

THE CENTRAL BANK AND THE IMPORTANCE OF ECONOMIC STABILITY



BANCO DE MEXICO

June 16, 2008



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1. What is a central bank?

- A central bank is the public entity responsible for ensuring that there is enough banknotes and coins circulating in the economy for transactions to take place.
- Such money, along with the amount provided by the financial system, is known as liquidity.
- The central bank undertakes different actions in order to regulate liquidity and assure there is never an excess supply or a shortfall in the markets. These actions constitute monetary policy.
- Money performs different functions, the main ones being:
 - ✓ As a means of exchange
 - ✓ As a deposit of value
 - ✓ As a unit of account



2. What goal should the central bank have?

- In the 1970s, the debate centered on whether monetary policy should be used to permanently stimulate economic activity.
- Based on those ideas, some governments and central banks tried to lower unemployment by using an expansionary monetary policy.
- The experience from economies that applied this “formula” and economic theory proved that assumption was wrong.
- It became clear that monetary policy cannot stimulate economic and employment growth directly and systematically.
- For these reasons, modern central banks have made price stability their main goal.



3. The negative effects of inflation

■ High inflation

- ✓ Weakens economic growth and job creation.
- ✓ Deteriorates real income by eroding the purchasing power of wages and other income, increasing inequality and making low-income people poorer.
- ✓ Makes it difficult for individuals and companies to plan and ultimately encourages inefficient resource allocation.

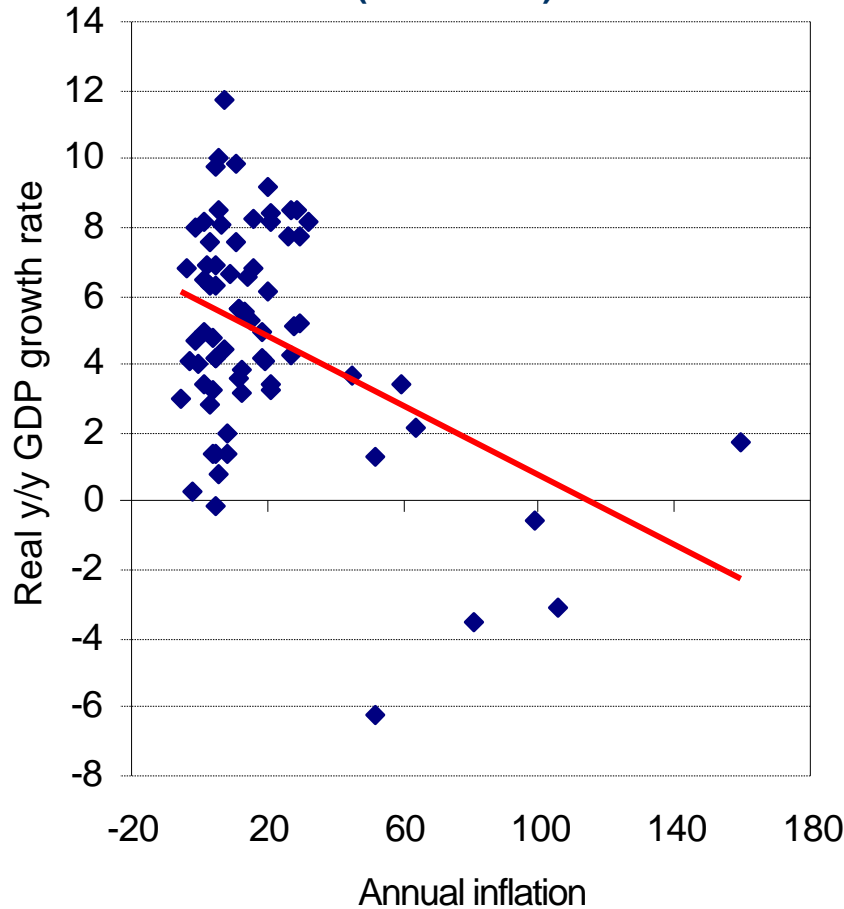
■ Thus, an inflation environment is clearly an obstacle to economic growth and social well-being.

