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Dual-Objective Monetary Policy for Latin America

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Abstract

When an economy has achieved a level of price stabilization consistent with its own fundamentals, and macroeconomic discipline has become a government's commitment, inflation and growth should have the same priority. In Latin America, the persistent search of low inflation through a single-objective monetary policy has left aside the goals of growth and social well-being. This has also generated a conflict of interest between fiscal and monetary policies. This natural conflict can result in a macroeconomic inefficiency expressed in a mediocre economic development. The solution to the conflict lies in a political decision that assigns central banks a dual-monetary mandate: maximum growth with minimum inflation. This paper proposes a monetary policy with dual mandate for Latin American central banks as a way to attain a more efficient policy coordination that allows the region to achieve a more balanced economic development.

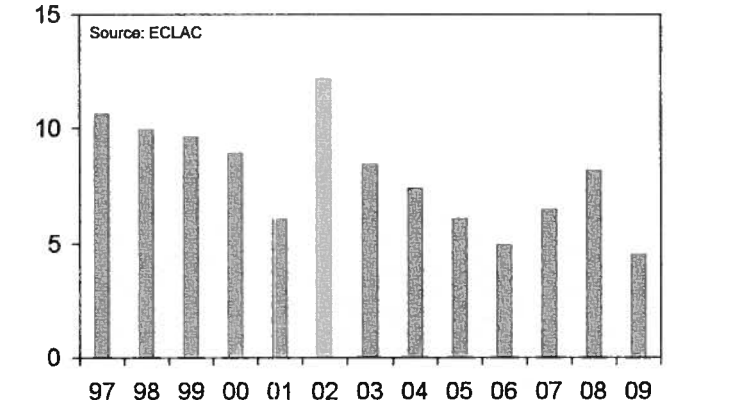
I. Stabilization task

A few decades ago, Latin America was characterized by hyperinflation episodes, dramatic currency devaluations, chronic macroeconomic imbalances, and repetitive financial and economic crises. In most cases, if not all, the explosive inflation was the result of the region's fiscal and monetary indiscipline. Thus, for some decades, inflation was the common enemy of Latin American governments, until the arrival of stabilization plans imposed by international financial organizations. As a result, governments were subject to strict adjustment programs in terms of fiscal, monetary, and exchange rate policies. Even though governments retook the inflationary control, the region continued to suffer from a persistent inflation above international standards. Despite the structural changes and openness implemented, inflation was still resilient to fall to a single-digit rate.

Certainly, after all, there was a missing piece in the unfinished inflation battle in Latin America: the independence of monetary policy from fiscal decisions taken by the executive branch. Undisciplined fiscal policy continued to be a source of inflation pressures, which implied an expansionary monetary policy. In order to solve the problem, some Latin American governments accepted to cut the dependence of monetary policy by granting autonomy to central banks. This independence was accompanied with the assignment of a single-objective monetary policy. Hence, during the decade of the 1990s, countries such as Brazil, Chile, Colombia, Mexico and Peru already counted with independent central banks. After their independence, central banks adopted the "inflation-targeting[1]" approach, with the commitment to using the monetary artillery to attain a numeric inflation target.

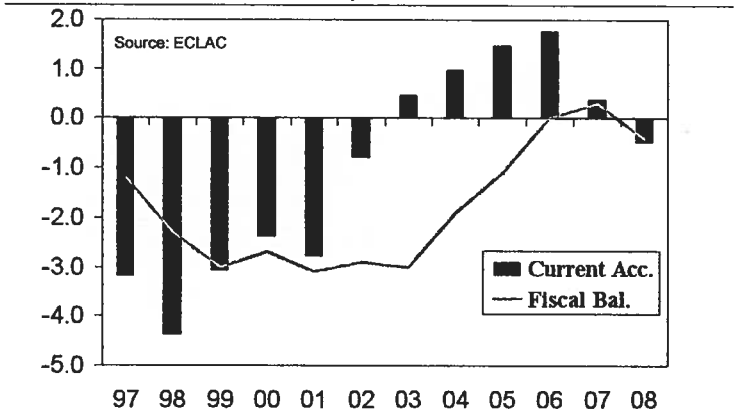
Thus, the autonomy and the single-objective monetary policy were key factors to achieve the largely-desired price stabilization, with inflation finally falling to single digit by the end of the 1990s and 5% by 2006 (see chart 1). Even though price variability was still high, the region successfully achieved a structural reduction of inflation. This way, the single-objective monetary policy has been effective in achieving a satisfactory stabilization task. However, this has been possible thanks to the fact that inflation was mostly caused by an expansionary policy, which was finally resolved by governments' commitment to macroeconomic discipline and the consequent correction of the main macroeconomic imbalances (see chart 2).

