Office Memorandum

To: Mr. Evans

September 3, 1997

From: Paulo Neuhaus

Subject: **Transcript of Mr. Fischer's Address in Lima, Peru**

Please find attached a transcript of Mr. Fischer's address at the Central Reserve Bank of Peru on November 20, 1996. We did our best to ensure that it faithfully reflects the lecture (given the poor quality of the tape recording and the simultaneous translation in Spanish). Nevertheless, we would appreciate it if you could advise us that Mr. Fischer is in agreement with the transcript before we release a copy to the central bank (which subsequently will publish it in a Spanish version).

Attachment

cc: Mr. Bonangelino

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Price Stability, Financial Systems, and the Role of the Central Bank

Address by Mr. Fischer, IMF First Deputy Managing Director
Central Reserve Bank of Peru, Lima

Let me say what a great pleasure and honor it is to have been invited on behalf of the IMF to speak at the Central Reserve Bank of Peru, particularly because the changes that have happened in Peru since my last visit, five or six years ago, are truly remarkable. The achievements of your country in stabilizing inflation, restoring growth, and achieving structural transformation are not only impressive, but they are also of historic proportions. From the viewpoint of the economist they are all interesting, as this is one of the few successful stabilization programs that was implemented without using the exchange rate as a nominal anchor, and with a flexible exchange rate. The success of this stabilization will undoubtably affect the way future stabilizations are conducted.

What has been achieved in Peru was made possible by strong monetary and fiscal policies that have helped reduce inflation from 7,600 percent in 1990 to a current range of about 10-11 percent a year. This is a remarkable achievement, which also is noteworthy because most countries that have succeeded in reducing inflation from the 5,000 to 10,000 percent or more range have not succeeded in reducing it to a level as low as 10-11 percent. They have usually remained stuck much longer in a range of 20-30 percent a year. A question that we ask ourselves, as economists, is whether these achievements can be explained by the fact that Peru

did not use an exchange rate-based approach. Another question that we must ask ourselves is whether Peru, once having reduced inflation to the 10-11 percent range, will be able to reduce it to industrial country levels within the next few years. I suppose the answer to that question depends not only on monetary but also on fiscal policy. The other remarkable achievement was that the reduction in inflation was accompanied by a very rapid return to growth. This element is increasingly seen in other countries that have succeeded in stabilizing their economies after severe disruptions.

I am, indeed, pleased to meet with you today, because there is no doubt that the central reserve bank played an important role in the stabilization effort. It is equally certain that the role of the central bank has changed through time and that it is now recognized that it needs to be independent to be successful in the fight against inflation. Its role in pursuing price stability will continue to be essential in shaping the economic future of Peru.

My presentation originally was entitled "Price Stability and the Role of the Central Bank", which is what am going to talk about, but I have modified the title slightly to "Price Stability, Financial Systems, and the Role of the Central Bank" because I would like to spend a few minutes discussing the relationships between the financial system and the central bank, since there is a growing recognition of the importance of the role of a sound financial system in ensuring and promoting growth.

Before discussing the role of the central bank, I would like to talk about two issues that are very familiar to all of us. One is the Phillips curve, and the other one is the relationship between inflation and growth. I think that the views of the specialists on the role of central banks are heavily influenced by what they understand about these two issues. Thus, I would like to speak briefly about things that are quite well known in the case of the Phillips curve and about other things, somewhat less known but becoming less so, regarding the relationship between inflation and growth.

On the Phillips curve we have, as a result of both theory and evidence, reached a considerable consensus that there really is no long-run relationship between unemployment and inflation. It took a long time to get there, and there are still questions about what the relationship looks like at very low inflation rates, particularly as the inflation rate becomes close to zero. That is a key question, which is being widely discussed in the United States right now. It has been very important in Japan in the last few years, where inflation has in fact been about zero. The question of whether there is a relationship between inflation and unemployment at very low rates of inflation will be an increasingly important one. And so is the question of what level of price stability central banks should aim at, as we reach lower and lower inflation rates. Fortunately or unfortunately that is not the question of the day in Peru, but I hope that it will become an issue over the next few years.

The other issue that I would like to talk about is the inflation-growth relationship. It used to be argued at one point, say, in the models of Tobin of the 1960s, that a little bit of inflation

was good for growth. Empirical evidence is strongly against such a relationship, at least for double-digit inflation. The old concept that some inflation is good for growth is just not right. However, whether or not the relationship exists when inflation is below 10 percent is another issue. The evidence is not strong. In my work I have found a negative relationship to continue in the low, single-digit range (4-5 percent). However, other studies by Sorel, Barro, and colleagues at the IMF support the position that at a level of about 8 percent the relationship changes and becomes slightly positive. Notwithstanding the uncertainty about the negative inflation-growth correlation at low inflation rates, no one has yet found evidence of a positive correlation over a sustained period of time.

