Alster Model United Nations

Forum: 2nd Committee (Economic and Financial)

Issue: Stabilizing currencies in South America

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Description of the issue

Most Latin American countries experienced chronic monetary instability during the 1980s. This resulted in high and volatile inflation and plunging currency values. As a consequence, many localized Latin American economies experienced annual inflation rates of over 100% and some countries, including Argentina, Brazil and Bolivia even experienced periods of hyperinflation[1]. None of the larger economies could post an inflation rate of less than 20% throughout the entire decade. Argentina, the country which suffered the most during this period, posted and average annual inflation rate of 350% for the decade. Consumer prices in that country had increased by a factor of more than 100 million by the end of the period.

Apart from destabilizing the local economies, the poor inflation figures led to social unrest, as the disparity between rich and poor became ever more pronounced. A report by Mishkin and Savastano[2], from the year 2000, concludes that the cost of high inflation during that period fell disproportionately on the poor.

During the late 80s and early 90s, reforms were introduced to try to tackle the economic instability of the South American economies. Among various other measures, plans were introduced to try to stabilize volatile currency exchange rates. Essentially, two distinct approaches were employed to achieve this goal. The first approach involved anchoring local currencies to a fixed exchange rate, often linking (or 'pegging') the local currency to the U.S. dollar.

[1] **Hyperinflation: Simply, when inflation reaches a level that is considered out of control.**
[2] **http://www.nber.org/papers/w7617**

The second approach involved ‘inflation targeting’, using monetary policy measures to ensure that preset inflation targets were met (see *Keywords* below). In many cases, a combination of both approaches was used to stabilize the exchange rate and curb inflation.

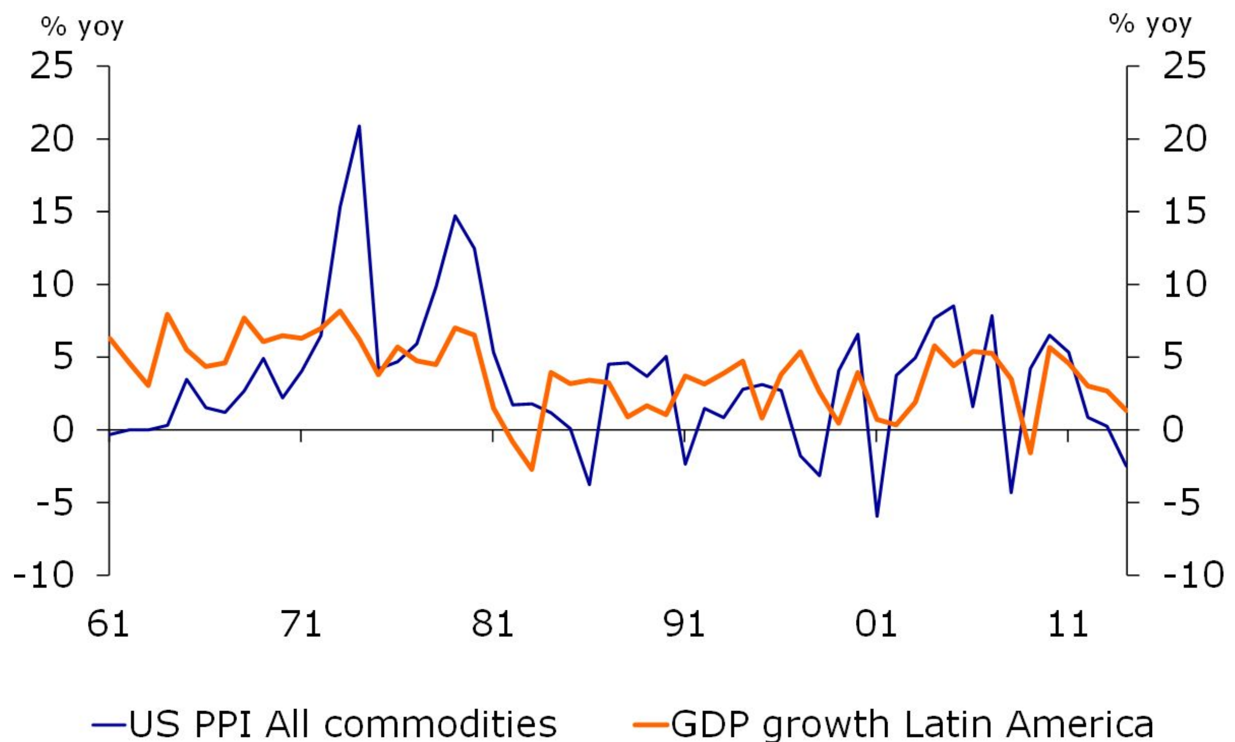
Both approaches met with some initial success. Countries that chose a more rigid exchange rate anchor policy managed to address the depreciation of their currencies almost immediately and were able to bring inflation rates down to single figures within a short space of time. As a rule, it was the countries with the highest pre-stabilization inflation rates that chose more rigid exchange-rate anchor policies. However, these countries were unable to convert this initial success into long-term stability as the exchange rate anchors proved too inflexible to deal with fluctuations on the global market. Countries which had experienced more moderate rates of pre-stabilization inflation chose measures based on inflation targeting. While these economies enjoyed relatively modest and slow initial success, their economies proved to be more stable in the long run, as they were more able to introduce monetary-based measures to counter fluctuations on the global market.

