



**Stability and Economic Growth: The Role of the Central Bank**  
**(Banco de Mexico, 2006)**  
by Lisa Drakes\*

In November 2005, the Bank of Mexico (BOM) hosted a conference to commemorate its eightieth anniversary. Academics and policymakers from around the world were in attendance and shared their findings and experiences on how central banks can assist in ensuring stability and economic growth. The book entitled **Stability and Economic Growth: The Role of the Central Bank** is a compilation of the papers presented at that conference.

The text discusses matters related to the design and implementation of monetary policy. In particular, it focuses on the importance of central bank independence (CBI), inflation targeting (IT) and the monitoring of asset prices in the conduct of monetary policy and in the pursuit of stable economic growth. Academics, policymakers, as well as students who are interested in understanding the intricacies of modern-day monetary policy, will find this a very useful resource.

In addition to two keynote addresses, the book comprises eighteen papers, which are divided among five sections. Section 1 discusses how CBI can be beneficial to the conduct of monetary policy and to the prevention of macroeconomic volatility. Section 2 is centered on the role monetary policy plays in promoting growth and macroeconomic stability. However, the importance of various types of institutions in achieving this end is also recognised. The third section highlights the different views on issues surrounding the design and execution of monetary policy within an IT framework. Lessons from four different country experiences are provided. Section 4 analyses the monetary policy complications that often stem from swings in asset prices and suggests some appropriate policy responses. The final section focuses on the experiences of monetary policymakers in Brazil, Argentina and Mexico.

**Keynote Address #1 – Stability and Economic Growth: The Role of the Central Bank**

In the first keynote address, Alan Greenspan advocates the development of a flexible economy. In his opinion, this has made the United States' (U.S.'s) economy more stable and, consequently, has increased economic growth and raised the standard of living. He argues that competition fosters such flexibility, as it creates self-correcting mechanisms within an economy that enable it to respond to shocks, resulting in greater stability in the process. Greenspan's view, therefore, is that market forces should take the leading role in ensuring stability, which implies that governments and central banks should lessen their intervention in the economy.

**Section 1 – Performance of Independent Central Banks: Achievement of Objectives and their Contribution to Macroeconomic Stability**

The paper, *Central Bank Independence – What Role Does it Play in Shaping Mexico's Economy*, written by Malcolm Knight, gives a positive evaluation of the stability of Mexico's monetary system. Mexico recovered from the crisis of the early 1990s and has been able to keep inflation down to 3%, while maintaining economic growth. Knight is of the view that this stability is the result of the independence the Bank of Mexico gained in 1994, which insulated it from political forces and allowed the undertaking of a successful IT regime that brought inflation to an all-time low by 2005.

In his presentation on *Central Bank Independence and Policy Results: Theory and Evidence*, Alex Cukierman states the theoretical case in support of CBI. An inflation bias can result from monetary expansion that is driven by an "employment motive". When policymakers have discretion they use inflationary surprises to increase employment to a rate that is most often above its natural level. However, economic agents expect such action and are able to correctly predict inflation. The result is that the policymakers' decisions have no effect on employment, but the inflation they induced is still present. Thus discretionary

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\* Miss Lisa Drakes is a Research Officer in the Research Department of the Central Bank of Barbados.

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monetary policy has elements of dynamic inconsistency. To partially eliminate this bias, the responsibility for monetary policymaking can be allocated solely to an autonomous central bank, which is likely to be more conservative than the public or politicians.

The “employment motive” tends to exist in many developed countries that have easy access to capital markets and, therefore, little difficulty in financing a deficit. On the other hand, for developing countries with underdeveloped capital markets, deficit financing usually falls on the central bank and this “revenue motive” for monetary expansion often has an inflation bias. One solution is to have rules and regulations on lending by the central bank.

Cukierman also notes that the empirical literature shows that CBI is inversely related to inflation in both developed and developing countries. In developed countries, CBI was found not to be associated with economic growth, while mixed results on the nature of the relationship between growth and CBI were obtained for developing countries.