■ As a result, the world consensus is that the best contribution of monetary policy to sustained economic growth is to set price stability as its priority.



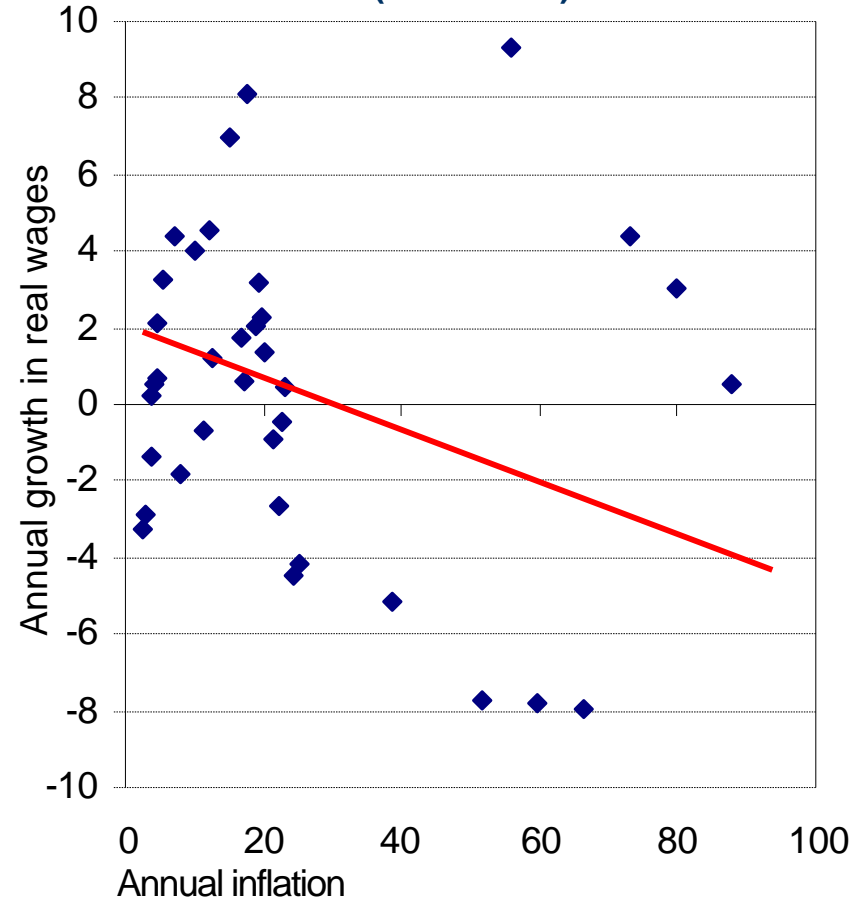
3. The negative effects of inflation

Inflation and economic growth in Mexico (1935-2007)



Source: INEGI and Banco de México.

Inflation and real wages* in Mexico (1969-2007)



* Growth in real wages corresponds to the 5Y moving average of mean real annual growth in remuneration per occupied person (IRM-PO).

Source: Banco de México.



4. Banco de México's autonomy

- In the past, different countries adopted expansionary fiscal policies partially financed by the inflation tax.
- After such policies proved to only lead to higher inflation, monetary policy began to focus on price stability.
- In this setting, in order to reinforce compliance with the stability goal, the global trend has been towards greater central bank autonomy.



4. Banco de México's autonomy

Year in which autonomy was granted to different central banks

Cou	Year
Germany	1998
Austria	1998
ECB *	1998
Belgium	1998
Chile	1989
Colombia	1991
Spain	1994
France	1993
Holland	1998
Ireland	1998
Mexico	1993
New Zealand	1989
Peru	1993
United Kingdom	1998
Sweden	1998
Switzerland	2000

* ECB: European Central Bank.

Source: Official websites of the abovementioned banks.



