition of the degree of monetary autonomy as:
\[
d(L/R E) = d\text{IR} \leq 0.
\]
If the monetary and currency markets variables meet this condition, the highest sustainable interest rate and the degree of autonomy tend to remain stable or increase. If they do not meet it, the degree of autonomy tends to fall, although this does not mean that sterilization rapidly becomes unsustainable.

We show that the permanence condition of the degree of autonomy can be expressed as another constraint on the domestic interest rate:
\[
i \leq (e + r) + (B/L) \beta (p + y) - (C/R)(1 - \text{IR}) / \text{IR}
\]
Domestic rates equal to or lower than the second member of the expression are required to maintain the degree of autonomy over time. Higher rates imply that the degree of autonomy is tending to fall, because the ratio between the central bank’s stock of interest-bearing liabilities and its reserves is tending to rise. The constraint depends on the ratio between the monetary base and the stock of interest-bearing central bank liabilities (B/L) and on the rate of growth in the demand for base money \( \beta (p + y) \). As can be seen in the last term of the expression, the constraint depends negatively on the ratio between the flow of central bank purchases in the FX market and the stock of reserves (C/R) (equivalent to the rate of international reserves growth, net of interest).
The insight is clear: the greater the purchases of the central bank in the currency market, the faster the stock of sterilization liabilities and its cost will increase.

The above analysis assumes freedom of capital movements. Over and above the theoretical discussion, however, it highlights the functions that can be performed by controls on capital inflows and foreign currency purchases by the government. Capital controls that moderate the scale of central bank purchasing help preserve whatever degree of autonomy is possessed by the economy at a given time. In the same way, fiscal policy can also help preserve monetary autonomy. If there is a fiscal surplus, the government can invest part of that surplus in external assets, thereby reducing the amounts the central bank needs to purchase to keep the exchange rate on target.

Conclusions on sterilization policy sustainability and monetary autonomy

In summary, the conclusions we arrived in Frenkel (2007) are as follows. If the conditions
\[ i \leq (e + r) / lR \text{ and also } i \leq (e + r) + (B/L) \beta (p + y) - (C/R)(1 - lR) / lR \]
are met, the policy of sterilization is sustainable and the degree of autonomy is permanent. Conversely, if \( (e + r) + (B/L) \beta (p + y) - (C/R) (1 - lR) / lR < i \leq (e + r) / lR \), the sterilization policy is sustainable but the degree of autonomy tends to diminish.

The mentioned study presents a number of numerical exercises, involving different inflation and growth scenarios and using plausible data and parameters. The results suggest that sterilization policies are sustainable and that a considerable degree of permanent monetary autonomy exists in contexts that are by no means uncommon in many developing economies. The conclusion must be that exchange rate policy in a SSCRER regime does not usually inhibit the exercise of monetary policy. The orthodox criticism is not valid. Even with freedom of capital movements (on the obvious assumption that domestic and external assets are not perfect substitutes), this regime is not incompatible with a considerable degree of monetary autonomy.

The above conclusion does not imply, however, that in a SSCRER regime (or, more generally, in any context in which the central bank intervenes in the FX market to avoid the appreciation of the RER) the control of aggregate dynamics and inflation pressures can exclusively rest on the monetary policy. The sustainability conditions put an upper limit to the policy interest rates. This constraint could combine with a low interest rate elasticity of the aggregate demand to generate circumstances in which the
regulatory capacity of monetary policy becomes greatly impaired. The level of the interest rate capable of influencing the aggregate demand dynamics could be higher than the maximum sustainable interest rate (Frenkel, 2008). A low elasticity of aggregate demand is observable even in economies with a high degree of financial intermediation. It seems highly probable that many developing economies share this feature. Our conclusion in that regards is that in a SSCRER regime active monetary policy can and should be practised because all available instruments should be used to control the pace of aggregate demand and inflationary pressures. But the responsibility could not rest primarily or exclusively on monetary policy. This observation highlights the crucial role that fiscal policy has to play in a SSCRER regime.

4. Conclusion: guidelines of the SSCRER macroeconomic policy regime

The most general lesson that can be learnt by contrasting the developing countries experience in the 2000s with the previous three decades of financial globalization is the crucial importance of macroeconomic policies in promoting growth, employment, financial stability and robustness vis-à-vis real and financial external shocks. Our main claim in this regard is that there is a set of viable and consistent macroeconomic policies that contribute to the simultaneous accomplishment of the mentioned objectives. The preservation of a SSCRER is a key ingredient in that set. As a way of conclusion we present in what follows the guidelines of the SSCRER macroeconomic policy regime5.

The first subset of guidelines focuses on the promotion of growth and employment, the robustness of external accounts and the prevention of crises against negative external shocks. It comprises: i) a managed floating exchange rate regime, combining exchange rate flexibility with discretionary interventions by the central bank in the foreign exchange market; ii) a competitive level trend in the real exchange rate, avoiding strong appreciations in the short run; iii) a surplus trend in the current account of the balance of payments and moderate current account deficits in the short run; iv) the accumulation of sizeable international reserves.

Relatively high rates of growth and employment are fostered by the competitive trend of the RER. The current account surplus trend plus the accumulation of reserves

5 The guidelines were first presented in Frenkel (2010)
warrant the sustainability of the growth process by helping to avoid external crisis and cushioning negative real and financial external shocks.

The policies involving the RER, the external accounts and the reserves management should be accompanied by consistent fiscal and monetary policies focused on the control of aggregate demand and inflation. An important point in this regard is that in a context of managed floating exchange rate, competitive RER level and surplus trend in the current account, generally exists a considerable degree of monetary autonomy that allows the implementation of active monetary policies. So, with regard monetary policy, the suggested guideline is: v) an active monetary policy, facilitated by the sterilization of the interventions in the FX market and the inexistence of fiscal dominance.

As we comment above, coordination between the three macroeconomic policies -exchange rate, monetary and fiscal- is essential in this regime. In particular, monetary policy should be implemented in coordination with short run fiscal policy. Depending on the pressures in the foreign exchange market, capital controls might be necessary to simultaneously attain the preservation of competitive RERs and the preservation of monetary autonomy.

As in any macroeconomic policy regime, short run fiscal policy can be either expansionary or contractionary. Although we point out above that in this regime monetary and fiscal policies should normally play a braking role on the aggregate demand dynamics, our last guideline refers to the orientation in the fiscal accounts: iv) an equilibrium trend in the fiscal accounts and moderate fiscal deficits in the short run. The orientation focuses on allowing counter-cyclical policies in the short run (aggregate demand and inflation control in the booming phases and expansionary stimuli in the recessionary phases) and on avoiding the accumulation of significant public debts.

Bibliography


