# Alternatives to Inflation Targeting for Equitable, Stable and Sustainable Development

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# Developing countries must take significant responsibility for their policies

- Must shield themselves as best as possible from strong negative forces heading from the global recession or possible depression.

- Must adopt domestic policies to promote employment generation and in particular, the generation of decent jobs.

- Developing countries need an appropriate macroeconomic framework that will promote decent employment while helping to maintain financial and macroeconomic stability

# “Best Practice” Central Bank Policy

Inflation Targeting

Single goal: Maintain inflation in low single digits

# Maintaining Moderate Inflation:

An Important Goal of Central Bank Policy

# The Problem:

When Moderate Inflation Becomes the ONLY Goal of Monetary Policy, other goals suffer

# Shifts in IMF's research

"Before the crisis, mainstream economists and policymakers had converged on a beautiful construction for monetary policy. ... we had convinced ourselves that there was one target, inflation. There was one instrument, the policy rate. And that was basically enough to get things done.

If there is one lesson to be drawn from this crisis, it is that this construction wasn't right, that beauty is unfortunately not always synonymous with truth. The fact is that there are many targets and there are many instruments." Blanchard (March, 2011)

Source: From Anis Chowdry

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# The Result:

Investment in Employment Generating Activities of high quality jobs is too low in many countries

Aggregate Demand growth too low

Real Exchange rates go through cycles of appreciation and depreciation that are destabilizing and harmful.

We now face a critical period.

# Perhaps the Biggest Problem

Central Bank's almost single-minded focus on keeping inflation in the low single digits allows central banks to shirk their responsibilities to contributing more broadly to employment generation and poverty reduction and to refuse to cooperate with other agencies of government attempting to solve these problems

Price Stability does not automatically generate employment creation, poverty reduction and growth

# But What About Taylor Rules?

Taylor rules have inflation targets, but also output gaps and even sometimes exchange rates.

Doesn't this prove inflation targeting Central Banks focus on many targets?

# Out of Many Comes One

With IT, central banks focus on these other variables BECAUSE they affect inflation, not because they are significant in their own right.

# What About the Assignment Problem?

Let CB ‘s focus on inflation

Other branches of government focus on other issues, such as employment and poverty reduction

# Two Problems

Without coordination, de-centralized activities can lead to instability

Too low (or high) inflation can undermine the ability to promote employment and  more rapid sustainable economic growth

# Employment Generation, Poverty Reduction and Economic Development Needs a More Coordinated Set of Policies Among Major Macroeconomic Policy Institutions

# What about Central Bank Autonomy?

In some countries Central Banks need sufficient autonomy to maintain moderate inflation at moderate levels.

But *ownership* by central banks of employment and poverty reduction is also crucial

# Inflation Targeting has had been impact on CB procedures

# Central Bank Operations

- Switch from direct instruments, such as credit allocation, to indirect instruments, primarily short term interest rates as main tool of monetary policy
- Financial liberalization reduces central bank leverage over the financial system in terms of quantitative controls

# Reduced Targets and Instruments

- Targets: inflation
- Instruments: Short-term interest rates

# Neo-liberal Approach: Departure From historical practice

- Central Banks historically have used many tools of monetary policy to reach multiple objectives: including credit allocation to develop social sectors of the economy, credit allocation techniques to develop dynamic industries, capital management techniques to manage inflows and outflows of international capital.

# Implicit Assumptions of Neo-liberal Approach to Central Banking

- Inflation rates above the low single digits are harmful to economic growth
- Financial markets allocate savings efficiently so there is no need for central bank directed credit
- International capital flows are allocated efficiently so no need for capital management techniques (capital controls)
- Economy automatically reaches full employment, at least in the medium to long-run. So no need for central bank to target employment.

IT Approach with almost sole focus on inflation:

Departure From historical Practice

# Central Banks historically have used many tools of monetary policy to reach multiple objectives

- Including credit allocation to develop social sectors of the economy,
- Credit allocation techniques to develop dynamic industries,
- Capital management techniques to manage inflows and outflows of international capital.

# Arthur Bloomfield

Prominent Historian and Adviser of the New York Federal Reserve

In 1957, wrote a report on Central Banks in Developing Countries:

# Arthur Bloomfield

"Many of the central banks, especially those established since 1945 with the help of Federal Reserve advisers are characterized by…wide and flexible powers. A large number of instruments of general and selective credit control…are provided

# Bloomfield

"..the central bank can seek to influence the flow of bank credit and indeed of savings in directions in keeping with development ends"

# Historical Examples Among Currently Developed Countries

U.S. in Post-WW II period

   -Savings & Loans specialized in housing finance

France- part of indicative planning—directed subsidized credit to key industries

Japan-part of planning policy of industrial policy

# Historical Examples Among Currently Developed Countries

- Post WWII, capital management techniques usually accompanied these credit allocation techniques to prevent capital from avoiding regulations
- Central Bank policy was part of general government apparatus of industrial planning

# Currently "Developing Country" Experiences

Alice Amsden: the "Rise of the Rest": China, India, Indonesia, South Korea, Malaysia, Taiwan and Thailand in Asia; Argentina, Brazil, Chile and Mexico in Latin America; and Turkey in the Middle East.

