

The Conduct of Monetary Policy in Central America and Dominican Republic, in an increasingly Globalised Environment¹

1. Introduction

First I would like to introduce you to the Central American Monetary Council (the “Council“), institution that belongs to the Central American Integration Institutions. The Council was created by the “Agreement to Establish the Central American Monetary Union”, signed by the Central Banks of Central America on February 25, 1964. The Central Bank of Dominican Republic became full member of the Council on June 22, 2002.

The Council is a body ranking of Economic Integration Subsystem of the Central American Integration System as a sectorial Council of Ministers with functional autonomy in the exercise of its powers. The Monetary Council is integrate by the Presidents of the Central Banks of Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Governor of the Central Bank of Dominican Republic.

The core strategic objectives of the Council defined to guide its work during five-year Term 2007-2011, are summarized as follows:

- A.** To encourage coordination, harmonization, and convergence in monetary, exchange, and financial policies of the countries members;
- B.** To promote a unique financial space in the whole region;
- C.** To strengthen cooperation between the Council`s central banks, as well as among the region`s institutions, and between these and other international institutions; and,
- D.** To encourage economic research leaned toward a regional approach, as well as to develop and publish harmonized economic and financial statistics.

The Presidency of the Council is filled on a yearly and rotational basis, sorting the countries alphabetically. The member in line to become President for the following term serves as Vice-President. For 2007 the Presidency is exerted

¹ By José Alfredo Blanco Valdés, Executive Secretary of the Central American Monetary Council, on occasion of the 35th anniversary of the Central Bank of Barbados. May 10, 2007.

by the Central Bank of El Salvador and the Vice-Presidency by the Central Bank of Guatemala.

The Council has three permanent advisory Committees: Monetary Policy; Capital Markets; and Legal Studies. As a reference one of the core recent works of the Council is the Treaty on Regional Payments which is currently under consideration of the Congresses of the member countries. It is expected to be fully implemented by early 2008.

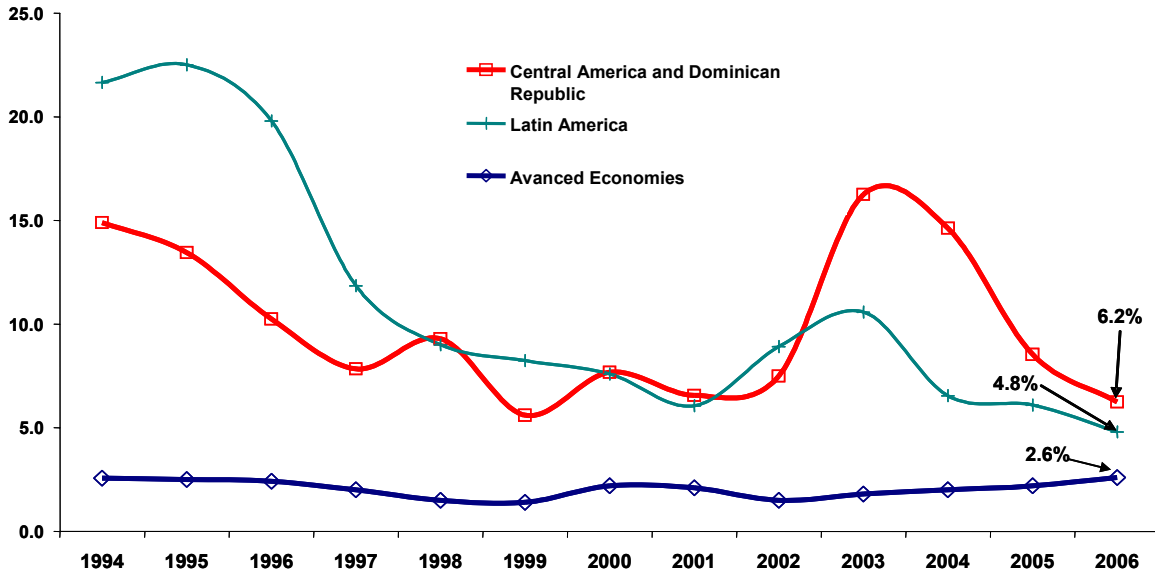
The encourage macroeconomic coordination the Council discusses the implementation and conduct of monetary and financial policies in the region. In general terms, macroeconomic stability has been achieve since mid nineties as it is described in the next pages.

