LATIN AMERICAN CENTRAL BANK REFORM: PROGRESS AND CHALLENGES

Mr. Carstens

Presented at the High-Level Regional Seminar on Inflation Targeting
Hosted by the International Monetary Fund and Bank Al-Maghrib
Rabat, Morocco–April 4, 2007

Latin American Central Bank Reform: Progress and Challenges

March 2007

Organization

I. Introduction

II. New Institutional Framework for Monetary Policy

III. Central Bank Independence (CBI) Index

IV. CBI and Macroeconomic Trends

V. Remaining Challenges

VI. Concluding Remarks

Introduction

- In Latin America 1990 was characterized by
  - unprecedented high inflation (500% on average)
  - the end of a 10-year period of stagnation on per capita GDP (-0.1% on average).
- Governments faced the need to tackle inflation and made structural changes aimed at laying the foundations for a rebound in economic growth.
- Central bank reform became a key component of the new economic agenda in most Latin American countries.
- The objective of the reform was to restore confidence in monetary policy to fight inflation.

In the 1990's, the legislation governing Latin America's central banks was reformed, based on four main pillars.

1. Defining a clear mandate for central banks' to ensure price stability

Price stability as the sole or primary objective	Price stability plus other objectives, with no indication of priority		
	Operation of the payment system	Stability of the financial system	Growth or economic development
Argentina, Bolivia, Colombia, Costa Rica, Dominican Republic, Mexico, Peru, Venezuela	Chile, Honduras, Nicaragua	Guatemala, Paraguay, Uruguay	Brazil

2. Giving central banks political independence to design monetary policy

The reform was based on four main pillars…

3. Granting operational independence to perform monetary policy

- ✓ Central banks have freedom to formulate and execute monetary policy.
- ✓ They are severely restricted of financing public expenditure.
- ✓ Operational independence is sometimes undermined as a result of central banks' quasi-fiscal losses.

4. Making central banks accountable

- ✓ Governors are required to appear before the legislature to report on the performance of the central bank.
- ✓ Central banks publish its monetary program and inflation report.

An Index of Central Bank Independence was estimated based on the provisions contained in the central bank legislation.

- ✓ **The index of CBI measures *de jure,* and not *de facto,* independence.**

- ✓ **The index is built on five aspects of central bank independence, which are assigned different weights:**

  1. **Political independence (20%).**
  2. **Central bank's mandate (15%).**
  3. **Autonomy in the formulation of monetary policy (15%).**
  4. **Restrictions in lending provisions to the government and to commercial banks, as well as financial independence (40%).**
  5. **Accountability requirements (10%).**

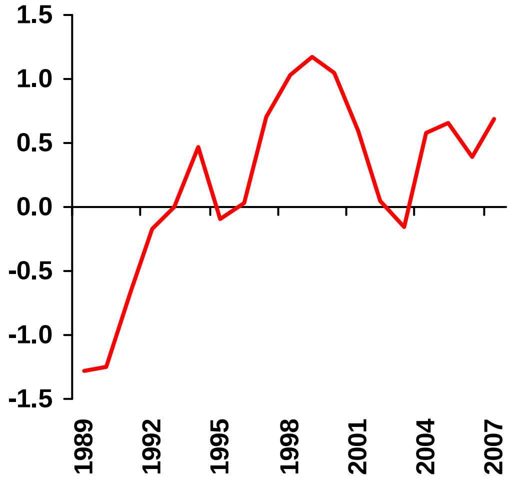
- ✓ **The resulting value of the CBI gives a score between zero and one.**

Latin American central banks are more independent today than they were in 1990. The degree of independence varies from one country to another.