# "The Rise of the Rest"

Development Banking + Industrial Policy + Performance Requirements (usually export performance)

Central Banks Usually played a supporting role in managing, supply credit and helping to assess performance

# Role of Capital Management Techniques Key

In most of these cases, central bank policies to maintain competitive exchange rates, supported by capital management techniques (capital controls) were key.

# International Project on Alternatives to Inflation Targeting

Co-directed by Gerald Epstein, Co-Director of PERI, University of Massachusetts

Erinc Yeldan, Bilkent University

# Motivation of our project

Building from Bloomfield's discussion: in concrete cases, *how can central banks in developing countries improve on IT to contribute more directly to employment generation, economic growth and poverty reduction*, WHILE KEEPING INFLATION IN CHECK AT MODERATE RATES OF INFLATION.

# Alternatives to Inflation Targeting

## Goal:

To develop *country specific* targets and instruments for Central Banks and related institutions that can help central banks contribute more to employment generation, poverty reduction and other important social goals.

# Motivation for the Project:

The conclusion that Inflation Targeting – may not be the best framework for developing countries that place a high priority on generating more employment, reducing poverty and speeding economic growth, while maintaining a moderate inflation rate.

# Core of Project on Alternatives: Country Case Studies

South Africa
India
Viet Nam
Mexico
Brazil
Argentina
Turkey
The Philippines

# Some Over-all Consensus of the Researchers:

Central Bank policy and inflation targeting in particular must be broadened or replaced to include other important social goals such as:

- Employment generation
- Stable and Competitive Real Exchange Rate (SCRER)
- Investment Promotion
- Reduce Gender Bias Impacts of Contractionary Monetary Policy

# One Size Does NOT Fit All

As our project shows, one main target for all central banks may NOT be appropriate

# Tinbergen Rules

Central Banks with more targets need to recover more instruments

# Problem of the So-Called "Tri-lemma"

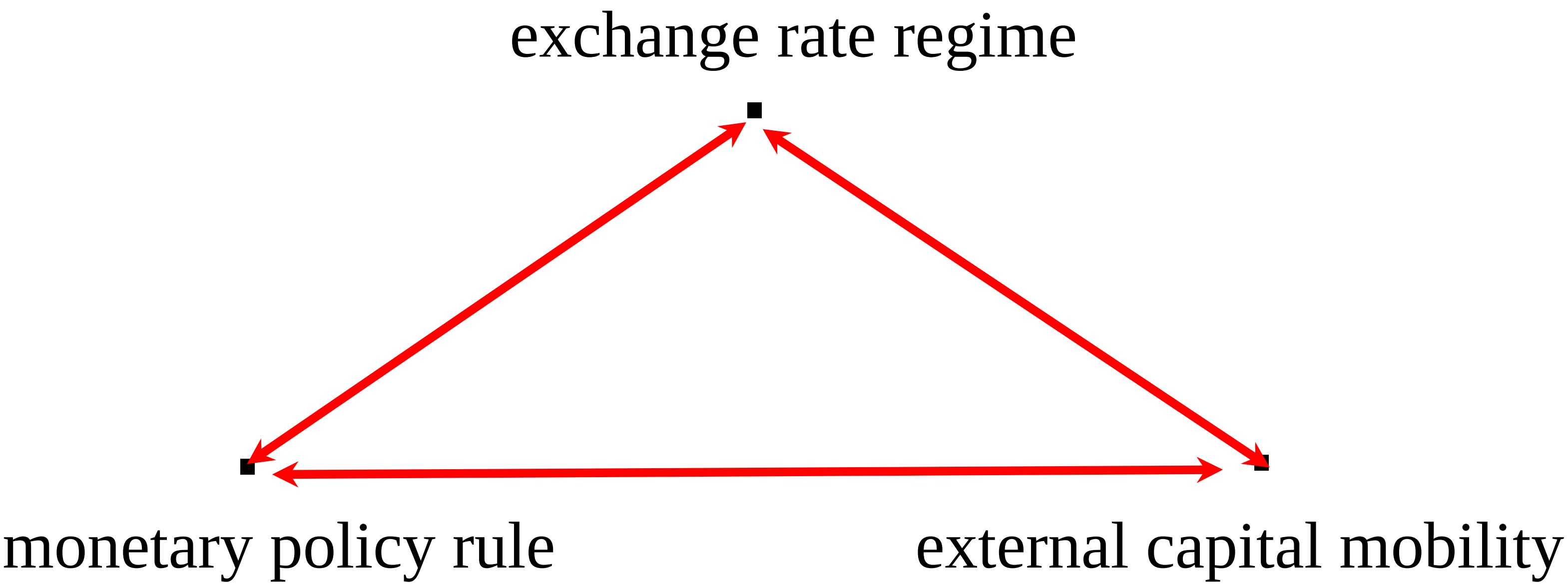
Policy makers can pick at most TWO out of the following three:

Fixed exchange Rates

Free Capital Mobility

Autonomous Monetary Policy

# Tri-lemma


exchange rate regime
monetary policy rule
external capital mobility

# Tinbergen + Trilemma

For both the Tinbergen Targets and Instruments constraint and the Trilemma constraint it is useful and even necessary to expand the tool-kit of central banks to achieve these social and macroeconomic stabilization goals.

