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

Average Inflation 1980-2000: 127%
I. Inflation Targeting

Global GDP Growth
(%, quarter over quarter, annualized)

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 have increased.
  - 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 $\rightarrow$ 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.