4. Banco de México's autonomy

- Banco de México underwent different stages before finally gaining autonomy through an amendment to article 28 of its Constitution and the enactment of its organic law at the end of 1993.
- The first feature of this reform was the clear definition of the central bank's mission (art. 28):
 - ✓ *“The State will have a central bank that will be autonomous in both functions and management. Its main priority will be to ensure the stability of the local currency's purchasing power, thereby strengthening the State's goal of fostering domestic economic development. No authority can order the bank to grant financing.”*
- In addition to this goal, the law also states that the central bank shall promote the healthy development of the financial system and the sound working of the payment systems.



5. Monetary and fiscal policy coordination

- Fiscal policy also plays a key role in creating conditions conducive to monetary policy, achieving and maintaining price stability, and thereby contributing to economic development.
- Indeed, when a country has an unsustainable fiscal stance it puts price stability in peril.
 - ✓ On the one hand, the tax authorities may find it difficult to fund the fiscal deficit.
 - ✓ On the other, monetary authorities may find it difficult to adopt a restrictive monetary stance tending towards a lower and stable inflation rate, making financing the fiscal deficit even more difficult.
- This is precisely the reason why healthy finances are essential to economic stability.



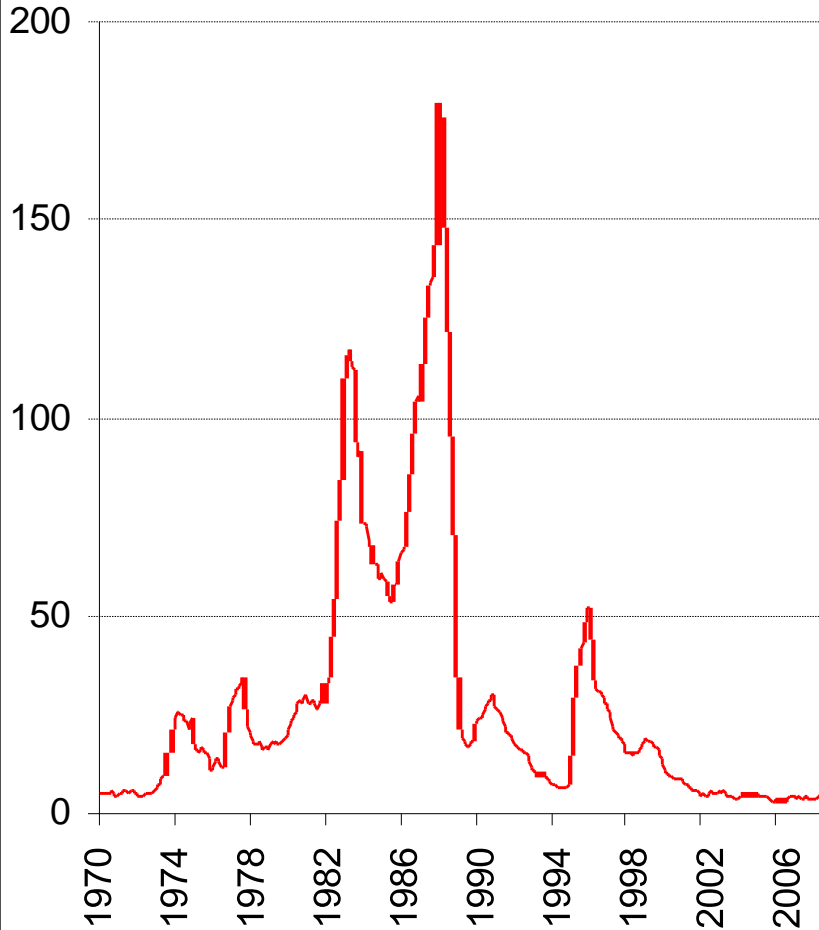
6. Benefits of stability

- Achievements in terms of stabilization in Mexico have been notable. This has partly been the result of applying monetary policy under an inflation targeting framework.
- A floating exchange rate regime along with low and stable inflation has translated into big advantages for the economy:
 - ✓ Lower real and nominal interest rates
 - ✓ Slower pass-through of exchange rate volatility to both inflation and its expectations
 - ✓ Less persistent inflationary process
 - ✓ Financial system efficiency, flexibility and depth have been stimulated
 - ✓ There are greater indicator levels and a decrease in volatility of diverse macroeconomic aggregates (consumption, investment, production, etc.).