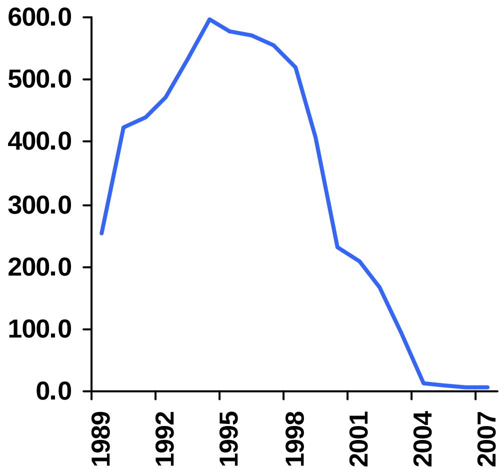
- ✓ **After the reforms the average index of CBI increased from 0.427 to 0.774.**
- ✓ **Countries that currently have a CBI Index of over 0.80: Peru, Chile, Colombia, Bolivia, Mexico and the Dominican Republic.**
- ✓ **Countries that currently have a CBI Index in the range of 0.64 and 0.79: Argentina, Venezuela, Costa Rica, Nicaragua, Paraguay, Guatemala, Honduras, Uruguay and Brazil.**
- ✓ **The difference between countries is found primarily in terms of political independence.**

Even though inflation has been reduced in most Latin American countries, there are still some macroeconomic challenges.

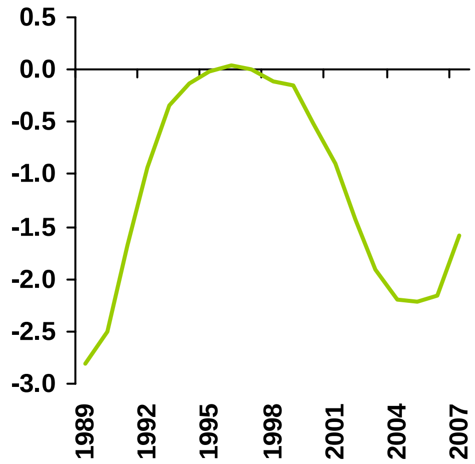
Per capita real GDP growth
(%,moving average t=10)



Inflation
(%,moving average t=10)



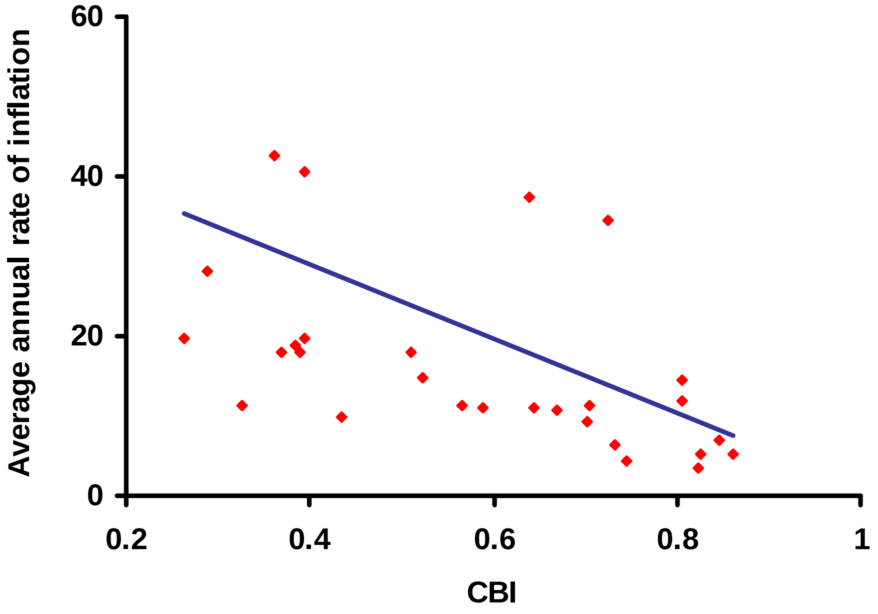
Fiscal Balance / GDP
(%,moving average t=5)



CBI is statistically significant in explaining inflation performance between 1990 and 2002 for the Latin American and Caribbean economies.