2. Recent Developments

As it is shown in the graph below, the regional inflation has decreased since mid nineties with a pattern observed along most countries in the world. In fact, regional inflation has gone down from 22% in 1995 to 6.2% in 2006. Besides the worldwide decrease of inflation, country members have also applied prudent and disciplined monetary and fiscal policies having achieved macroeconomic stability, and therefore having increased the credibility of macroeconomic performance. This credibility is also supported by a great degree of transparency and accountability reinforced by new Central Bank Organic Laws in all the members countries.

GRAPH 1

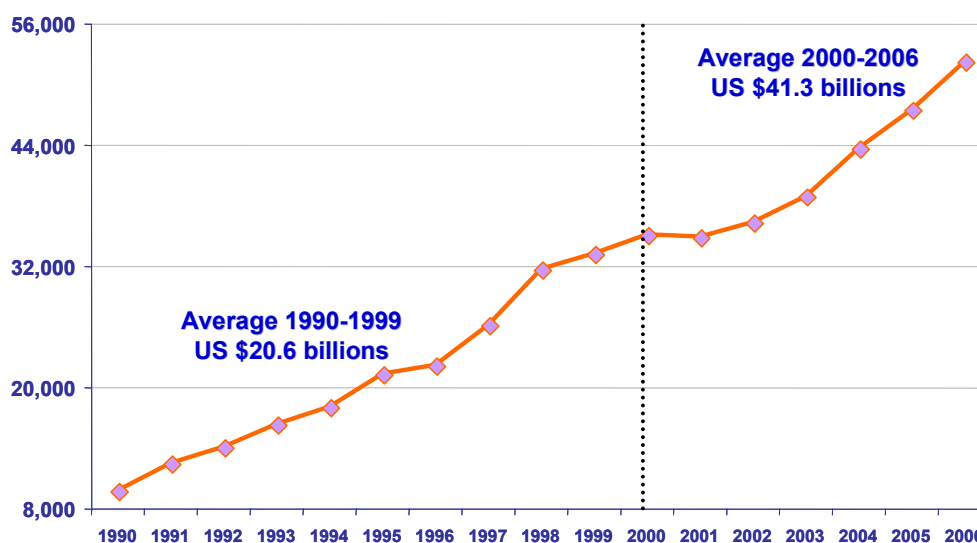
**Inflation in Central America and Dominican Republic,
Latin America and Advanced Economies**



Before referring to the different monetary frameworks adopted at present by the six member countries I will note the difficult global environment that has influenced each country's conduct of its monetary policy. In effect, since 2003 the high increase of oil international prices has been one of the main obstacles to the conduct of monetary policy. In this scenario, countries have adopted cautious and prudent monetary measures to counteract the second round effects on domestic prices caused by the oil market behavior. A second obstacle to the monetary policy effectiveness is the increased flow of capitals to the regions, due to a better macroeconomic performance, better management of public debt and an improved policy of competitiveness recently adopted.

GRAPH 2

Central America and Dominican Republic:
Capital Inflows. (Millions of US \$)