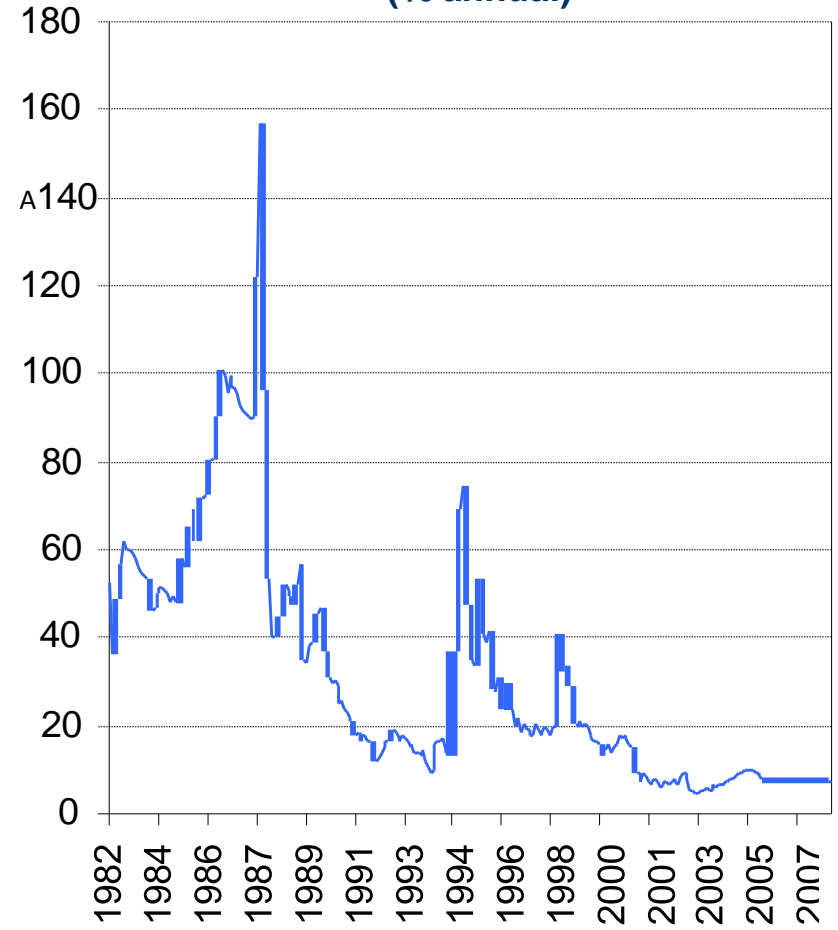
6. Benefits of stability

Inflation in Mexico: 1970-2008
(% annual)



Source: Banco de México.

28-day Cete interest rate
1982 - 2008
(% annual)