CBI and Inflation in Latin America

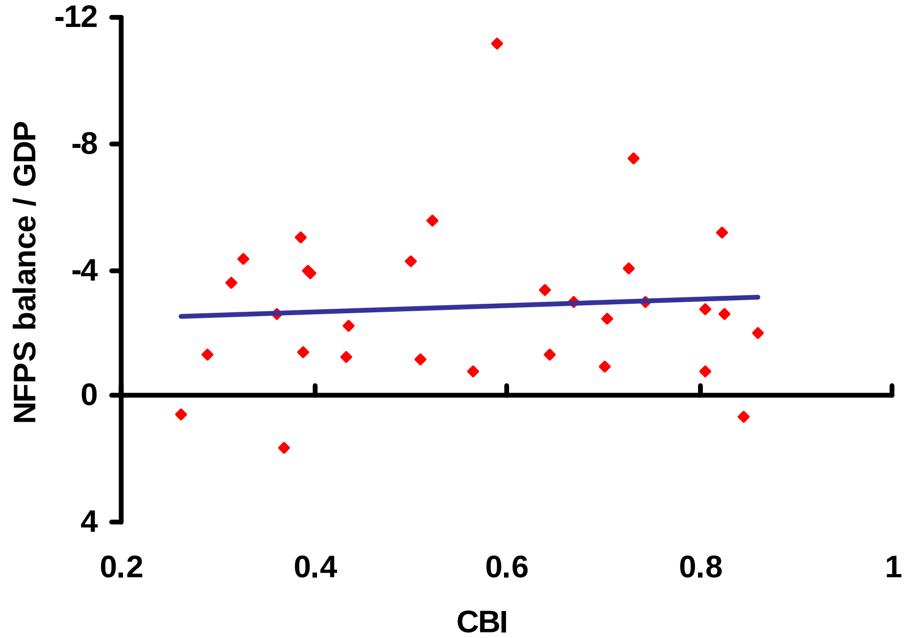
(Before and after the reform of central banks)



Source: Jácome and Vázquez (2005) and IMF, IFS.

CBI and Fiscal Deficit in Latin America

(Before and after the reform of central banks)



Source: IMF, IFS and Western Hemisphere Department

The reform of central bank legislation in Latin America contributed to the change in the monetary policy regime and the operating framework observed in most countries.

- ✓ **Most central banks increasingly migrated from exchange rate pegs towards exchange rate flexibility.**
- ✓ **A number of central banks adopted an inflation targeting (IT) strategy as a way of anchoring inflation expectations.**
- ✓ **Central banks modernized their operating framework for monetary policy, shifting from money base control to an alternative regime where the central bank uses a short-run interest rate as an operational variable.**

Despite the successes in defeating inflation, central banks in Latin America still face important challenges.

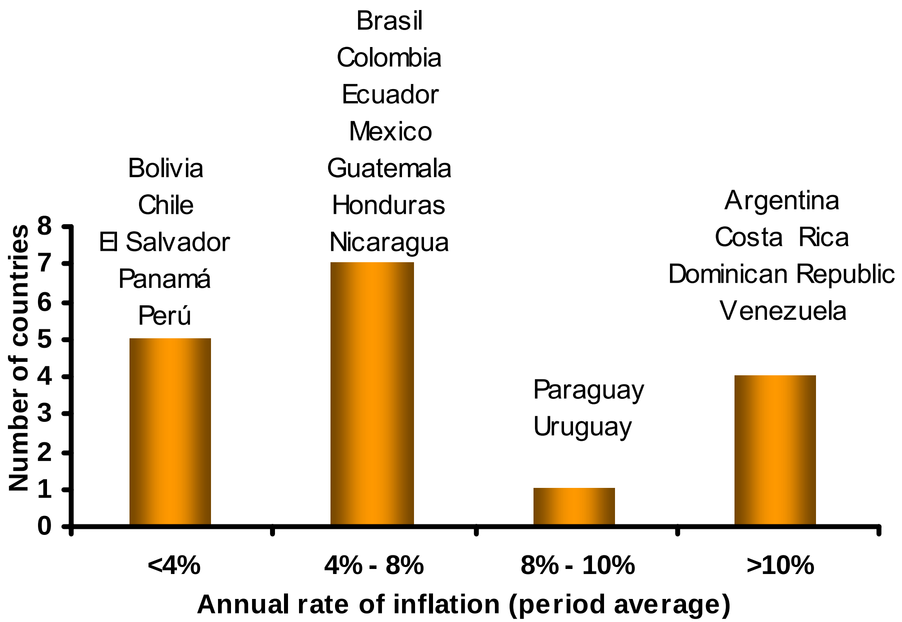
1. **Achieve price stability**
2. **Restore confidence in domestic currencies**
3. **The need to cope with capital inflows while maintaining policy consistency**
4. **The perils of financial system weaknesses and the lack of fiscal discipline**

