Comments on Inflation Targeting, Financial Stability and Monetary and Fiscal Policies

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March 7, 2011

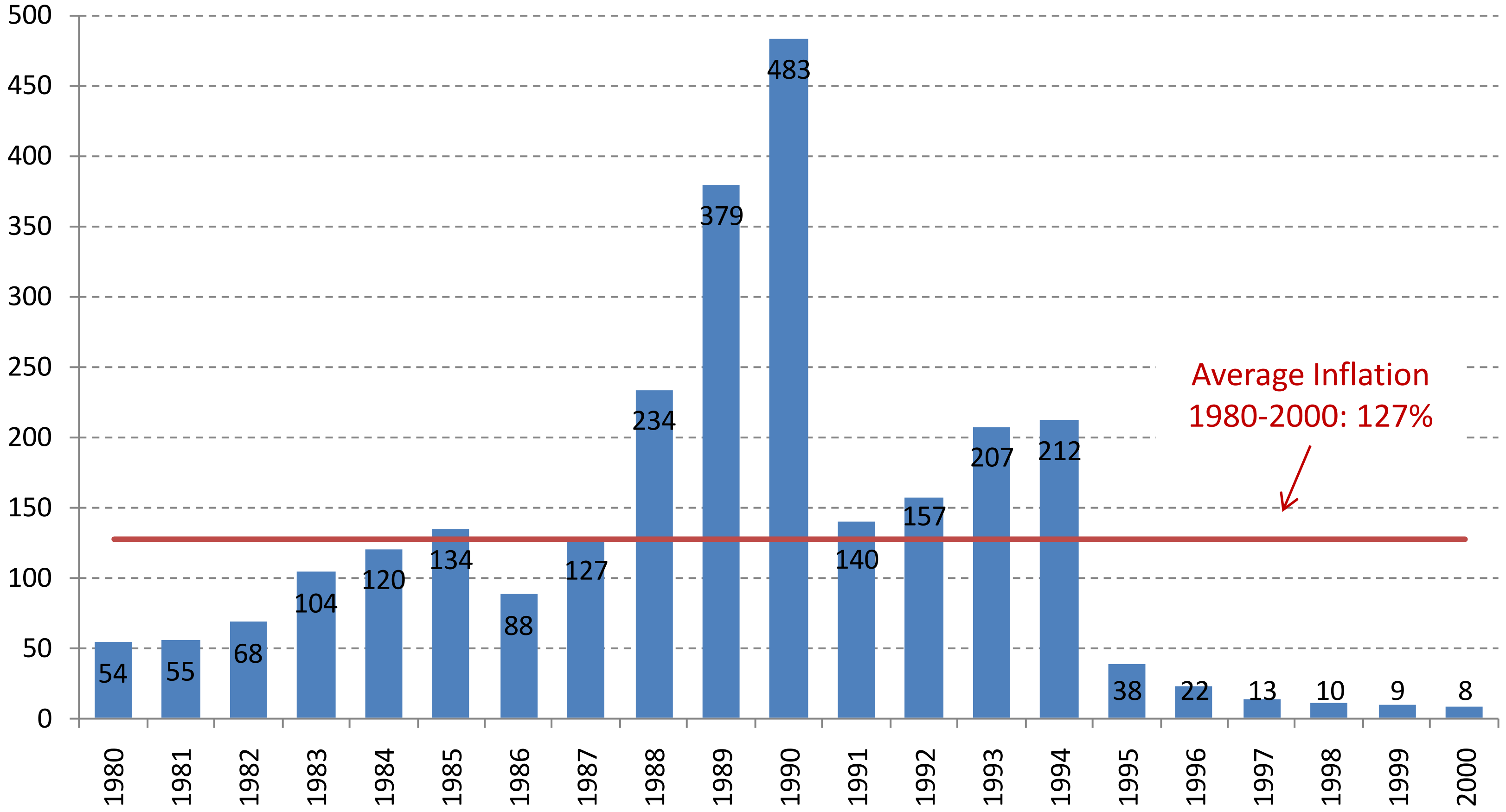
I. Inflation Targeting

- Since the crises of the 90s and early 2000s there has been a much **stronger policy framework** in most EM:
  - ✓ **Fiscal positions** were strengthened.
  - ✓ **International reserves** were increased.
  - ✓ **Domestic capital markets** were developed.
  - ✓ A consistent **monetary/exchange framework** was developed.
- This framework (IT) was fundamental in the achievement of economic stability.

I. Inflation Targeting

Inflation in Latin America and the Caribbean

(Average Consumer Prices, % Change)