Axel Weber’s contribution was entitled *The Role of Institutions in Monetary Policy Making: Optimal Design for Conflicting Policy Areas and the Need for Public Support*. Factors other than monetary policy, such as fiscal policy and the wage bargaining process, influence price stability. Therefore, even an independent central bank may be unable to achieve monetary stability. Using examples of Europe, Weber notes that the success of an autonomous central bank in attaining price stability also depends on support from the public, particularly when there is conflict with another policy area. When conflict occurs between monetary and fiscal policies within a single economy, Weber suggests that the best approach is for monetary policy to focus on maintaining a low level of inflation, while fiscal policy should concentrate on smoothing the intertemporal tax burden. In addition, Weber examines the case of the European Economic and Monetary Union and concludes that when conflicts occur within a union, fiscal policy should focus on reducing the effects of asymmetric events, while monetary policy should be used in response to symmetric shocks.

Victor Corbo, in discussing *Monetary Policy and Central Bank Independence in Chile*, describes the legal

framework underlying the Central Bank of Chile (CBC) independence since 1989. The CBC has successfully implemented monetary policy, within an IT regime, that has brought the economy to full recovery from recession and financial crisis of the early 1980s. The writer cites the 1998-1999 period as a turning point in the CBC’s policy. Inflation was low and the advantages of a flexible exchange rate regime were acknowledged. Major policy reform involved the adoption of a generally clean float, the removal of capital controls, and the introduction of full-fledged IT. According to Corbo, over the last two decades, the policies adopted by the CBC have made the Chilean economy progressively more stable.

## **Section 2 – Monetary Policy and Economic Growth: The International Experience**

Robert Barro examines whether low and stable inflation promotes economic growth in his paper *Monetary Policy, Inflation, and Economic Activity*. He notes that there is evidence to support this hypothesis. However, a cross-country study shows that the impact low inflation has on growth is minimal. For a decrease in the inflation rate of ten percentage points, real per capita gross domestic product (GDP) rises by just 0.2% per year. Still, as Barro points out, countries with high inflation tend not to experience any increases in GDP. Thus, he concludes that although monetary policy aimed at lowering inflation helps to promote growth, other factors such as low levels of corruption and effective educational and health systems are crucial for economic expansion.

*The Role of Central Banks in Fostering Economic Growth* by Ronald McKinnon describes how this role has evolved. In the era of the gold standard, when the main goal of monetary policy was to sustain a fixed exchange rate, central banks indirectly promoted growth. After the collapse of the gold standard in the 1930s and up until the 1980s, countries developed their monetary policy independently of the international monetary system, enforced by the belief in the Phillips curve. Monetary authorities, concerned with the consequent contraction in employment, refrained from taking measures to combat

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rising inflation. The result was low productivity and the feared increase in unemployment, which prompted the questioning of the validity of the Phillips curve. It was suggested that if workers anticipate that the central bank's policy will lead to inflation, they would bargain for higher wages, causing higher unemployment than if inflation was low and stable. Therefore, the achievement of low and stable inflation became the mandate of central banks. Today, it is believed that this is best obtained through an independent central bank.

McKinnon also makes mention of the role of the central bank in the 1950s and 1960s when import substitution, the objective of which was to further growth and development, was strongly advocated. The central bank, following directives from government, facilitated lending to newly developing industries at rates below the market rate. According to McKinnon, this led to financial repression.

Otmar Issing, in *The Role of Fiscal and Monetary Policies in the Stabilization of the Economic Cycle*, presents the case of the European Central Bank (ECB) in order to illustrate how monetary policy can bring about stabilisation. The Maastricht Treaty gives sole responsibility of monetary policymaking to the ECB, the main mandate of which is to ensure price stability. Stable expectations of inflation help to reduce macroeconomic volatility and add to economic welfare. In terms of the role of fiscal policy in maintaining stability, Issing argues that such policy should be countercyclical, which can be achieved through automatic fiscal stabilisers or by discretion. Studies of European economies have shown that when policy makers are allowed to exercise their discretion, fiscal policy tends to be pro-cyclical and offsets the responses of automatic stabilisers, thereby intensifying instability. However, as Issing points out, discretionary fiscal policy still has a role to play, particularly when structural modifications of government finances are required and when severe shocks occur.