1. Achieve Price Stability

- ✓ **While inflation in Latin America has already declined to single digits, in most countries it has not converged yet to the world inflation.**
- ✓ **Further reducing inflation will be increasingly difficult because of its potential adverse effects in output.**
- ✓ **Central banks may face opposition to tight monetary policies.**

Average Inflation in Latin America

(2002-2007)



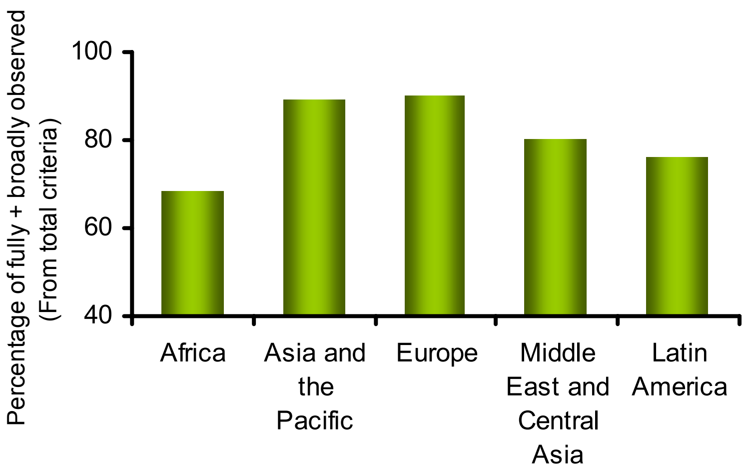
1. Achieve Price Stability

- **Implementing a more efficient monetary policy hinges not only on central banks' ability to conduct monetary policy, but also on making central banks' policy more transparent and predictable.**

- **While central banks in the region have already enhanced accountability and transparency standards, there is still room for improvement.**

Transparency of Monetary Policy

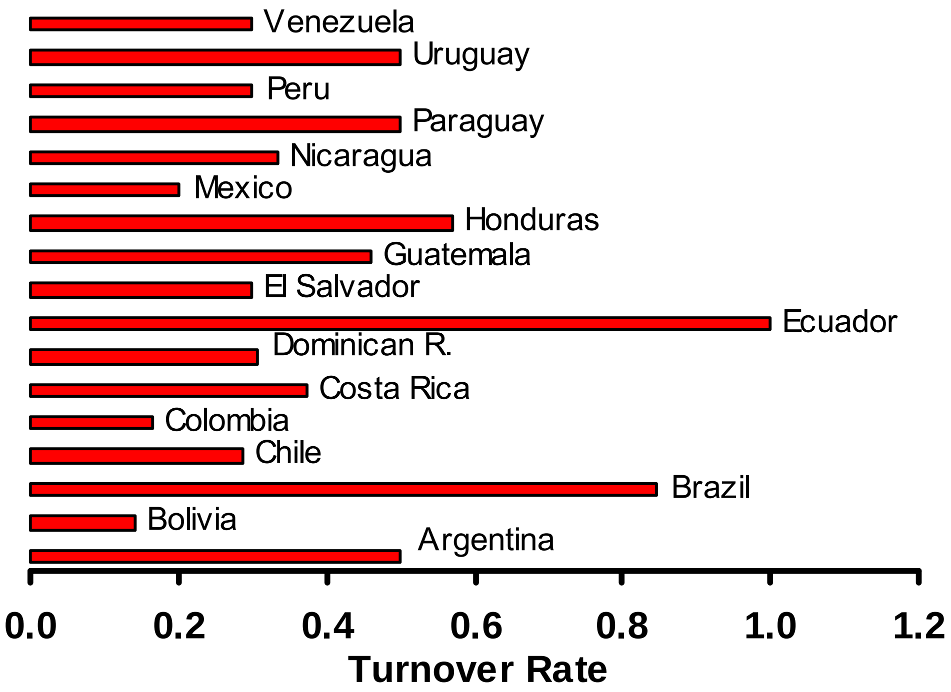
(Latin America versus other regions)



1. Achieve Price Stability

✓ **The high rate of turnover of central bank governors in a number of Latin American countries suggests that monetary authorities remain vulnerable to political pressures an to periods of political instability.**

Turnover rate of central bank governors



2. Restore Confidence in Domestic Currencies

- ✓ **Two groups of countries facing lack of confidence in national currencies:**

  a. **Countries with pegged currencies to the US dollar.** The use of an exchange rate anchor has helped to bring down inflation but this policy regime bears costs and vulnerabilities

  - The lack of a rapid and low-cost exit strategy from the exchange rate peg.
  - The limitation for conducting monetary policy, and hence developing the necessary skills and institutional credibility.