A question that is paramount to discuss in the Peruvian context—and in fact in all countries—is the issue of the short-run relationship between inflation and growth. In countries with a fairly stable inflation rate or a very low inflation rate, like the United States or Germany, there is considerable evidence that there is a short-term Phillips relationship, that is, that one can in the short run increase output through an expansion of monetary policy, with a lagged effect on inflation. Whether there is such a trade-off in countries with higher inflation rates is a different matter. My conclusions are that in such countries the benefits of short-run monetary expansion in terms of what it does to output are very brief, and that the translation into inflation is more rapid. This is a crucial issue because, if it is true that one can affect output in the short run through monetary policy, the political pressures that one faces are much stronger than otherwise. And the pressures are always there for the central bank to be expansionary in

the short run. It would be convenient if we could truly say that it makes no difference, that we do not have the capacity to affect output.

Unfortunately, that is not really true, and in the short run monetary policy—in the United States, in Germany, in Britain—does affect output. We then have to argue that if we use this capacity in the wrong circumstances, if we use it in full employment, we will get an inflationary impact. But the existence of the short-run trade-off is a problem that central bankers everywhere have to deal with, and we cannot avoid it by denying that it exists. We have to rationally explain to those who want to use it that the trade-off exists. As Peru returns to macroeconomic stability, it will be an issue that will have to be dealt with by the central bank from time to time. This issue has to do with the independence of the central bank: If it did not exist, there would not be such a strong need for central bank independence.

This is the background against which I want to discuss a number of issues that relate to central banking. First is the issue of **central bank independence**, a topic that is not very much debated in Peru, where independence was given to the central bank in 1992. The second issue I want to discuss, in light of the short-term trade-off, is whether the central bank should have the **additional goal** of helping to achieve full employment, in addition to that of preserving the value of money. Third, I want to discuss **inflation targeting** as a potential rule for monetary policy versus other policy options. Fourth, in that context I will discuss the **inflation rates** that should be targeted. Fifth, an immediate policy question is whether there is any benefit to identifying some specific **intermediate monetary targets** or whether one

should simply give the central bank the task of achieving a particular inflation rate. And, finally, I will discuss the **exchange rate regime** and see whether there are some specificities in the Latin American region. So let me briefly treat those six headings before turning to the question of the financial system.

The arguments in favor of **central bank independence** are well known. If everybody always behaved optimally, there would be no need for an independent central bank because we could expect politicians to do everything exactly right. Since we cannot assume that, the argument for the independence of the central bank is that we need an authority that will take a longer-term view. The argument is that elected politicians always have operated with shorter term license and are tempted to behave myopically in a way that stresses short-term trade-offs between output and inflation. This is an uncomfortable argument for those of us here who believe in democracy, but not so terribly uncomfortable, because we have no trouble supporting an independent judiciary, and well-organized democracies set up organizations that are not subject to the day-to-day pressures of politics as a way of running the society well over the long term. I do not, therefore, find a basis for the argument that independence of the central bank conflicts with the notion of democracy. While we can have fine theoretical arguments in favor of central bank independence, they would not be worth anything unless economies with independent central banks outperform those with nonindependent central banks. On that issue, the evidence is very clear. Empirical evidence from OECD countries plainly shows that countries with more independent central banks have lower inflation and better growth performance than countries with less independent central banks. Of course, one

can always find countries within which the central bank is not independent and where inflation is relatively low, such as Singapore, but these are exceptions. The bulk of the evidence is very clear, i.e., there exists a positive relationship between the independence of the central bank and the achievement of a low rate of inflation, which helps growth.

It is also essential that the central bank report to the public authorities on what it is doing or trying to do, and whether it is achieving its objectives. This must be examined very closely by the general public, and the ways in which the central bank reports to the public on its activities are important. An independent central bank, as has been in place in Peru since 1992, offers confidence to the private agents.

With respect now to the **goals of the central bank**, the Central Reserve Bank of Peru has, like many other central banks, the primary goal of preserving the value of the currency while maintaining price stability. There was a time, if one looks at the central bank legislation in various countries in the 1930s and the 1950s, when the central bank was required to do everything: achieve price stability, encourage growth, reduce unemployment, develop a financial system, and do all that on a more-or-less equal basis. With so many goals, and so many things to do, no one was quite sure which goal was given priority. If the central bank is concerned with one goal only, it is much easier to work toward achieving it. That is the basic argument for giving central banks just the price stability goal.

However, there remains a question. Given that we know that there is a short-run trade-off, should the central bank also be preoccupied with the objective of maintaining full employment, or moderating the economic cycle? This is a very interesting question. If an economy is hit by demand shocks, it does not really make a difference: Policies that stabilize inflation are also those that stabilize demand. If forces driving the economy increase demand, on average they will tend to increase output, which also tends to raise prices. So if an economy is beset by demand shocks, it does not matter whether the central bank is given responsibility for promoting growth or it is just told to stabilize inflation. What it will do to stabilize output is essentially what it should be doing in any case just to stabilize inflation. For instance, if the economy is in a recession, then the policy that would achieve the inflation goal would be one that allows an easing of monetary policy.