Chart 1
Latam Price Stabilization Accomplished Consumer price index, annual % change



[1] Details on this monetary approach can be found in Blinder (1998).

Chart 2
Latam Chronic Imbalances Corrected Current account and fiscal balance, % of GDP



II. Limits of the monetary effectiveness

Undoubtedly, the monetary effectiveness has been demonstrated in the successful inflation battle of the last decade in Latin America. However, the success has much to do with the fact that inflation was mostly a monetary event. Certainly, monetary policy is highly effective against inflation when the origin of price increases lies in an excess demand generated by money expansion[2]. However, the effectiveness reduces when the inflation comes from supply shocks. When price increases are the result of supply disruptions caused by weather conditions, natural disasters, lack of competition, structural bottlenecks, and external prices, then monetary policy is less effective and also inflation becomes immune to the monetary artillery.

Hence, fighting an inflation that is generated by market failures or by prices determined in international markets is both useless and costly in terms of economic growth. In these cases, monetary action directly hits domestic demand, which is not responsible for inflation, consequently affecting economic growth. In the end, inflation can certainly be reduced, but in exchange of an unnecessary economic contraction. In this sense, monetary policy should not be used indiscriminately against any inflation, but only when inflation has monetary roots. In other words, there is no reason to use monetary policy to fight an inflation generated by either lack of market competition or by imported prices, since most of domestic problems should be resolved through public policies to promote structural changes.

In the region, the monetary intervention against a supply-shock inflation is generally justified by the argument of trying to avoid price contamination or expectation deterioration. However, both contamination and expectations are only the results of inflation but not its causes[3]. Thus, under these cases, monetary policy would be fighting

[2] Inflation as a monetary phenomenon has been widely studied in Friedman (1990).
[3] Details on causes and consequences of inflation can be found in Friedman (1990).

the consequences of inflation but not the roots. This also explains why inflation becomes immune to monetary restriction, since the roots come from supply shocks, not from domestic demand. This way, the effectiveness of monetary policy is limited by the fact that inflation must necessarily be a monetary phenomenon.

In general, a consistent monetary policy should be activated when inflation is caused by demand factors rather than by supply shocks. However, when supply shocks are more permanent and threaten with the development of a generalized contamination of other prices, then a monetary intervention can be justified[4]. The reason is simple, supply shocks–like in the case of international prices of energy and food or unfavorable weather conditions–only generate temporary movements in the rate of inflation, but not a sustained increase in prices. In other words, supply shocks produce changes only in relative prices, not a generalized increase in all prices.

III. Monetary ineffectiveness against external shocks

During the past few years, the world economy was threatened by an inflation mainly caused by high commodity prices. Domestic inflation in most countries was mainly the result of an external shock. Thus, in Latin America, inflation showed an upward trend since 2007 and particularly in 2008, but the price increase had a significant imported component. Even though there was some evidence of demand pressures in few countries (Colombia, Chile and Peru), inflation was caused mainly by high prices of food and energy.

Despite the recognition of the imported component of inflation, central banks activated the monetary artillery indiscriminately without caring about the real roots of inflation. Latin American central banks were not an exception; they were also contaminated by the global inflationary panic, thus showing their "inflation-phobia[5]" by raising the policy interest rate in 2008, consequently neutralizing the stimulative effect of fiscal policy.