The Influence of Commodity Shocks on Latin American Economies

One of the major recurring economic problems in Latin America is that many of the region’s countries are reliant on the export of prime commodities, either directly or as a result of regional interdependence, for sustaining their economies. However, the commodity producing nations have little control over the price of their exports, which is, more often than not, determined in trading centers in New York and linked to the value of the U.S. dollar. Global fluctuations in the price of these commodities can cause instability throughout Latin America. When commodity prices drop drastically,

the result is a so-called ‘commodity shock’[3]. Historically, commodity price shocks have repeatedly destabilized Latin American economies. However, after the Millennium, rapid economic expansion in emerging economies such as China and India led to a simultaneous increase in demand for Latin American commodities and to consistent increases in commodity prices.

The graph below illustrates South America’s economic dependence on global commodity prices from 1961 to 2011:



During the past few years, however, global demand for South American commodities has slowed considerably. In particular, the slowdown in China’s growth rate – and the associated reduction in demand for commodities – has had a significant effect on Latin American exports, resulting in lower GDP growth in several countries.

[3] **https://blogs.imf.org/2017/05/25/how-flexible-exchange-rates-helped-latin-america-adjust-to-commodity-price-shocks/**

In the case of Brazil, lower economic growth has led to other issues, such as rising unemployment. Venezuela, which has relied on high oil prices to sustain its economic growth for many years, has been hit particularly hard by the fall in commodity prices. Dependence on the commodity market remains a potentially volatile factor for the long-term stability of Latin American economies.
From the perspective of those economies that rely on the export of commodities for their principal means of foreign exchange earnings, unstable commodity prices create fundamental economic instabilities and complicate fiscal and monetary management. Erratic price movements generate erratic movements in export revenue and can cause instability in foreign exchange reserves, which, among other things, are used to service foreign debt. In many cases, a commodity shock can lead to temporary inflation and the rapid devaluation of the local currency.

The graph below compares the decrease in commodity export revenue to the decrease/increase in the revenue generated by other exports in Latin America over a period from 2010-2015. In 2009, commodities accounted for 55% of all export revenue across Latin America. Furthermore, this figure had increased from just over 50% in 2005.

Explanation of key terms

Equity: The “real worth” of a company when you subtract the liabilities (things the company owes) from the assets (things that the company owns).

Commodities: Basic products (or services) such as grain, soya beans, coffee, gas or oil. These are often made into something else.

Monetary Policy: are measures set by a central banking system (central bank, currency board or other regulatory committee) to control the amount of money (via credit) in circulation in an economy. Monetary policy is maintained through actions such as modifying the interest rate, buying or selling government bonds, and changing the amount of money banks are required to keep in the vault (bank reserves).

Fiscal Policy: are measures set by the Government and are based on tax rates and public spending (the amount the Government spends to stimulate the economy).

Exchange rate anchors: when a local currency is linked to a fixed exchange rate in order to stabilize drastic exchange-rate fluctuations and facilitate long-term international trade and investment. The local currency can either be linked to a real existing currency (usually the dollar) or to a designated fixed amount.

