Contribution to Panel: Inflation-Targeting in an Uncertain External Backdrop

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Introduction

The last five years have been very generous to Latin American economies. The rest of the world has been hungry for our primary commodity exports, and their prices have soared. At the same time international financial markets have lent to us at very low interest rates. And up until 2006, inflation has been subdued, in part due to cheap manufactured imports.

But this might be about to change. Coming up ahead is a slowdown in the United States. We can also expect more turbulence and adjustment in international financial markets, which could most likely raise rates on our external borrowing. And then, at this very moment, we are all dealing with a large rise in inflation.

In this speech I want to take the opportunity to respond to two criticisms that monetary policymakers fighting inflation in the region have faced.

- First that the current burst in inflation is caused only by food and energy prices.
- And second that this current crisis is an indication that our existing monetary policy frameworks are inadequate and should be overhauled (again).

In other recent speeches I have discussed the resilience of Latin American growth to this current international financial crisis and so I won't go into that now.

Against the argument that the current burst in inflation is caused only by food and energy prices

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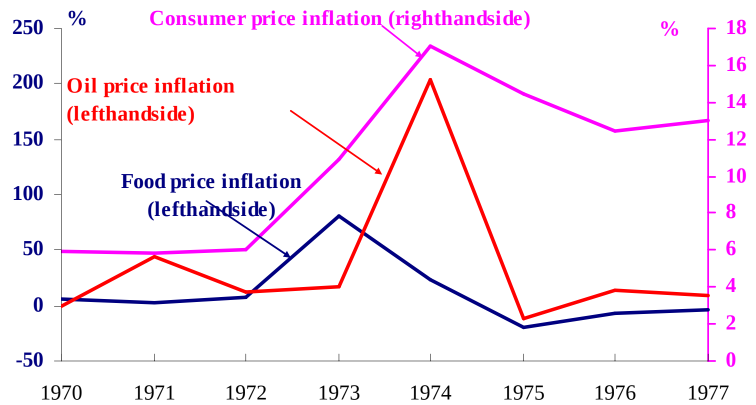
Inflation picked up suddenly in Latin America last year. Chile, Colombia and Peru all breached their inflation targets in 2007. It is certainly true that when we mechanically decompose this acceleration in prices, the largest contribution is in food items. One might then think that this means that this burst in inflation would disappear by itself with a few good harvests.

But there are important reasons why this inflation needed monetary policy action. First the sensitivity of food prices to disturbances in supply reflects that there is an excess of demand. Second, there are some non-food consumer prices that are also increasing strongly. And even where inflation in non-food and non-energy items is lower that may only because the income effect of higher food and energy prices is temporarily restraining a strong inflationary pressure there too. Once food price inflation slows down, inflation in those important items could pick up.

The underlying problem is that many countries in the region are showing signs of excess demand. Many of us have been growing rapidly. Current account deficits have been widening for some of us. And private sector credit in Latin America has been increasing strongly.

At this point it is worth revisiting the experience of the early 1970s. Chart 1 presents world food prices, world commodity prices and world oil prices from 1970 to 1977.