*Monetary Policy and Economic Performance: The Experience of New Zealand* by Alan Bollard and Chris Hunt asserts that New Zealand, in terms of key macroeconomic variables, has outperformed the majority

of other Organisation for Economic Co-operation and Development (OECD) countries. However, with these achievements have come threats to inflation. Therefore, the Reserve Bank of New Zealand adopted an IT regime, which is flexible in the sense that the Bank can choose how it will obtain price stability. However, it has been mandated to select the channel that least compromises short-run growth and the stability of the exchange rate and interest rates. Additionally, Bollard and Hunt suggest that increasing globalisation has led to the dependency of monetary policy on the actions of other countries. Despite this, the authors conclude that monetary policy, as a result of its countercyclical nature, has been successful with stabilisation of New Zealand's economy leading to higher growth rates since the beginning of the 1990s.

### **Section 3 – Design and Lessons from the Implementation of Monetary Policy Under Inflation Targeting: Four Perspectives**

As noted by Lars Svensson in the article entitled *The Instrument-Rate Projection Under Inflation Targeting: The Norwegian Example*, there has recently been some debate on the instrument-rate assumption used for projection in an IT regime. What assumption should be made about the instrument-rate and whether this assumption should be made public have been some of the main concerns. According to Svensson, since the assumption of a constant instrument-rate is unrealistic and in conflict with market expectations, it can pose numerous problems. He, therefore, recommends other alternatives such as what the market expects future instrument rates to be. The Norges Bank has adopted a flexible IT regime, and has been described by Svensson as making monetary policy history by publishing a comprehensive overview of its decision-making process. Svensson advocates such transparency and public communication, as this will influence expectations and promote the effectiveness of monetary policy.

Jacob Frenkel's paper, *Inflation Targeting, Disinflation and Exchange Rate Policy: The Israeli Experience*, shows that after inflation reached 450%

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per year in the 1980s, the exchange rate was used as a nominal anchor to bring inflation down to 18% in 1991. However, the fixed exchange rate combined with inflation that was still much higher than many countries led to a loss in international competitiveness. To reduce inflation to a level consistent with the rest of the world, Israeli authorities opted for an IT regime. In its search to regain its competitiveness, Israel also adopted a slope exchange rate band, where the slope took into account the difference in inflation between Israel and the rest of the world that would prevail under the targeted inflation rate. Frenkel identifies some lessons from the Israeli experience which include: the inflation target should not be set as a specific percentage, a range is preferable, and instead of setting the target for each year, a multi-year approach should be taken.

John Taylor wrote on the topic, *Lessons Learned from the Implementation of Inflation Targeting*. According to the author, the main lesson is that high and variable inflation inhibits macroeconomic stability. Another finding is that among central banks with price stability as their main objective, there is not much distinction between the response of policy instruments when one compares the banks with an IT regime and those without. In addition, there is no consensus on whether, and if so, how, monetary authorities use policy rules. It is the author's belief that while policymakers do not explicitly follow policy rules, they do use the recommendations they suggest to crosscheck their decisions.

One other important lesson learnt through the execution of IT is the three principles embedded in policy rules. The goal of price stability is one such principle; another is that interest rates should be allowed to respond to changes in the real economy. The third principle is the "greater than one" principle, which says that when there is an expansion in the rate of inflation, interest rates should be immediately raised by more than this increase. Taylor attributes the success of several central banks to these three principles

Two other lessons, discussed by the writer, relate to the exchange rate. Under an IT regime, central banks usually respond to changes in the exchange rate;

for instance, when faced with an appreciation, central banks normally decrease interest rates. Finally, it has been observed that IT has reduced the pass-through of the exchange rate to inflation.