However, this question becomes more complicated when an economy is hit by supply shocks. Then there really is a trade-off between the goals of maintaining output and dealing with inflation. We are dealing with the fact that in the case of a supply shock, if the central bank is told just to stabilize inflation, then there will be a problem, as for a while the central bank might seem to be acting in a way that worsens the business cycle. It is interesting that in Australia or New Zealand the objective is to stabilize domestic prices, taking out the impact of changes in the terms of trade. The solution I prefer is that the central bank be given price stability as its main goal, but that the legal framework in which it operates makes allowance for the other goal. The fact is that the central bank should not be held responsible for stabilizing shocks that it cannot in fact deal with through its main instruments. If the central

bank is going to promote growth, that is best achieved by maintaining a low rate of inflation and by making sure that the financial system is in good health.

The next issue is whether or not the central bank should set **explicit inflation targets**. That is a very interesting question that is widely debated. Some of the most successful central banks, like the Swiss central bank do not want to set explicit inflation targets. When we meet at the Executive Board of the Fund and discuss inflation objectives, our Swiss colleagues are always against explicit inflation targets. Why? Because, like all central banks, they like to preserve some flexibility. I think, though, that for central banks that do not have the credibility that the Swiss and the German central banks have, there is a case for setting explicit inflation targets. If there is no explicit objective, it is difficult to assess what the central bank is doing.

Nevertheless, one must be very sophisticated about how that target is set. It would not be of any good for Peru to set an inflation target of, say, 3 percent for the next year if there was no chance of achieving it. If the central bank target cannot possibly be met, then it will lose its credibility. So what precisely the target should be for any specific year is a matter that has to be worked out very explicitly. The establishment of an inflation target favors accountability. I do not think that it is necessary for the Swiss or German central banks to present low inflation targets, but the situation is quite different for countries that need to reduce their rate of inflation. I believe that it is very important for these countries to establish inflation objectives.

As to what the **long-run inflation target** should be, I do not intend to spend much time discussing what it should be for countries with a history of sustained low inflation (between zero and 5 percent). I believe that it is very hard to get down to zero because there are biases in the measurement of inflation. In the United States it is estimated that inflation is overstated by about 1-1½ percent. I believe that one should not seek to achieve an inflation of zero percent but somewhat more, because if the inflation rate is zero, then one would have in fact negative real interest rates. Therefore, I see some arguments for very low inflation rates, something around 2-3 percent, but the question is how a country with a moderate rate of inflation can reduce it. I think that the only way is for the authorities to seek a slow, consistent reduction in inflation by about 2 percent a year. I do not believe that the authorities can do it very fast, but, nonetheless, they should never allow inflation to rise. In that respect, what Chile did was very impressive—the country moved from about 12 percent to 9 percent, and then to 6 percent, over a three-year period.

With respect now to the use of intermediate targets for monetary policy, there are some central banks, like the Bundesbank, that say: "do not give us inflation targets because we cannot control inflation. Give us an intermediate target that we can control, like money growth." While this formulation may have had some validity in the past, in recent years the Bundesbank's ability to comply with its targets has not been good. I think that in fact the Bundesbank has deviated less from its inflation objectives than from its monetary objectives.

I do not consider it wise to set the main emphasis on **monetary targets**. It is better to tell the central bank what its responsibility should be: achieving a particular rate of inflation or an inflation range. How it achieves it is a technical matter. If it does this best by setting a monetary target and sticking closely to it, then fine, let it operate that way. The central bank should not put the emphasis on any particular monetary target but rather on inflation developments, which can be directly observed by the public. It is true that there is a close relationship between monetary aggregates and inflation, but the focus should be on inflation targets. Other variables—like growth, interest rates, and exchange rates—can play a part in achieving the inflation target, but they should not be the target instead of inflation.

Let us now turn to the last issue that we are going to discuss under the general heading of monetary policy, the **exchange rate**. And we will also talk about currency boards, which have received a lot of attention lately. There is one obvious thing to say about exchange rate arrangements. If there were a single best exchange rate system in all possible circumstances, we would have known what it is by now, and we would not find some fifty different exchange rate systems around the world.

We know that when we choose an exchange rate system there will always be a day on which we wish we had a different exchange system. If we have a fixed exchange rate system, we would wish that we had a more flexible rate system. If we have a flexible exchange rate system, the market might at times behave so erratically that we would wish we had a fixed rate system. The notion that by somehow choosing a specific rate, for instance, we are going

to get rid of all our problems is just wrong. All the systems will generate problems, albeit different types of problems. What is important is to choose an exchange rate system that is appropriate for the circumstances and keep open the possibility of changing it if needed.