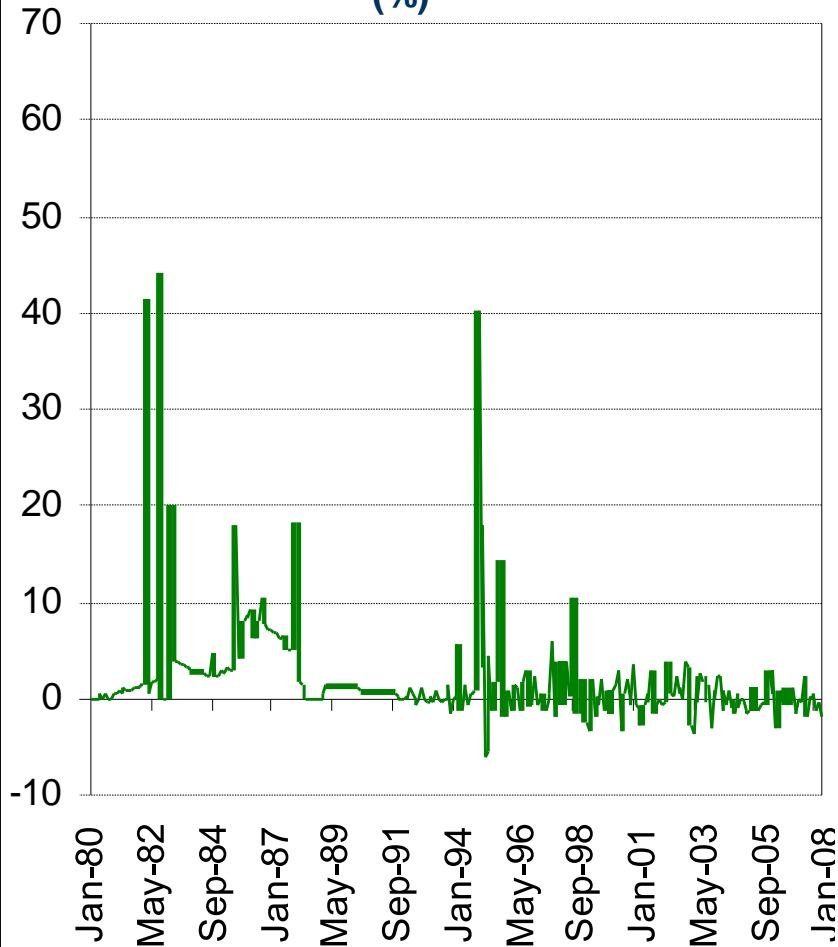


Source: Banco de México.



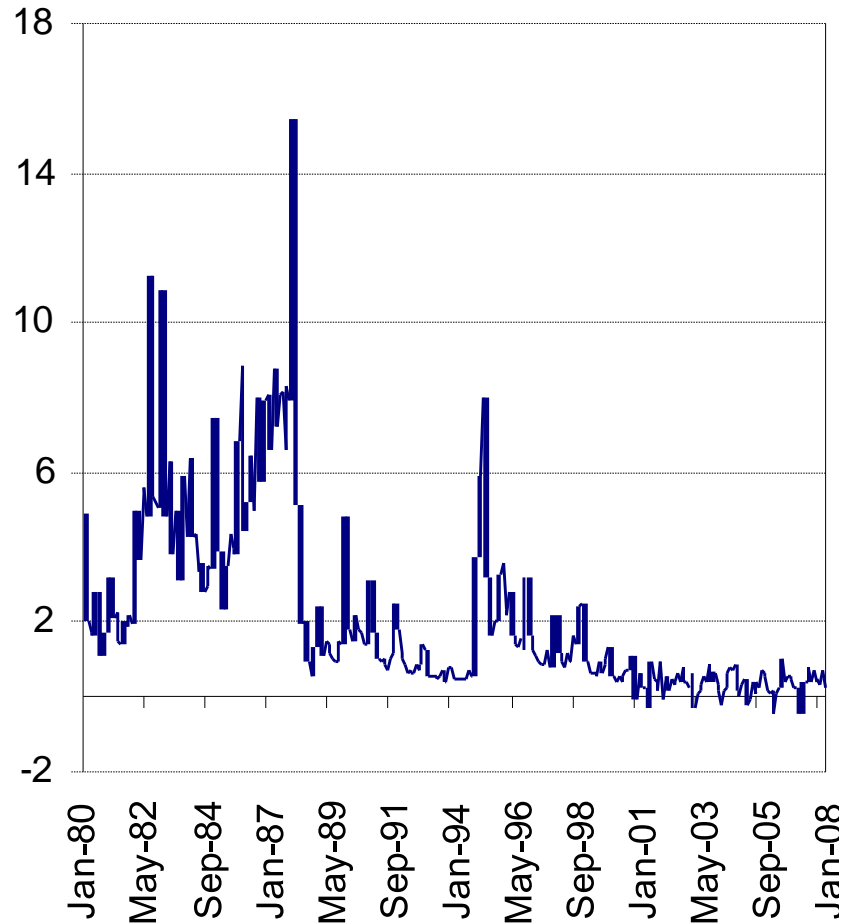
6. Benefits of stability

Monthly depreciation of the nominal exchange rate (%)



Source: Banco de México.

