Inflation Targeting in Latin America: a trilemma or an irreconcilable duo?

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Abstract

In the economic literature policy management in an open economy has been discussed under the trilemma configuration. This framework derives from the basic Mundell-Fleming model and states that a country can only choose two of the following policy options: financial openness, fixed exchange rate and monetary policy autonomy. While its recent extensions still suggest a continuous trade off between these policies, other authors have argued that the trilemma has actually morphed into a dilemma, or an irreconcilable duo, since free capital mobility implies a loss of monetary autonomy regardless of the exchange rate regime. This paper aims to stress this thesis conducting a study of the monetary policy autonomy and efficiency in five emerging Latin American countries (Brazil, Chile, Colombia, Mexico and Peru) that adopt a combination of flexible exchange rates, financial integration and a monetary policy of inflation targeting. While the effectiveness in achieving the established inflation target is analyzed through descriptive statistics, the autonomy is studied with two different strategies. While the first one reconstructs the traditional indexes of monetary autonomy, based on the correlations between internal and external interest rates, the second estimates a modified Taylor rule for each country using a vector autoregressive model in order to test its sensitivity to movements of the exchange rate, the US interest rate and the VIX.

Keywords: Latin America, Monetary Policy

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