I think that in many cases it makes sense to bring inflation down by pegging the domestic currency to a foreign currency. I see that as the quickest way to assign monetary policy to the fight against inflation. To peg the exchange rate is a very simple decision, and it places a very clear constraint on policy. I believe that if a central bank has a pegged exchange rate, it clarifies for everyone what the impact of a loosening of the fiscal policy will be. The problem is that those exchange systems are inclined to crisis. This is something that we saw in the European monetary system in 1992-93 and in Mexico in 1994, and it becomes more of a problem with financial liberalization. Although it is true that this is something that can be avoided with a flexible exchange system, there is always the problem that some countries can allow their currency to appreciate. In some cases they will do it, in other cases it will be necessary to intervene with sterilization, but this is usually costly. We then have serious dilemmas.

With respect to the introduction of capital controls, an issue faced in all countries at some point, I believe that this is something that should be avoided as much as possible. If the external current account deficit is widening and we cannot change the fiscal stance, then we are faced with a severe problem for which there is no easy solution. If we are worried that the market does not work properly and the current account deficit is equivalent to 7-8 percent of

GDP, which may not be sustainable, we have to ask ourselves what we can do to get out of this situation. The use of capital controls is something that Chile has been using, for example, but it is not something that the IMF likes to support.

For countries with low inflation rates I support flexible exchange rates, which put a little more flexibility in formulating policy. There is a formulation that I am not sure I agree with, which says that as capital mobility increases, the choice is only between **full flexibility of the exchange rate** and a **fixed exchange rate**. We also have the option of currency boards, which have operated very well in some small countries, including the Baltic states and in Hong Kong. Argentina is not quite a currency board, but it is very close to that. Monetary theory of the currency board is very simple: it is the theory of the gold standard. And if the arrangement is credible, the country that adopts it will rapidly converge to international inflation and interest rate levels. We see that in Argentina, where interest rates have been much lower than in other countries that also have stabilized their economy. This is something very attractive. It also imposes severe constraints on monetary policy, and in some cases very tough decisions have to be made, as Argentina has had to make in the past two years because of external shocks. I believe that what Argentina is doing makes sense and that there will be a recovery in 1997 if the government stays with the currency board and with the reform program that is underway. But there are two problems with those systems: First, if there are capital outflows, one has to let interest rates move up. Second, there is no lender of last resort in such systems. These are two restrictions to monetary policy.

With respect to the lender of last resort, it is useful to mention a few points. When there is a banking panic and a liquidity problem caused by a sudden loss of confidence in the currency, this is a simple case because the central bank has the obligation to intervene. But in many instances there exists the tendency of using this lender of last resort function to recapitalize banks in cases of solvency problems, and there is a temptation, for fiscal reasons, to use the central bank to recapitalize banks. They should not be recapitalized this way, but of course politicians think that this is an easy solution for dealing with this problem. So I am sympathetic to seeing the need for a lender of last resort when the economy is hit by a macroeconomic shock, and this possibility is lost with a monetary board. In such a system we can only accumulate foreign reserves.

Let us finally look at the solvency of the financial systems. Why? Because there are financial problems in many countries. And we are not talking of underdeveloped countries. We are talking about the Scandinavian countries; Japan, which is still digging out from its banking crisis; the savings and loan institutions in the United States; and France. All large countries, or at least a very large number of them, have had financial problems, some of them with high costs. These are not small problems: massive macroeconomic problems arise out of banking systems that are not properly supervised and properly managed. The increasing attention that is being paid to controlling the banking system is due first to the recognition of the costs to the economy or the state that is faced with banking problems. And second, it is due to the fact it is very hard to conduct monetary policy well if one must worry about the health of the banking system.

We have not until recently had very good sets of rules, banking supervision, or prudential standards outside the context of the G-10. There exist norms for the G-10 that have been adopted by developing countries, but they have not really been adapted well. There is now a push from the IMF and from the World Bank to extend the Basle regulatory and supervisory standards, to make them applicable to emerging market countries and to other countries. The summit in Lyon in June asked the international financial institutions to make a special push in this direction. The IMF is interested in developing standards that we can use in programs to try to ensure that the banking system is and remains solvent. We will not avoid every banking crisis, but we will help avoid having individual banks go bankrupt. The tougher the prudential standards, the less central banks and bank supervisors will go with the easy option, which involves expansion of credit in the short run.

Let me conclude by thanking all of you and the Central Reserve Bank of Peru for your hospitality, and say again what a pleasure it is for the IMF to be associated with the success of the Peruvian government's stabilization. We are sure that our cooperation will continue for a very long time and, I am sure, successfully so.

Lima, Peru, November 20, 1996