Monthly inflation (%)

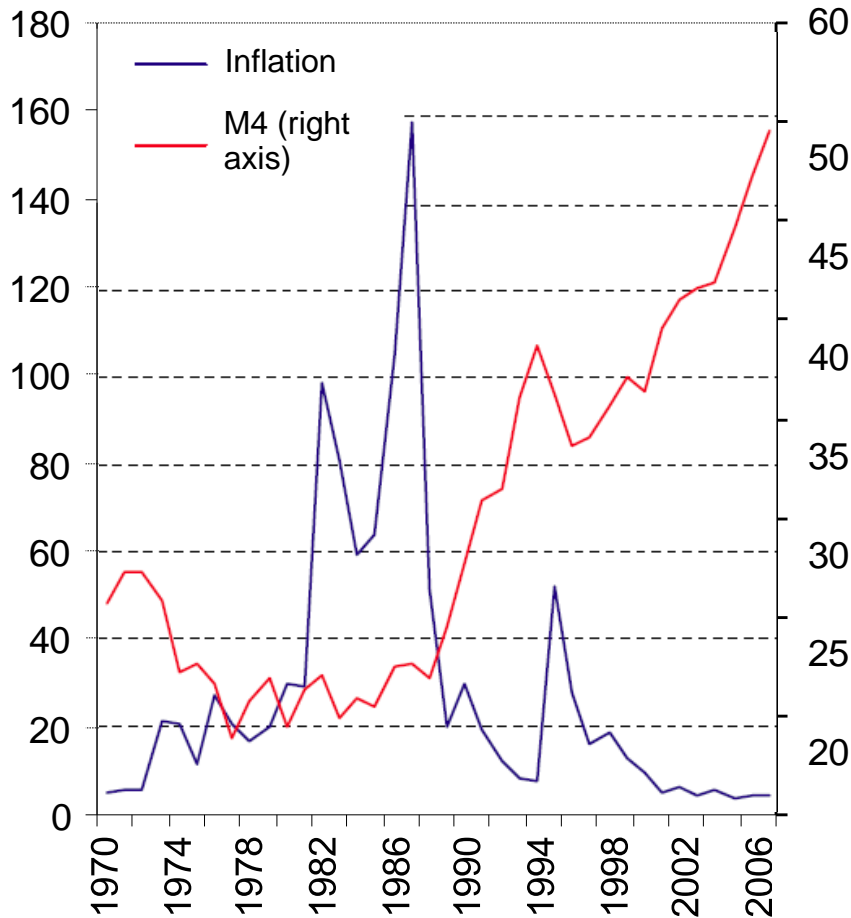


Source: Banco de México.