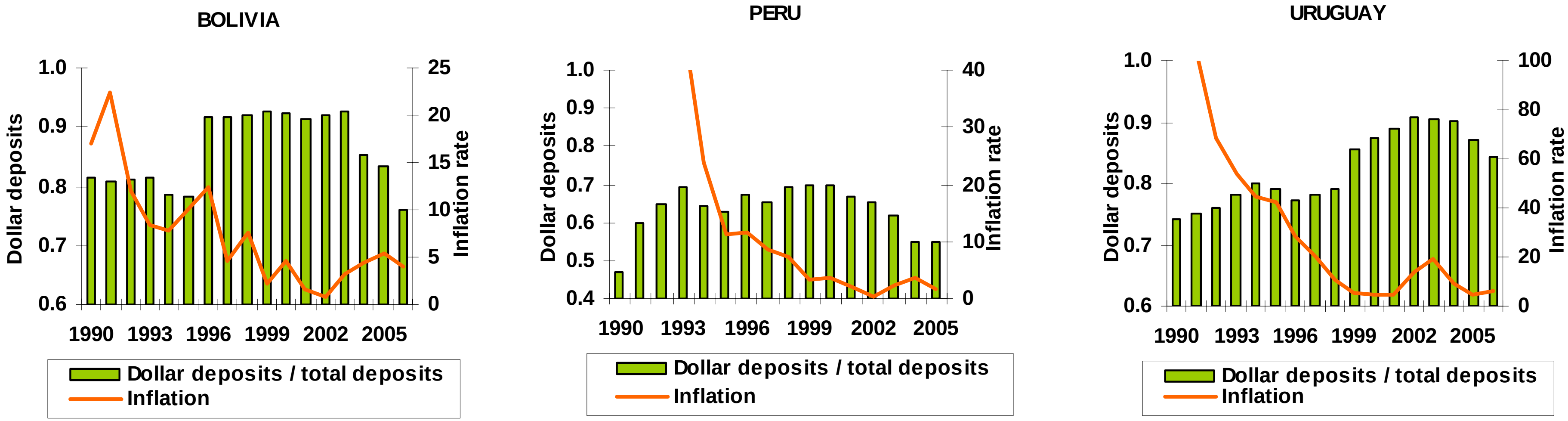
The central banks of this group need to assess whether it is wise to continue with the current monetary regime or to shift to an alternative scheme.

2. Restore Confidence in Domestic Currencies

b. Countries that have not recovered their monetary independence following past episodes of high inflation and/or financial instability.

- The years of macroeconomic instability are still alive in the market participants' mind. As a result, distortions endure: a high level of financial dollarization and the "peso problem".

Financial Dollarization and Inflation



2. Restore Confidence in Domestic Currencies

- Correcting these distortions will take a considerable length of time and will require the support of certain government policies.
- Central banks need to persevere in consolidating their reputation.
- Strengthening prudential regulations applicable to foreign exchange transactions is crucial to reestablish an independent monetary policy.

3. How to Cope with Capital Inflows While Maintaining Policy Consistency

- ✓ **If markets are unable to anticipate and understand the decisions of central banks, and if central banks lack a consistent policy reaction function, monetary policy will be less effective.**

- ✓ **Following the institutional reform of central banks, policy inconsistency decreased significantly.**

- ✓ **Inconsistencies remained in a few central banks as a result of using the exchange rate as a nominal anchor.**

- ✓ **The recent surge of capital inflows has put additional pressure on the consistency of monetary policy.**