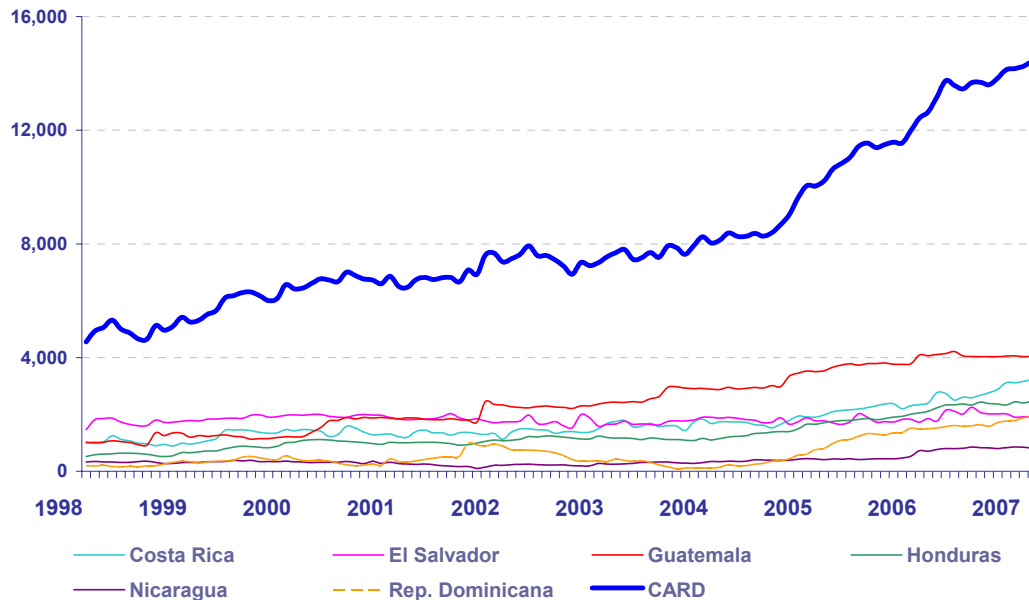


As shown on graph 2 average capital inflows have doubled from the period 1990-1999 to the period 2000-2006. Remittances and to a lesser extent Foreign Direct Investment in Guatemala, El Salvador, Honduras, Nicaragua and Dominican Republic, and Foreign Direct Investment to Costa Rica have increased along the last five years. In fact Remittances have accounted for between 10% and 20% in the mentioned countries. In this regard monetization has increased and Central Banks have had to sterilize it partially through open market operations², complicating then the conduct of monetary policy since Quasi-fiscal deficits were already large before facing the referred global environment.

² Open market operations are the main instrument used in the conduct of monetary policy, although changes in reserve requirements are used from time to time.

GRAPH 3

Central America and Dominican Republic:
Net International Reserves (Millions of US \$)
(1998:01 - 2007:02)



Consequently, accumulation of net international reserves (NIR) has been important in the whole region. As it is shown on graph 3 NIR increased from slightly above US\$ 4.0 billion in 1998 to around US\$ 15.0 billion in 2006, which represents slightly above 4 months of imports in each country and slightly above half of short term public debt.

In general, a good macroeconomic performance based on a disciplined monetary policy supported by a prudent fiscal management; an improved debt management; and policies adopted to enhance competitiveness have altogether reduced the credit risk evaluation of many of the member countries.

3. The Conduct of Monetary Policy

Increased capital flows have made the region to face the well known open economy trilemma that shows that a country cannot simultaneously maintain open capital markets, fixed exchange rates and an independent monetary policy

oriented towards domestic price stabilization. According to this, a government can choose any two of these but not all three simultaneously. If a government wants to target monetary policy towards inflation target, either capital mobility or the exchange rate will have to be abandoned.

In theory, to avoid the open economy trilemma countries have to adopt either a rigid monetary framework or a flexible one. This has been happening in the region after the year 2000. But before describing the recent experience, let us say that according to changes in the external environment, one can observe two periods in the region which corresponds to two different capital mobility environments.

TABLE

Countries	Before 2000	After 2000
El Salvador	Monetary Targeting	Dollarisation (2001)
Nicaragua	Crawling Peg	Crawling Peg
Costa Rica	Crawling Peg	Bands (2006)
Honduras	Bands	Bands (2006)
República Dominicana	Monetary Targeting	Monetary Targeting (2006)
Guatemala	Monetary Targeting	Towards Inflation Targeting (2002)

The first is that before the year 2000 in which capital flows to the region were relatively small and the measure of monetary aggregates was highly accurate so that countries could either target an exchange rate or a monetary aggregate. In this environment two countries (Costa Rica and Nicaragua) had a crawling peg regime, one country adopted a regime of bands (Honduras), and the

other three (Guatemala, El Salvador³ and Dominican Republic) adopted a Monetary Targeting regime.