Chart 1. World Inflation 1970-77

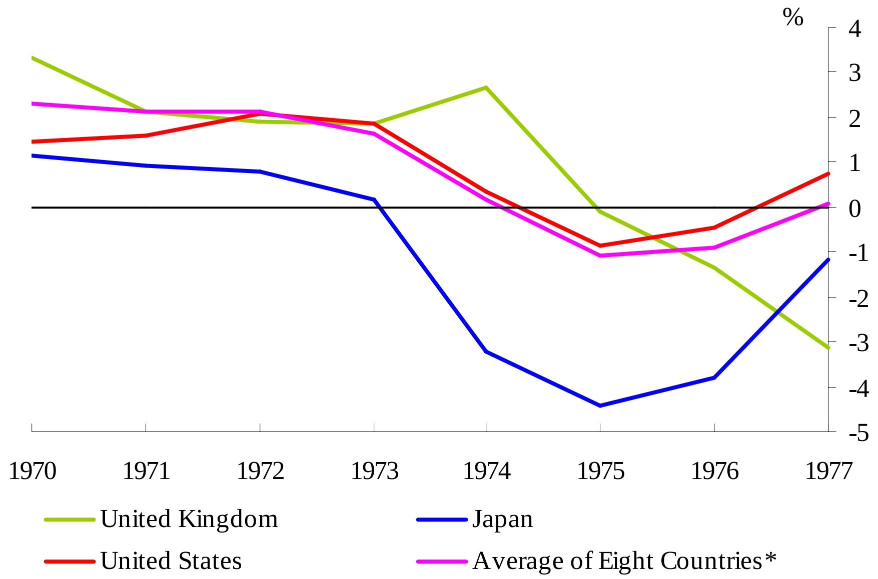


Source: IMF

There are two important lessons we can take from this chart. First we can see that food and oil prices in the world markets began to rise first in the 1970s, just as now. But, second, the chart also shows their subsequent effect on consumer inflation was not temporary. Consumer price inflation was left at a permanently higher level, passing from one to two digit rates.

How was this allowed to happen? In Chart 2 we can see that the response of the monetary authorities at that time was not to raise interest rates against that inflation but instead to let the real level of interest rates fall to negative levels.

Chart 2. Real Rates of Interest (ex-post) 1970-77

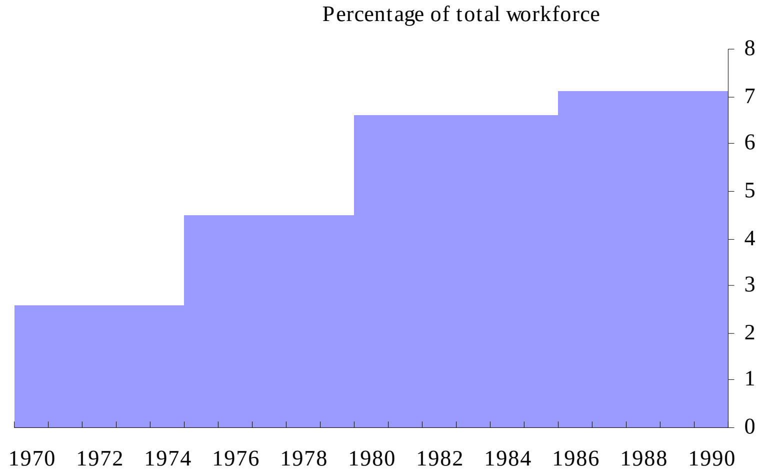


Source: IMF. Note. *=Australia, Canada, France, Germany, Italy plus the other three

And why did they make that mistake? In the first place, inflation was felt to be mostly due to isolated developments in food and energy markets and not due to excess demand. Second they did not believe that monetary policy was the best way of controlling inflation[2]. We should remember that the consequences of these mistakes were not just terrible for inflation but also for awful for unemployment. See Chart 3.

[2] Nelson, E (2004), *The Great Inflation of the seventies: what really happened?*, Working Papers 2004-001, Federal Reserve Bank of St. Louis and Nelson, E (2006), *The Great Inflation and Early Disinflation in Japan and Germany* Working Paper No. 2006-052 Federal Reserve Bank of St. Louis.

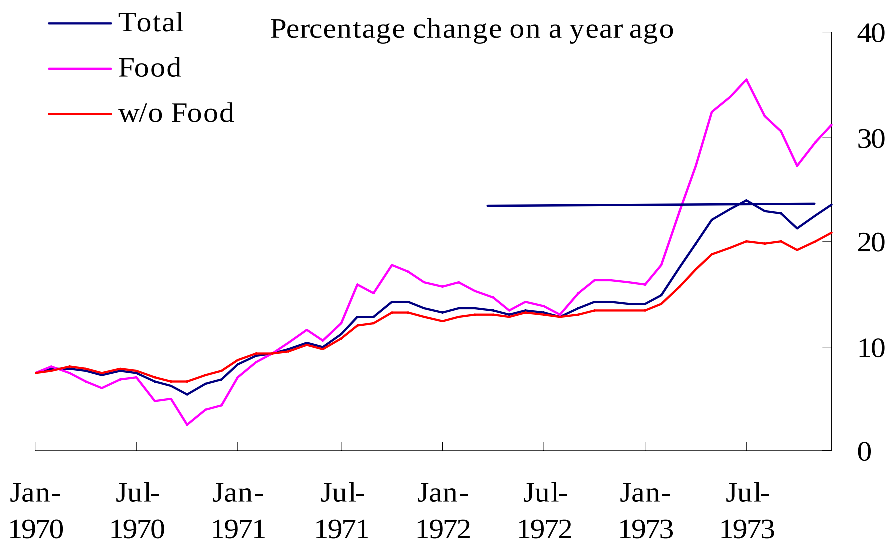
Chart 3. Unemployment OECD 1970-90



Source: Unemployment: Macroeconomic Performance and the Labour Market by Richard Layard, Stephen Nickell, and Richard Jackman (Oxford University Press 2005)