David Dodge's contribution to the conference was *Inflation Targeting in Canada: Design, Lessons and Challenges*. The Bank of Canada's targeted inflation rate is 2%, which lies within the target range of 1 to 3%. This range accounts for the lags associated with the conduct of monetary policy and for some inevitable degree of price volatility. In its efforts to maintain price stability, the Bank pays attention to inflation that is above and below the target. Under its IT regime, it uses the consumer price index as its target. Since this is the most well known index, it makes it easier for the Central Bank to communicate with the public and to be held more accountable. Efforts are also made to make the IT regime as transparent as possible.

The Bank of Canada has learnt that IT stems volatility in inflation, and that such a regime results in greater credibility of the Bank and more stable expectations of inflation. Moreover, price stability has led to macroeconomic stability. Some matters the Bank of Canada were addressing at the time of the author's writing include whether the 2% target was the correct one, whether the price level, instead of the inflation rate, should be targeted, and what should be the Bank's response to shocks like large asset price movements.

### **Keynote Address #2 – Monetary Policy in a Changing International Environment: The Role of Global Capital Flows**

In his keynote address, Martin Feldstein discusses how greater global capital flows, which result from increased international financial integration, are likely to affect monetary policy in the U.S. If the economy were closed, in response to excess demand the Federal Reserve would adopt a more restrictive policy by increasing the federal funds rate. However, in an open environment with higher international capital flows, the federal funds rate would have to be raised by more than would be required if capital markets were less integrated.

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## Section 4 – Asset Prices and the Implementation of Monetary Policy

In *Asset Price Levels and Volatility: Causes and Implications*, Robert Ferguson Jr. notes that the great decline in the extent of macroeconomic volatility in the U.S., termed the Great Moderation, has been accompanied by a rise in equity prices. This indicates the possibility of a relationship between these two variables. Empirical evidence suggests that the nature of this link depends on the way in which risk, as well as savings preferences of investors was modeled. However, the general consensus is that the Great Moderation has not led to a decrease in the volatility of asset prices. Ferguson also cites the increase in liquidity in financial markets as a possible cause of some of the volatility in asset prices witnessed in the U.S. In Ferguson's view, the main lesson for policymakers is that preparation is key. Thus, there is the need to ensure that inflation is low and stable. Well-anchored expectations of inflation give policymakers greater flexibility in terms of how they can respond to unforeseen circumstances. In addition, risk management by the private sector must be encouraged to guard against instability of the financial system.

*Monetary Policy, Financial Stability and Asset Prices*, by Jaime Caruana, explores the relationships between these three concepts. Monetary stability should foster a more stable financial system. However, Caruana gives cases where financial instability has arisen in the presence of a stable macroeconomic environment. Therefore, he recommends more prudent risk management even for a country with monetary stability. The author also advises that risk management should be forward-looking, since, although risks start to develop when the economy is expanding, they usually materialised during economic downturns. To combat the risks that changes in asset prices pose to financial stability, Caruana mentions some characteristics that the regulatory framework should possess, such as the presence of risk-sensitive shock absorbers. In addition, as asset prices can influence macroeconomic stability, Caruana encourages policymakers to monitor these prices. However, using the example of Spain's recent

boom in the housing sector, he notes that responding appropriately to asset price swings can be difficult when operating within the framework of a common monetary policy.

Stephen Cecchetti raises four key points in his paper entitled *Asset Price Bubbles and Inflation Targeting*. First, exchange rate, equity and property bubbles can undermine the profitability of financial institutions and distort the decision-making process of fiscal policy, investment, and consumption. Cecchetti also posits that when prices move way beyond traditional levels this is a good indication that a bubble is about to occur. The third issue is that reducing interest rates may not be the appropriate way to respond to a bubble. Finally, to account for bubbles in IT regimes, central banks need to revise the time period over which they expect to reach their target. However, whether a central bank operates under an IT regime or not, Cecchetti recommends the integration of bubbles into its policy, given the significant impact they can have on the stability of any economy.