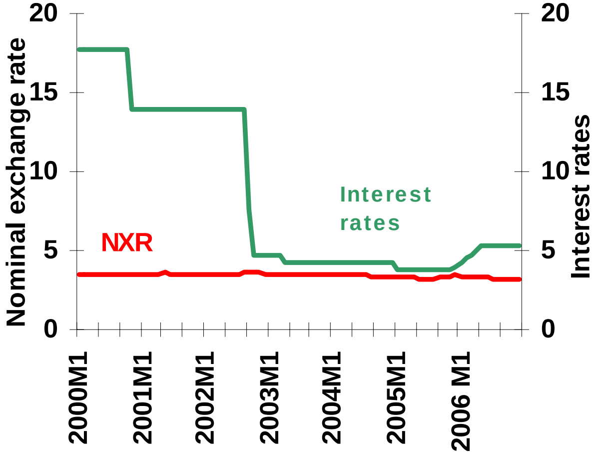
- ✓ **As capital inflows soared, domestic currencies tended to appreciate, leading central banks to the dilemma of whether or not to intervene in the exchange rate market to avoid real appreciation.**

3. How to Cope with Capital Inflows While Maintaining Policy Consistency

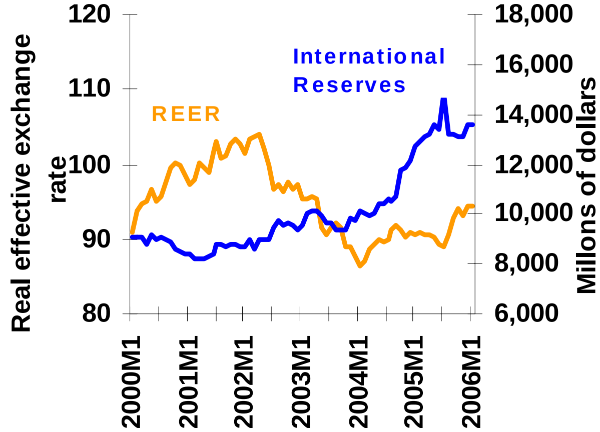
Response to Capital Inflows

Some Central Banks opted for intervention…

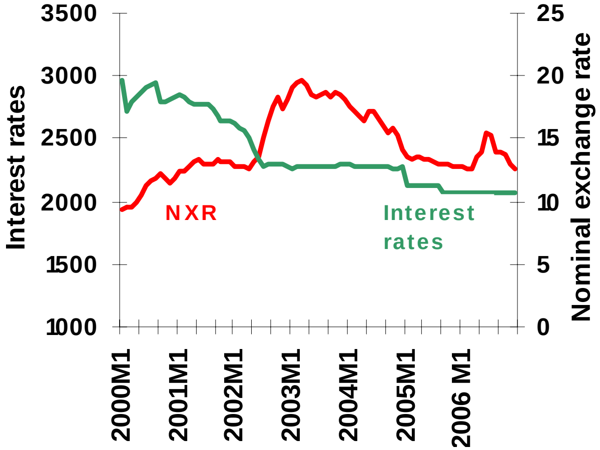
PERU



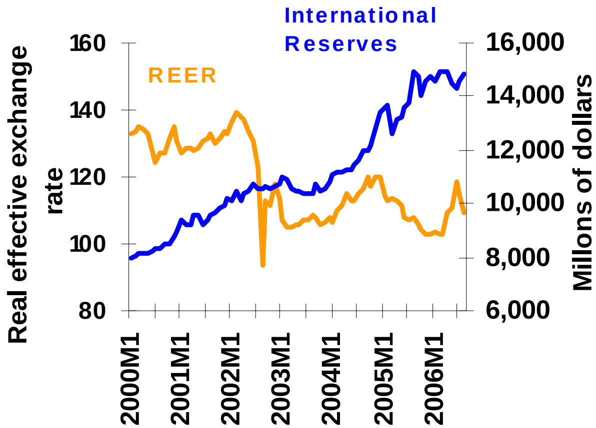
PERU



COLOMBIA



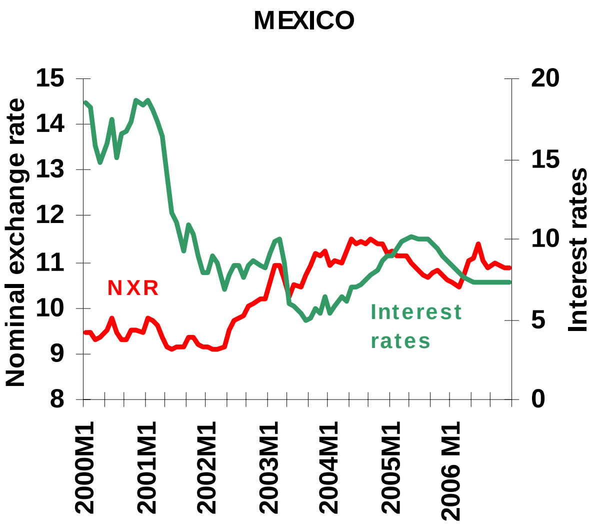
COLOMBIA

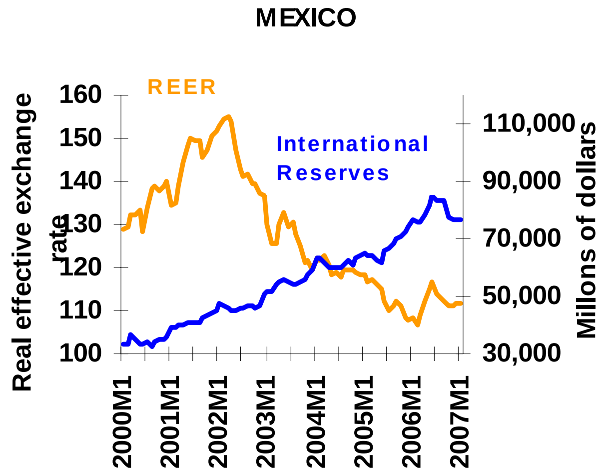


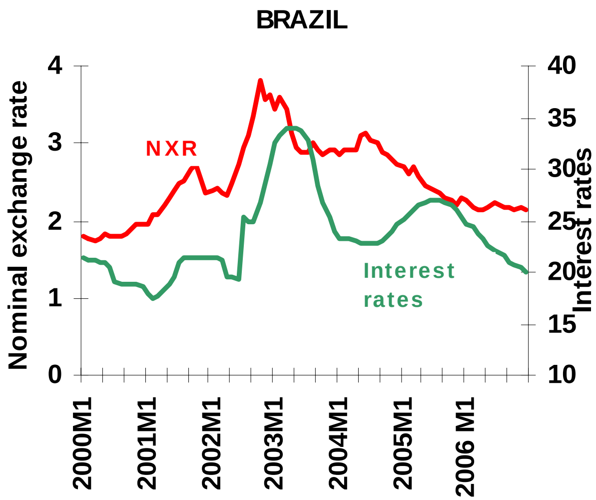