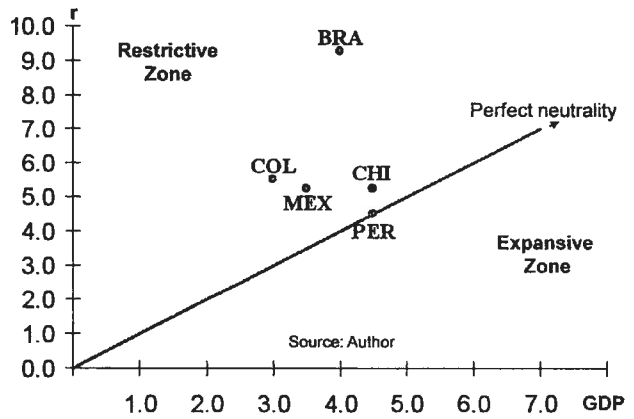
Chile, Colombia and Peru–whose economies were running at a speed faster than the potential in the past few years–generated an excess of domestic demand that was accommodated in higher inflation and more imports. In these countries, monetary conditions in 2008 were moved from expansionary to more neutral (Chile and Peru) or even to a more restrictive stance (Colombia). On the other side, countries like Brazil and Mexico, where there was no evidence of an excess demand, monetary policy turned more restrictive, and basically responded to the market's inflation fears rather than to the real inflationary roots[6] (see chart 3 and the appendix).

Hence, toward the end of 2008, with the global economy weakening significantly, Latin American central banks maintained monetary policy in restrictive territory rather than relaxing conditions. However, given their single-objective monetary policy, central banks could have been accused of violating their constitutional mandate if they relaxed conditions to support the economy. This way, the single-objective mandate seemed to be more of a limitation rather than a benefit for the region.

Inflation, however, continued to increase during the second half of 2008, despite the restrictive monetary policy. Meanwhile, economic activity decelerated by effect of the

[4] Examples of these cases can be found in Coutiño (2009).
[5] See Coutiño (2008).
[6] For details on the stance of monetary conditions see the appendix and Coutiño (2008a).

Chart 3
Latam Monetary Policy Stance, End 2008 Annual rates, %



monetary brake. Ironically, inflation started to fall at the end of the year even though monetary conditions started to relax, but commodity prices adjusted down significantly. This was a clear evidence of the monetary ineffectiveness against an inflation caused by an external supply shock.

IV. Conflict of interests

The fact that fiscal policy is traditionally in charge of promoting growth and monetary policy in charge of controlling inflation–each of them assigned to different institutions–naturally generates a conflict of interests. Given that each institution will perform its work according to the policy objective assigned, and its performance will be evaluated according to its effectiveness, then each one will direct its policy artillery to the achievement of its own goal. The conflict arises because nothing prevents both policies from moving in opposite direction, thus becoming an obstacle to each other.

In developing countries of Latin America, where economies come from chronic inflations generated by fiscal and monetary disorders, fiscal policy has been additionally assigned the responsibility of discipline in order to cooperate with the inflation goal. This implies that fiscal policy has indeed been assigned two objectives: promote growth and help control inflation. Meanwhile, monetary policy has been assigned only a single objective, as part of the central bank's independence and its role of "inflation targeter."In other words, while fiscal policy has been called to contribute to control inflation, for monetary policy, growth is only secondary. In fact, in an extreme case, a central bank can certainly send the economy into deceleration or even into recession[7]. In this sense, a natural conflict of interests is generated between the person in charge of fiscal policy (growth) and the one responsible for monetary policy (inflation).

[7] See Coutiño (2008a).

A conflict like this operated in Latin America in 2008, and in other countries as well, during the global slowdown. Given the deterioration of international conditions, and particularly the U.S. recession, fiscal policy tried to maintain a countercyclical nature to defend the economy from external shock, while monetary policy moved in the opposite direction (restrictive). This situation not only reduced the effectiveness of fiscal policy but also generated an inefficient use of resources that could have been used to better stimulate the domestic market. In fact, if the monetary restriction had not relaxed, Latin America would have fallen into a deeper recession in 2009.

V. The solution lies in politics

The conflict of interests between fiscal and monetary policies is not difficult to resolve, but implies an intense work of political leadership and negotiation skills, particularly to gain support from orthodox groups. The solution should not include radical measures that threaten the constitutional mandate assigned to central banks. Instead, it should go in the direction of ensuring a macroeconomic management more consistent, efficient and synchronized, which allows a mix of fiscal and monetary policies that promotes a more sustainable growth with price stability.

The solution implies that both policymakers (fiscal and monetary) should be committed to the goal of sustainable growth, allowing them to compensate growth in times of deceleration and moderate it in times of acceleration. To do this, it is necessary to assign monetary policy the same two objectives already assigned to fiscal policy: growth and inflation. Each nation's Congress is the institution in charge of changing and modifying the objective of monetary policy[8]. In this sense, politicians (not economists) are the ones in charge of assigning central banks a dual-objective monetary policy, in substitution of the single-objective policy. Under this new circumstance, the policy conflict can be resolved and policy synchronization can become possible to improve the region's well-being.