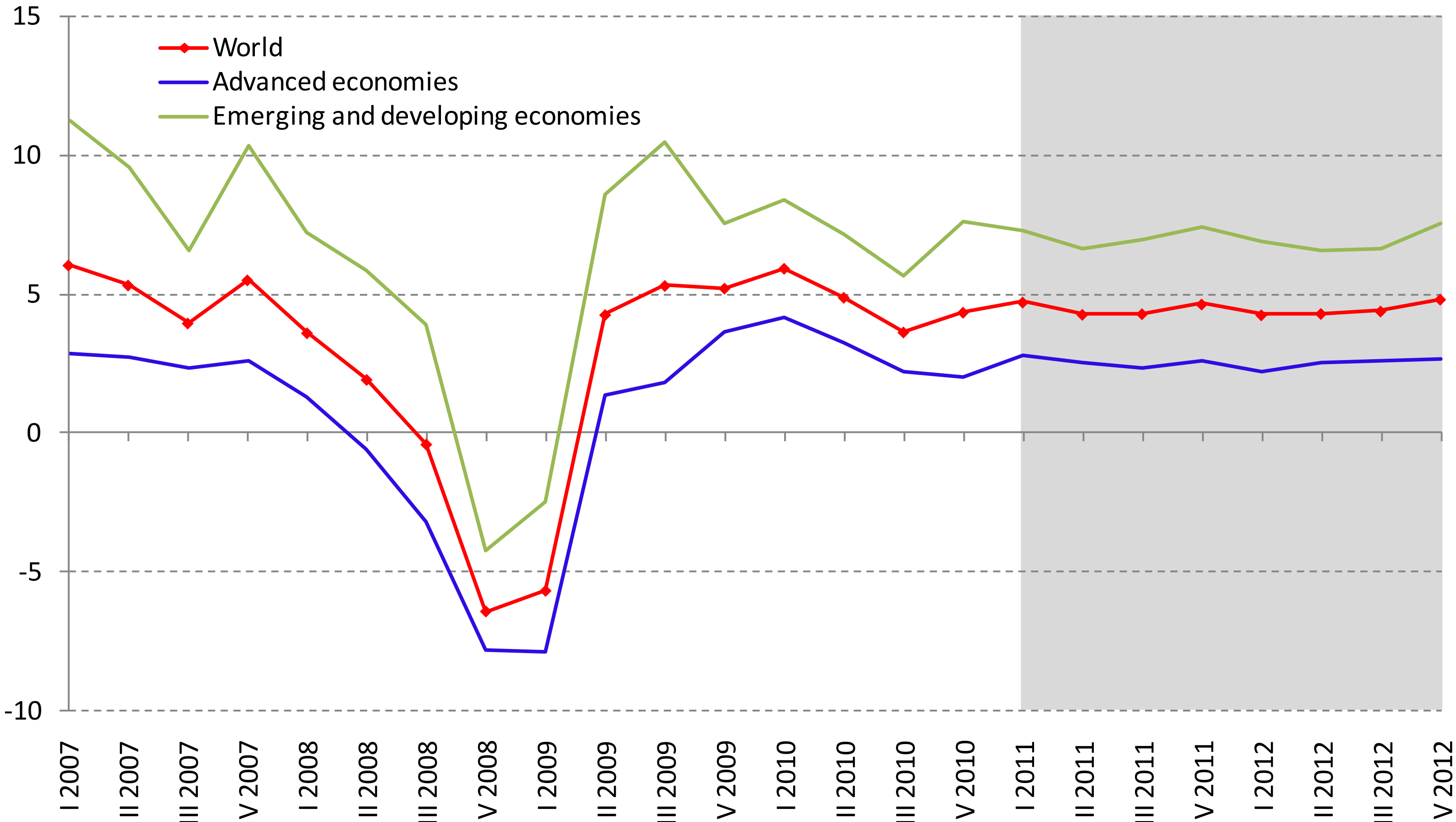


Source: IMF, WEO Database October 2010.

I. Inflation Targeting

Global GDP Growth

(%, quarter over quarter, annualized)



Source: IMF, WEO Update January 2011.

I. Inflation Targeting

- One of the **positive lessons of this crisis** was the effectiveness of the IT framework.
  - ✓ **Inflation** remained under control;
  - ✓ **Inflation expectations** stayed anchored;
  - ✓ IT countries saw sharp **real depreciations**.
- The case of Mexico:
  - ✓ The peso depreciated sharply and commodity prices ⇧
  - ✓ However, inflation has remained under control while expectations remain anchored.
- Though, the **operational simplicity of IT** may have provided the wrong view to some policymakers…

I. Inflation Targeting

- **Interventions** of EM inflation targeters in the foreign exchange market→ source of discussion.

- **Aiming at…** targeting a level of the exchange rate?

- They **reflect the implications of the different macro conditions** and speed of recovery between DM and EM.

II. Financial Stability and Banking Supervision

- For EM, the crisis was a **fundamental stress-test**.
  - ✓ A test on the ability to withstand a crisis, to absorb a shock and to experience a sharp-policy induced rebound.

- **EM learned** from their mistakes!

- After the 1990s and early 2000s crises → **macroprudential** considerations in EM.
  - ✓ In terms of implementing preventive regulation…

II. Financial Stability and Banking Supervision

- The great crisis was a massive **institutional failure**…

  … reflecting the **belief that market discipline was sufficient** to promote financial stability.

- The crisis showed us that :
  - ✓ Price stability $\neq$ financial stability;
  - ✓ Forces of market discipline do NOT suffice to allocate resources effectively and manage risk.

II. Financial Stability and Banking Supervision

- Therefore it is essential to rethink the **role of central banks as guardians of financial stability**…
  - ✓ Involvement in financial regulation.
  - ✓ Role in banking supervision.

- Bank's supervisory role → interference with its **independence** to conduct monetary policy.

III. Monetary and Fiscal Policies

- **Boundaries** between monetary and fiscal policies: → The special lending facilities to the financial sector and sovereign debt support

- **Justifications**:
  - ✓ First, there are political constraints.
  - ✓ Secondly, the crisis justified a broader policy response that would have been called for by orthodox economic theory.

- New to DM… but not for EM…

III. Monetary and Fiscal Policies

- **Despite** this departure from the orthodox view → monetary and fiscal policies have been kept separated for the most part.

- US, UK and ECB intervention.

- **Temporary expansion** of their balance sheet.

- Should **not influence** the **long-term** conduct of monetary policy or long-term inflation expectations.