And what happened to Colombia then? Chart 4 shows that here also both food inflation and headline inflation were allowed to rise to double digits.

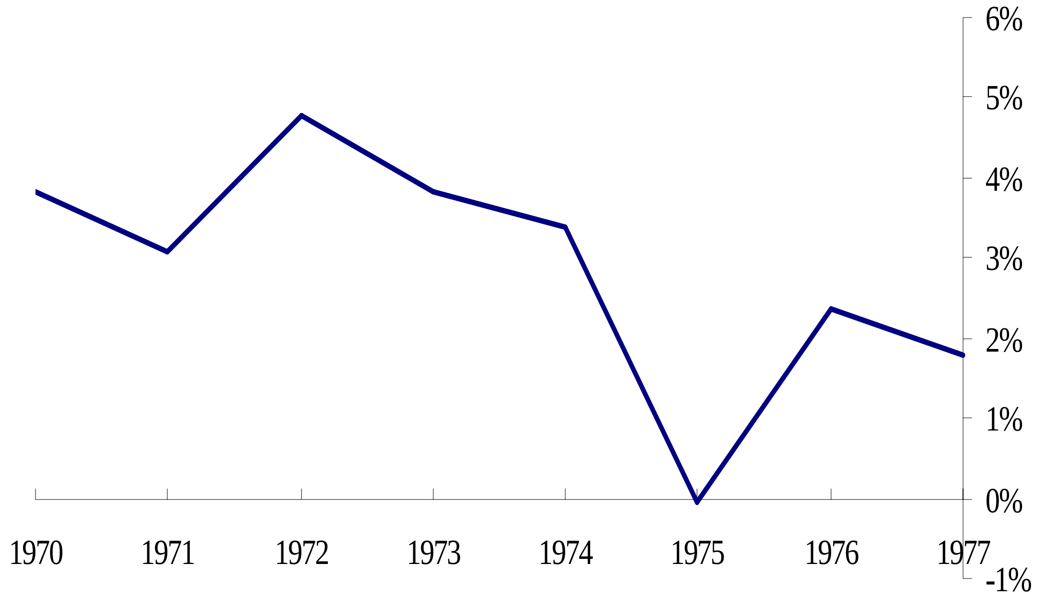
Chart 4. Colombian Consumer Prices 1970-74



Source: DANE

The problem was that demand was allowed to rise well above productive capacity. The authorities failed to act in time to push the economy back towards a sustainable path. Chart 5 shows that pattern of boom followed by bust in per capita terms. This macroeconomic instability caused by letting demand outstrip supply for too long denied us the possibility of a better level of economic development.

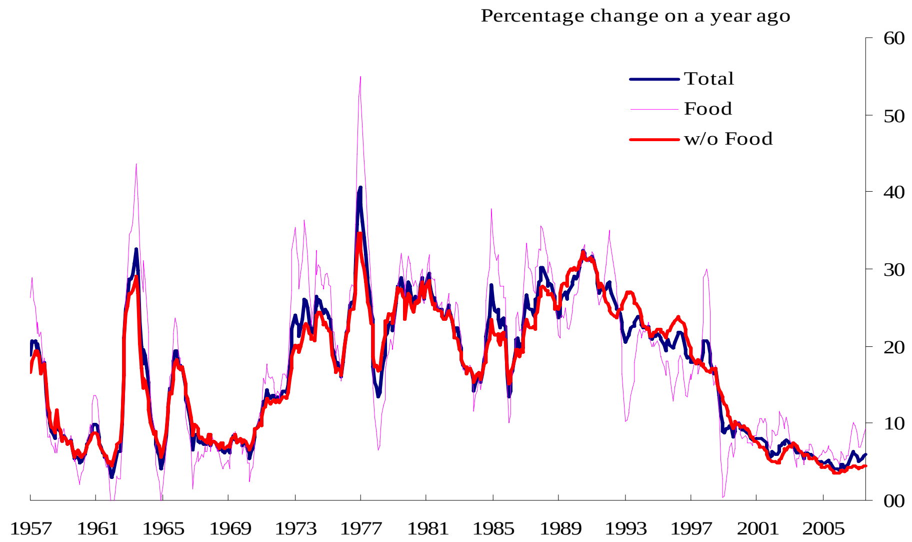
Chart 5. Colombian GDP growth per capita