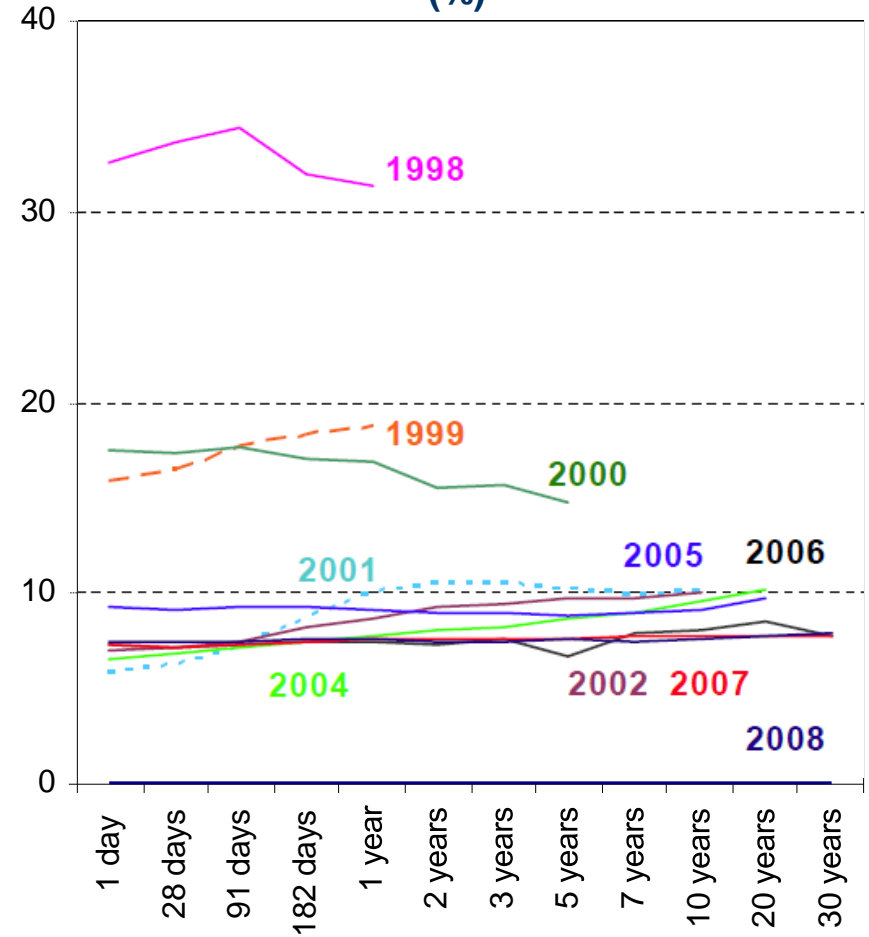
6. Benefits of stability

Inflation and M4 monetary aggregate (Annual % change; % of GDP)



Source: Banco de México.

Government bonds yield curve* (%)



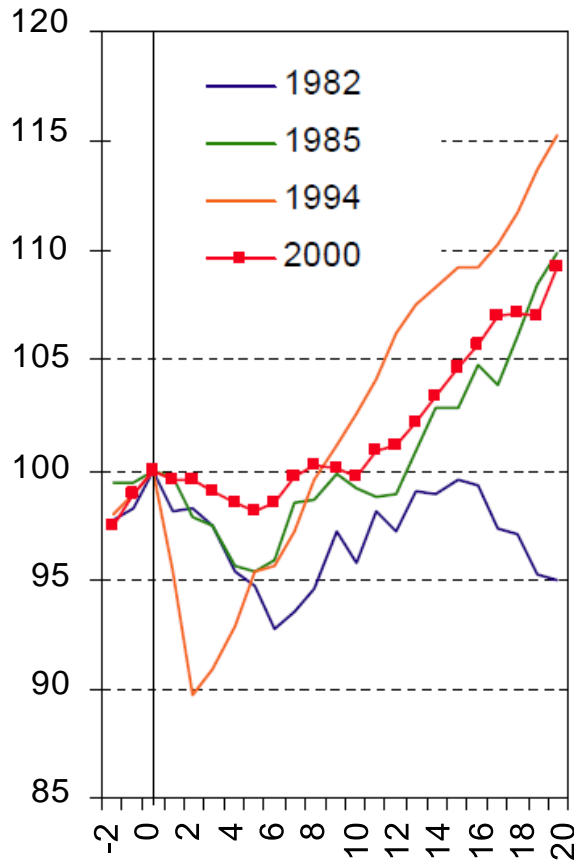
* Annual average.

Source: Banco de México.