After the year 2000 the external scenario changed and countries have followed two different policies. While El Salvador dollarised its economy on January 2001 most of the rest of countries have been taking steps –very gradually- to flexibilise their monetary frameworks. As shown in the table above Guatemala took steps since 2002 to adopt an inflation targeting regime (according to the IMF Guatemala has an Inflation Targeting Lite regime); Dominican Republic is in a Monetary Targeting framework but since 2006 the Central Bank is studying the IT framework –although no formal decision has been taken to change of monetary regimen-; Costa Rica on October 17, 2006 announced the abandonment of the Crawling Peg regime –wich last 22 years- to adopt a Band regimen as an initial step to a IT regime; Honduras has a Band regime and in recent years the Central Bank has improved the implementation of its monetary policy adopting the interest rate as a reference to the stance of the policy and has also made more flexible the band parameters; and Nicaragua is still in a band regime, though in the medium term this policy could start to change to a flexible exchange rate regime.

Since Guatemala is the country that has advanced the most on the adoption of IT regime, here we find a briefing of this process: after having working broadly well with a monetary targeting framework along the nineties the Central Bank of Guatemala faced the difficulty of loosing correspondence between the main monetary aggregate –currency issue- and inflation. This caused that in 2000 the Central Bank added 8 indicative variables to follow the effectiveness of the monetary policy. Then, besides the currency issue, monetary authorities started to take into account a “Monetary Condition Index”, a Taylor Rule interest rate setting, the Credit the Private Sector, a broader definition of the monetary aggregate – M2– and other variables to evaluate the effectiveness of its policy. In that regard there were years were the currency issued did not end into

³ El Salvador could also be classified as having a fixed exchange rate regime since capital inflows – mainly remittances- let the exchange rate be constant almost along the nineties. However the Central Bank also followed a monetary aggregate through the following of a monetary program.

the band estimated by the monetary program and the monetary policy did not overreacted to this, specially taking into account that those years –mainly 2002-2006- oil international prices also avoided inflation to decelerate as expected.

In 2002 the Central Bank of Guatemala was given a new Organic Law specially designed to fulfill the requirements of an IT framework, specially those aspects associated to transparency, accountability, a clear goal of price stability and independence in the use of monetary instruments. Besides press conferences, the minutes of the sessions of the monetary authority are published through internet and the President of the Central Bank has to report to the Congress twice a year on the effectiveness of the monetary policy. Also the Central Bank publishes the calendar of the days in which it will take a position on the level of the policy interest rate along the year. The policy interest rate is mainly used to eliminate inflationary expectations. In recent years actions have been taken to improve the forward looking approach of the monetary policy, mainly by implementing a Semi-Structural model to forecast inflation with a two years horizon, and therefore through improving the understanding of the mechanisms of transmission of the policy.

4. Big Challenges Ahead

However the countries of the region still face important challenges to improve the efficiency in the conduct of monetary policy in an increasingly globalised environment. The first one is that of **large Quasi-fiscal deficits** that impede to start the decreasing of the amount of monetary operations, and therefore impede the elimination on the interest paid on these operations –which are a main source of inflationary pressures-; the second is that **foreign exchange markets are underdeveloped**. This imposes an important restriction to advance in to make more flexible the monetary frameworks because economic agents can not find in the market financial instruments to hedge against unexpected important changes in the exchange rate. Finally, **capital markets are also underdeveloped**. In fact the region is still trying to develop the public debt market as a first step towards a

regional capital market. This avoids that the Central Banks can have a market yield curve as a reference to the effectiveness of its monetary policy.

To face this scenario, the Monetary Council is currently working in the improvement of the public debt market through a 3 year program that will begin at the end of May 2006. It is also working in the discussion to eliminate the Quasi-fiscal deficits –some countries have already started to reduce it through the delivering of bonds from the government to the CB or through payments done in cash; however the amounts delivered are still low-. In addition, the Monetary Council will begin discussions on topics of harmonization of policies, which involves legal reserve requirements, instruments used in open market operations, inflation report requirements, and others.