Source: DANE

Finally it is also worth dispelling the myth that inflation in food or energy is somehow independent of monetary policy. Of course we all know that the price of food items in Colombia and all over Latin America is very volatile. But in the long run, even inflation in food responds to monetary policy actions. Chart 6 demonstrates that on average food inflation follows the headline rate. During our recent disinflation, food inflation was also brought down to lower levels. Similar charts can be used to show that consumer energy price inflation is also ultimately determined by monetary policy.

Chart 6. Colombian Consumer Prices



Source: DANE

Is this current crisis an indication that our existing monetary policy frameworks are inadequate and should be overhauled (again)?

Now let's turn to issue of whether inflation targeting needs a revamp in the light of the current crisis. To bring forward my answer, I do not think that our existing frameworks need a major overhaul. But I do think that we need to use this experience to make them work better. What I think we need to focus on is on the coordination between our policies (monetary, fiscal, financial regulation, lender of last resort) and their relation with the economic cycle. In other words we should try harder to help our citizens smooth consumption and investment in the face of changes in international economic climate.

Let us begin with the objective of monetary policy under inflation targeting. We try to keep inflation on average close to preannounced and unrevisable target, as long as we do not generate excessive output losses. The other important commitment we have is to explain to the public and elected bodies how we are going about achieving this objective. In exchange for this commitment in objectives and explanations, we gain flexibility in the instruments that we can use.

One criticism faced in the build up to this current crisis and more so now is that the inflation targeting objective places too much emphasis on current consumer prices and not enough on asset prices. But the way Latin American economies work, excess demand pressure comes quickly on the heels of a build up of asset prices. So the threat of current consumer price inflation should be enough cause to deal with unsustainable asset price build ups. And as both often follow impulses of strong capital inflows and buoyant terms of trade, we should already have enough early warning without having to complicate our objectives.

Indeed a key responsibility of Latin American macroeconomic policy is to stabilize our economies in the face of inflows of capital and fluctuations terms of trade. The problem is that strong inflows of capital and high terms of trade come together in periods of bonanzas but then can also disappear together sometimes suddenly. In previous speeches, I have emphasized that the failure of consumption smoothing creates damaging cycles in Colombia because it amplifies the effects of these external shocks.

Building on this, perhaps the most important question we face now is not how to change our monetary policy frameworks but rather what supporting institutions would we need to build to help monetary policy stabilize our economic cycles and promote more consumption smoothing.

The first thing to say is that there is a lot of potential for improving our institutions in this aspect. In Latin America, only Chile has applied a legislated fiscal structural surplus rule. Another interesting initiative of this type that might usefully be imported into the continent is that of countercyclical loan provisions. The design of these institutions requires more careful thought than I have time to go through here. But I think we do have the scope to implement these types of institutions while still preserving some important degree of political accountability.

The second point to make in this respect is that the greater flexibility of exchange rates in the region should really help improve the countercyclicality of policy. When there are strong improvements in the terms of trade and large capital inflows, we are more likely to raise interest rates and prevent unsustainable asset price booms if we are not committed to resisting the nominal appreciation.

Conclusion

One topic of this panel is about the operation of inflation targeting regimes in the current crisis. My answer has been to explain how a monetary policymaker working with an inflation targeting regime can contain this current inflationary threat. We need to learn from the lessons of the 1970s. An important message is that stabilizing inflation is not just a means in itself: it really matters for the sustainability of growth in our countries. I also discussed what else we can do to make our management more effective. That was to do with eliminating any procyclical biases in our macroeconomic policies which would help the private sector smooth consumption and investment and benefit more from international trade in goods and capital.