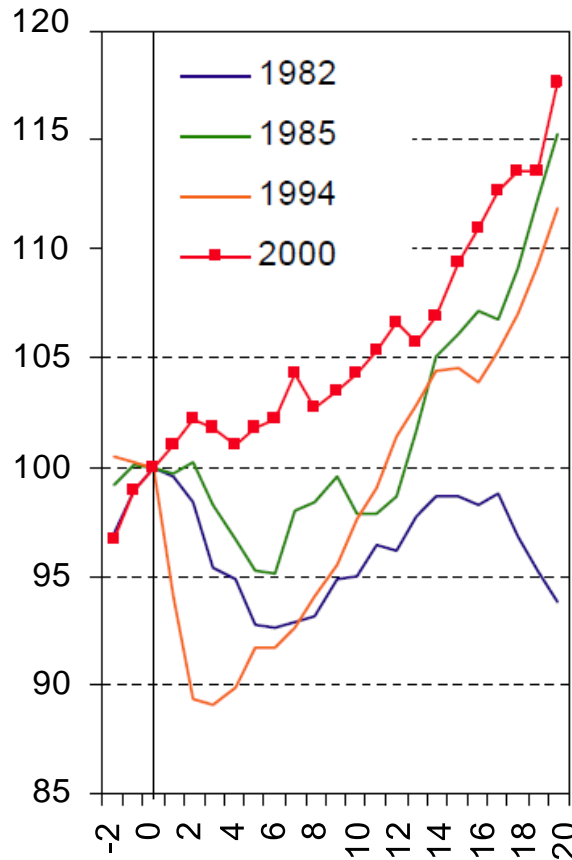


6. Benefits of stability

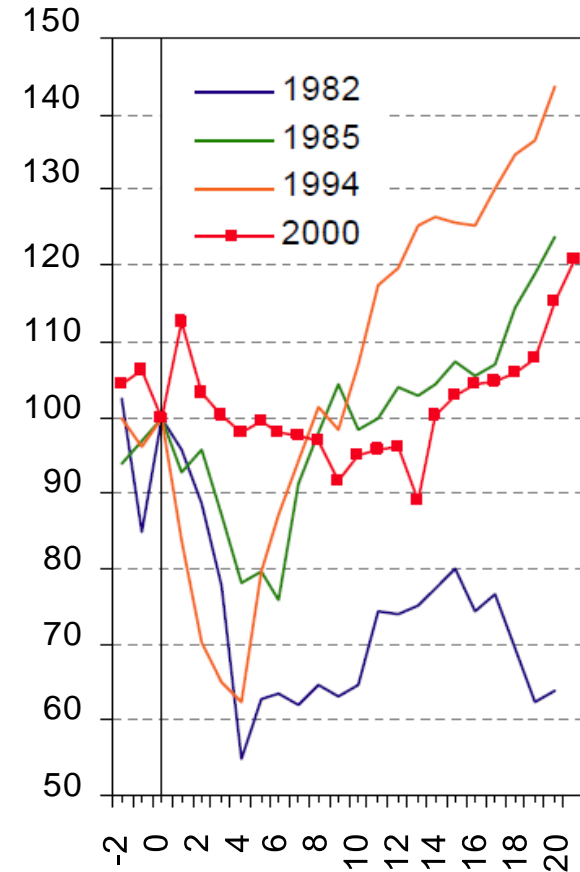
Gross Domestic Product* (Peak=100)



Private consumption* (GDP peak=100)



Investment* (GDP peak=100)



* Seasonally adjusted figures.
Source: INEGI.



6. Benefits of stability

- All what has been stated previously has translated into clear and significant benefits for the population, such as:
 - ✓ More household credit for both consumption and housing
 - ✓ More funds and alternative financing sources for long-term investment projects
 - ✓ Higher economic, employment and wage growth
 - ✓ Better planning by individuals and companies and therefore more optimal resource allocation



6. Benefits of stability

Per capita GDP and inflation in Mexico (Averages by period)

	Annual per capita GDP growth ^{1/}	Annual inflation ^{2/}
1961-1970	3.3	2.4
1971-1995	1.2	38.3
1996-2007	2.2	10.9

1/ Penn World tables 6.2. 2004 IMF WEO and beyond.

2/ Banco de México.



7. Final remarks

- The main goal of public policies is to achieve faster and more sustained economic growth.
- Banco de México must contribute to this endeavor by ensuring price stability.
- Banco de México has the legal framework and the appropriate instruments to attain this goal.
- Monetary policy, along with a responsible handling of public finances and a flexible exchange rate regime, has significantly lowered inflation, which in turn has translated into tangible benefits for the population.