Inflation: is the rate at which the level of prices for goods and services is rises in comparison with the value of the currency. High inflation means that the ‘purchasing power’ of a currency is falling – you get less for your money. Central banks attempt to limit inflation, and avoid deflation, in order to keep the economy running smoothly.

Deflation: is the opposite of inflation. Deflation is a contraction in the supply of circulated money within an economy. In times of deflation, the purchasing power of currency and wages are higher than they otherwise would have been. This means you get more for your money and that prices are relatively low. However, this is distinct from but similar to price deflation, which is a general decrease in the price level, though the two terms are often mistaken for each other and used interchangeably.

Inflation targeting: Inflation targeting is a central banking (monetary) policy that is based on meeting preset annual inflation targets. The benchmark used for inflation targeting is typically a price index of a basket of consumer goods, such as the Consumer Price Index (CPI).

The central bank can use a number of instruments to influence the economy – such as cutting lending rates or adding liquidity to the economy – should the actual rate of inflation vary considerably from the target rate. At the same time, the respective Government is usually compelled to adopt a conservative fiscal policy.

REER: The Real Effective Exchange Rate is a way the banks measure the weighted average of a country's currency compared to the major currencies such as the USD, Yen or Euro.

Procyclical fiscal policy: The measurement to reduce taxes and increase public spending during an economic boom while raising taxes and decreasing public spending during a recession.

Countracyclical fiscal policy: The opposite of Procyclical. Therefore increasing taxes and minimizing public spending during an economic boom but during a recession lowering taxes and increasing government spending. That way the

economy gets stimulated during a recession by consumer spending a national investment.

Capital inflows: The amount of capital made available by investment from foreign sources. Generally, foreign capital is good for the economy because it creates more money for the internal market. It is also a good indication that investors trust the economies that they are investing in. However, foreign capital investments also have to be paid back at some stage. During bouts of inflation, when the local currency loses its value against the value of the foreign currency, the foreign debt can become unserviceable, resulting a breakdown of creditworthiness.

Current Account: The sum of the balance of trade (all exports of goods and services minus all corresponding imports). A positive current account balance indicates that the nation is a net lender to the rest of the world, while a negative current account balance indicates that it is a net borrower from the rest of the world. A current account surplus (more exports than imports) increases a nation's net foreign assets by the amount of the surplus, and a current account deficit (more imports than exports) decreases it by that amount.

Foreign Exchange Reserves: Foreign exchange reserves consist of any foreign currency held by a centralized monetary authority (like a central bank). Foreign exchange reserves include foreign banknotes, bank deposits, bonds and other government securities. Foreign reserve assets serve a variety of purposes, but are primarily used to give the central government flexibility and resilience. If one or more currencies crash or become rapidly devalued, the central banking apparatus has holdings in other currencies to help them withstand such markets shocks. Foreign reserves are also used to service foreign debt. In periods of economic crisis, the foreign reserves can be used to prop up a country's internal economy.

However, this can be a dangerous undertaking as depleted foreign reserves can jeopardize a country's capacity to pay back its foreign debt.

Microeconomics: Is the branch of economics that deals with smaller economic units and the way they interact in the market. These units can represent single consumers, small businesses or even entire industries.

Macroeconomics: Is the branch of economics dealing with larger (national or international) phenomena, such as how an adjustment of interest rates would effect and economy.

Non Governmental Organizations involved

IMF: "The International Monetary Fund (IMF) is an organization of 189 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world."

World Bank: An International Institution with the goals to alleviate extreme poverty and to promote shared prosperity by investing in socioeconomic projects.

Position Paper Outline

Please include answers to the following questions in your position paper:

How does your country view fixed exchange rates as a long-term measure to stabilize currencies?

To what extend (and how) do fluctuating exchange rates in Latin America affect your country/organization?

Looking forward, what could the UN do to further ensure long-term currency stability in South America? How could your country, organization and/or economic region support UN policy in this regard?

Your position paper must be at least a page long and be sent to amun.secondcommittee@gmail.com latest by the 6/9/17.

If you have any questions concerning this topic or a source please fell free to contact me directly:
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