## Section 5 – Last Panel

Guillermo Ortiz's paper, *Inflation Reduction: Transforming the Mexican Economy*, identifies the domestic factors that account for the decline of inflation in Mexico, to a level close to its 3% target. These are an IT regime, the adoption of a flexible exchange rate and fiscal consolidation. The external causes of this disinflation incorporate greater competition, larger labour supplies and the consequent fall in labour costs, and increases in productivity that improvements in technology bring. Some aspects of the transformation the Mexican economy has undergone, as a result of the disinflation process, include inflation that has become less persistent and a decline in the pass-through effect exchange rates have on inflation and its expectations. Other benefits embody lower interest rates, modernisation and deepening of the financial system and a reduction in the financial cost of government debt. Despite a stable economic environment, Ortiz argues that a number of factors, particularly the fall in international competitiveness, will prohibit the continual growth of the economy.

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In *Monetary Policy and Crisis Management: The Argentinean Experience*, Martin Redrado describes the policy actions taken by the central bank in response to the financial crisis of 2001-2002. During the crisis, in order to curb a bank run, strict temporary capital controls were imposed and foreign currency was sold to avoid more overshooting of the exchange rate. The period after the crisis saw the almost total removal of the capital controls. In addition, the Central Bank of Argentina, in its efforts to ensure monetary stability, made several modifications to the policies and procedures that governed its operations. The implementation of a plan for foreign reserve accumulation was one such change. Moreover, peso-denominated securities were issued in order to curb the growing dollarisation. Recovery from the crisis would not have been possible without a micro-approach to the financial sector that focused on prudent risk management by the sector's participants.

The book ends with a paper that considers the very topical issue of globalisation. *The Implementation of Monetary Policy in a Globalization Process: The Recent Brazilian Experience*, by Alexandre Tombini, discusses some of the issues related to monetary policy that arise as a result of globalisation. One illustration of the challenges the integration of economies poses is the greater risk aversion derived from the events of September 11th, 2001, which, in part, led to the shock the Brazilian economy experienced in 2002. As a result, it became more difficult to follow the IT regime and in 2002, inflation went up to 12.5%. The response by the central bank was to revise the target path for inflation. Tombini is of the opinion that a more reasonable target of 8.5% in 2003, rather than 4%, was crucial in combating the inflation. Globalisation has also had some positive influence on the Brazilian economy, as reflected in the disinflation periods of 2004 and 2005.

However, Tombini claims that well-designed monetary and macroeconomic policy also contributed to the fall of inflation in Brazil during these periods.

## Conclusion

*Stability and Economic Growth: The Role of the Central Bank* presents the various experiences of monetary policymakers from a number of countries in their attempts to achieve greater stability and economic expansion. Some common sentiments include the need for transparency and communication in the conduct of monetary policy, in order to encourage public support and promote accountability and policy effectiveness. In addition, there is the consensus among the authors that CBI enhances the ability of the monetary authority to pursue successful policy.

Although it made no specific reference to economies as small as those in the Caribbean, the region's policymakers can still draw numerous lessons from this publication. For instance, in an era of escalating prices in several Caribbean countries, the discussions on IT should prove very useful. In light of the formation of the CARICOM Single Market and Economy, suggestions for the conduct of monetary policy within a union are made. Attention is also given to the influence exchange rate policy can have on stability. Moreover, mention is made of the policy implications of greater cross-country capital flows that will result from further liberalisation and increasing globalisation. Perhaps the most important lesson for the Caribbean, and for countries in general, is that stability and growth cannot be achieved through monetary policy alone. Fiscal, wage and exchange rate policies as well as a sound financial system, among other things, contribute to a nation's economic success.