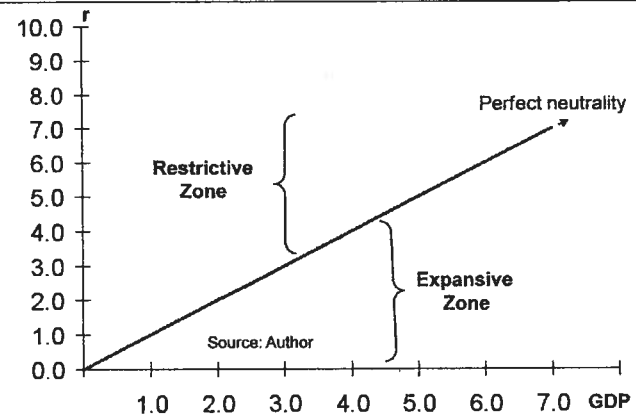
With that policy-objective modification, neither the constitutional mandate is violated, precisely because it will be adjusted accordingly by the ones who have the right to do it (politicians), nor is the central bank's independence threatened. On the contrary, the dual-objective policy reinforces the monetary instrument to better serve the goal of social well-being. The main critique from the orthodox side would be that the dual-objective policy could put the inflation target at risk. However, under these new circumstances, the level of inflation would be determined by the economic structure of each country, probably between 3% and 5% in most cases. In fact, as long as governments are committed to fiscal and monetary discipline, inflation should not be at risk, particularly because it would not be a monetary phenomenon.

The main challenge lies in the government's ability to convince political groups of giving monetary policy more flexibility. Given that most Latin American countries have attained a degree of price stability consistent with their own fundamentals, to a great extent, it is time for those countries to give back part of the well-being lost in the past. This way, under a new dual-objective policy, Latin America would find a better balance between the maximum growth attainable and the minimum inflation.

[8] On this topic, see Blinder (1998).

VI. Appendix: Methodology for computing monetary conditions

Chart 4
Monetary Conditions Annual rates, %



The neutral interest rate is that at which the economy reaches its steady state growth. The steady state is a situation in which the fundamental variables grow at a constant similar rate without generating macroeconomic disequilibria. In this situation, the economy grows at its potential rate with a real interest rate that maintains a neutral stance (neither stimulates nor restricts). In other words, the potential growth rate is the implicit neutral interest rate in real terms.

The potential growth rate –the speed at which an economy naturally expands according to its production capacity–is determined by the fundamental sources of growth: saving-investment, productivity, and technological change. Our own estimates for the five Latin American countries with independent central banks indicate the following potential rates: Brazil 4.0%, Chile 4.5%, Colombia 3.0%, Mexico 3.5%, and Peru 4.5%. The nominal neutral interest rate can be roughly estimated as the sum of the potential rate and the long-term inflation expectation.

In the diagram above (chart 4), the "X" axis represents the real GDP growth rate, and the "Y" axis shows the real interest rate. The 45-degree line indicates the "perfect neutrality" since it matches the potential rate with the neutral interest rate, thus representing the steady state situation. In other words, a real interest rate that lies on the neutrality line is just the one that allows the economy expand at its potential rate. Any real interest rate below the line of perfect neutrality indicates a monetary policy in the expansionary zone. Similarly, a real interest rate above the line indicates a monetary policy in the restrictive zone.

Thus, the determination of the monetary policy status for a particular country involves the computation of the actual level of the real benchmark interest rate, which is determined by the nominal interest rate used for monetary policy decisions and the expected inflation rate–given by the central bank's inflation target. The comparison between the actual real interest rate and the neutral real interest rate gives us the position of monetary conditions in that particular country. If the actual real rate is higher, then monetary policy is restrictive; if it is lower, then monetary policy is expansionary.

The estimation of potential growth can be done through the Solow Growth Model[9], where the production function is a Cobb-Douglas type with constant returns to scale and includes capital, labor and technological change[10].

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[9] Details on this model can be found in Jones (1998).
[10] For the case of Mexico, see Coutiño (2000).