3. How to Cope with Capital Inflows While Maintaining Policy Consistency

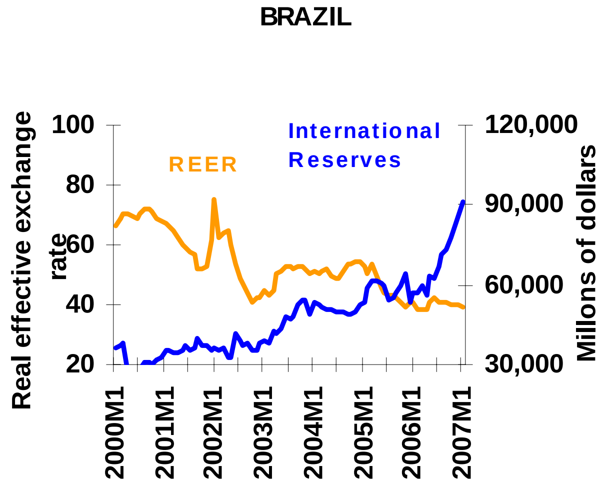
Response to Capital Inflows

Others opted for no intervention…









3. How to Cope with Capital Inflows While Maintaining Policy Consistency

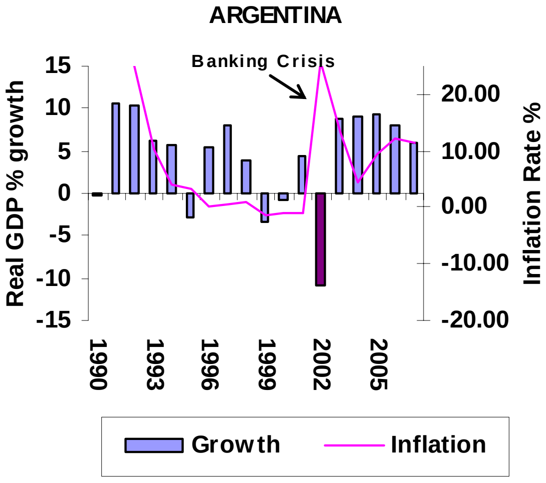
- ✓ **Central banks' intervention may be damaging from an institutional standpoint.**
- ✓ **In the long-run, central banks may not be very effective in containing the real appreciation because the real exchange rate is an endogenous variable.**
- ✓ **The appropriate way to mitigate the effects of the real appreciation is that tradable activities increase productivity.**

