Latin American Central Banks: Inflation Targeting vs Economic Growth

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Inflation Targeting vs Economic Growth

- In the last 20 years, most central banks have used a framework in which the main role of monetary policy (MP) is to achieve and preserve price stability.
- But central bankers are well aware that MP has effects on output:
  - Short run: there is a Phillips curve and therefore, MP affects the output gap (unemployment) and inflation;
    - That is the reason why central banks use a flexible inflation target (FIT), and work with a tolerance range around the target.
  - Long run: by reducing inflation uncertainty, price stability contributes to long term growth by improving the information content of relative prices.
- Furthermore, inflation is a regressive tax that damages with particular intensity those who are less endowed.

Inflation Targeting vs Economic Growth

- Usually the flexible inflation targeting (FIT) framework is accompanied by a flexible exchange rate system.
- Monetary policy acts are followed by a slow adjustment of prices, so that a change in the policy rate affects the real interest rate.
- This way of conducting monetary policy was becoming the norm up until the eve of the Great Financial Crisis.
- It was understood that Financial Stability was assured by price stability and an appropriate (micro) prudential regulation and supervision of the financial system.
- Now we know that this is not enough to achieve Financial Stability, that central banks and regulatory agencies also have to be concerned with systemic risks that affect Financial Stability.
- Today there is a growing consensus that central banks (CBs) have an important role to play in promoting Financial Stability.

Inflation Targeting vs Economic Growth

- Financial Authorities need a second instrument to deal with the sources of systemic problems: that instrument is macro prudential regulation and supervision.
  - Macro prudential regulation and supervision can deal more effectively with fragilities and distortions in the financial system and can also have a countercyclical role. They complement micro prudential regulation.
    - Examples are pro-cyclical capital buffers, higher capital requirements, liquidity requirements, loan to value and debt-service to income ratios ratios for mortgages and adjustments to the risk-weight of assets.
- CBs and Regulatory authorities also need to have procedures in place to deal with the failure of systemically important institutions.
- CBs also need to develop richer models, in which the financial sector and the incentives of its players are key building blocks.

Inflation Targeting vs Economic Growth

- Price Stability and Financial Stability are preconditions for sustainable growth and they do not compete with each other.
- Determinants of long-term growth.
  - Theory and empirical studies show that growth is the product of “perspiration” (physical and human capital growth) and “inspiration” (TFP growth).
  - High and sustained growth rates cannot be achieved without an important contribution of “inspiration”.
- Economic policies and institutions have a crucial role on growth, since they affect factor accumulation and TFP growth.
  - In particular, price stability promotes long term growth through its effects on factor accumulation and TFP growth.
  - But other policies also have a central role: integration to the world economy, competitive markets, human capital development, property rights and an adequate provision of infrastructure and public goods.
- From this long list, CBs can only help with the first point.

Inflation Targeting vs Economic Growth

- To promote long term growth, the region has many opportunities in several fronts:
  - (1) Increase competition, especially in service sectors;
  - (2) Strengthen human capital formation (improve the quality of public pre-school, primary, secondary and technical education and training);
  - (3) Improve the functioning of labor markets (more flexibility in working conditions, improve the access of women and young people, and more security in contracts);
  - (4) Improve the efficiency of the State (from poverty focus to a focus on providing services to the middle class and improving governance);
  - (5) Upgrade the framework for technological innovation.