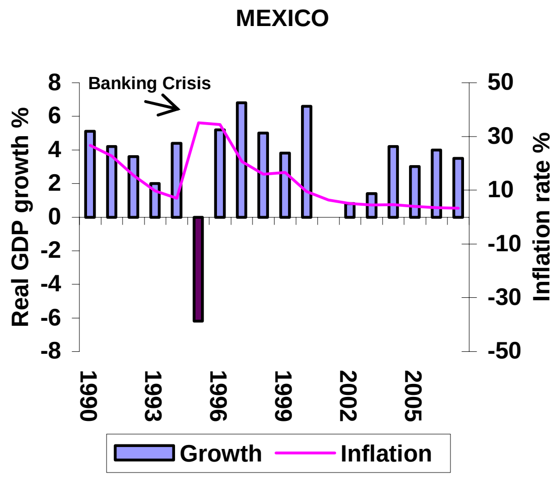
4. The perils of financial system weaknesses and the lack of fiscal discipline

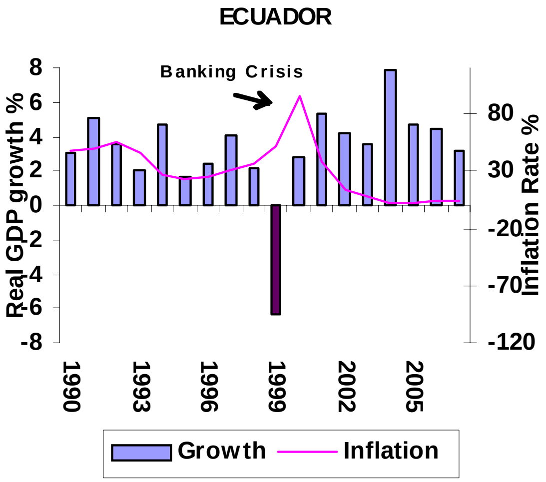
- ✓ **Most countries have made progress in establishing appropriate framework for preventing and managing banking crisis, but more needs to be done.**
- ✓ **The new reforms must emphasize precautionary regulations.**
- ✓ **The role of central banks in the prevention and management of banking crisis should be clearly established in law.**
- ✓ **After fiscal consolidation during the early 1990s, fiscal deficits have soared again in a number of countries. A tight monetary policy combined with a loose fiscal stance produces an inconsistent policy mix.**

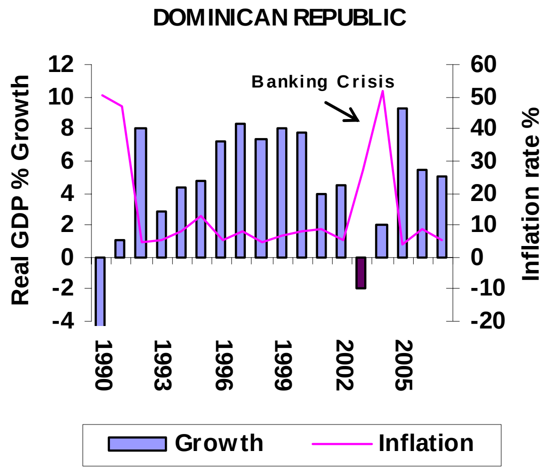
4. The perils of financial system weaknesses and the lack of fiscal discipline

Effects of Banking Crisis on Growth and Inflation









Concluding Remarks…

- ✓ Under the new institutional framework, monetary policy has modernized and inflation has dropped to single-digit rates in a majority of countries of the region.
- ✓ Today, central banks still need to address important challenges.
- ✓ Central banks will not succeed in their endeavors unless government ensure macroeconomic stability and the viability of countries.
- ✓ Governments should make sure that actions speak louder than words in supporting the autonomy of central banks, demanding in exchange rigorous accountability and transparency procedures from monetary policy.