# “New Tools” for Central Bank Policy

“Capital Management Techniques”: help control de-stabilizing inflows and outflows of capital (“HOT MONEY”) so that countries can maintain “stable and competitive real exchange rates” while moderating inflation or generating more expansionary monetary policy.

# Examples from our Country Case Studies

Various Goals and Policy Tools from Central Banks

| *Country* | *Ultimate Targets* | *Intermediate Targets* | *Additional Tools/Instruments* |
|---|---|---|---|
| *Argentina* | **Inflation, activity level employment external sustainability** | **SCRER Interest rate** | **Sterilization, reserve requirements (other prudential requirements), capital management techniques** |
| *Brazil* | **inflation, exports, investment** | **Inflation rate SCRER, real interest rate** | **Asymmetric managed float (moving floor on exchange rate), bank reserves, bank capital requirements, bank capital requirements** |
| *Mexico* | **Inflation, SCRER** | **Domestic inflation measure, SCRER, "sliding floor" on exchange rate** | **Capital Management Techniques** |

| *Country* | *Ultimate Targets* | *Intermediate Targets* | *Additional Tools/Instruments* |
|---|---|---|---|
| *India* | **GDP Growth, inflation, slightly undervalued exchange rate** | **Same as ultimate targets** | **Capital management techniques, if necessary** |
| *South Africa* | **Employment, inflation, exchange rate instability** | **GDP Growth, employment intensity of production** | **Credit allocation techniques (eg. asset based reserve requirements, loan guarantees, etc.), capital management techniques** |
| *Turkey* | **Inflation; SCRER** | **Employment; public investment; solvency of public debt** | **Capital management; labor tax reform; public investment** |

| Country | Ultimate Targets | Intermediate Targets | Additional Tools/Instruments |
|---|---|---|---|
| **Philippines** | ***Inflation; SCRER*** | ***Same as Ultimate Targets*** | ***Capital management techniques; prudential supervision of banks; targeted credit; incomes policies;*** |
| **Vietnam** | ***Growth, SCRER, Inflation*** | ***Same as Ultimate Targets*** | ***Capital management techniques; prudential supervision of banks; targeted credit; incomes policies;*** |

# Example: Employment Targeting

# Extended Example

Madagascar: PERI work done for ILO:

Gerald Epstein, Leonce Ndikumana, James Heintz, Grace Chang

## *Challenges Facing Madagascar to Reduce Poverty Include:*

- Structural Transformation: Shifting more workers to productive employment outside of agriculture
- Raising productivity and incomes within and outside agriculture

# *Key Argument:*

The financial system must be part of the solution, but currently it is not adequately doing so.

After making this case, we suggest some alternative policies that can help transform the financial system so that it can play a more productive role in enhancing employment and reducing poverty.

***BUT:***

***Madagascar Financial Sector Seems Inadequate to the task of helping Madagascar Undergo Sectoral Transformation and Raise Employment and Incomes***

# Interest Margins Are Too High

Table 5.2 Interest rate margins in selected areas, 2000 - 2004

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | AVG |
|---|---|---|---|---|---|---|---|
| **Madagascar** | 11.50 | 13.25 | 13.25 | 12.75 | 10.31 | 8.25 | 11.55 |
| **Sub-Saharan Africa** | 13.08 | 13.72 | 13.00 | 12.11 | 12.85 | 11.67 | 12.74 |
| | | | | | | | |
| **Low-Income** | 13.08 | 13.72 | 13.00 | 12.44 | 12.17 | 11.26 | 12.61 |
| **World** | 7.35 | 7.14 | 7.18 | 6.97 | 6.47 | 6.52 | 6.94 |

Source: World Development Indicators (2007b)

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# Large Enterprises in Key Traded sectors get Easiest Access to Credit: % Satisfied After Application Process

| Branch and Type of Enterprise | Satisfied (%) |
|---|---|
| Extractive Activities | 100.0 |
| Manufacturing | 27.8 |
| Production and Dist. Of Energy | 100.0 |
| Construction | 43.6 |
| Trade | 28.6 |
| Hotels and Rest. | 34.2 |
| Transport and Communications | 63.4 |
| Real Estate and Other Services | 16.3 |
| Micro Enterprises | 30.3 |
| SME’s | 46.7 |
| Large Enterprises | 51.0 |

Source: Enterprise Survey, 2005

# To Assess Impact of Investment and Demand in Different Sectors on Incomes and Employment:

We Built Input-Output Model Based on 2001 Data, (the latest available)

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# *Credit is Not Allocated To Sectors with Greatest Value Added or Upstream Links*

| Sector | % of credit Needs Satisfied | Value Added Multiplier | Upstream linkages |
|---|---|---|---|
| Commerce/Trade | 26.6 | 2.0 | 75% |
| Agriculture | NA | 2.0 | 65% |
| Real Estate/Business Services | 16.3 | 1.9 | 89% |
| Extractive Industry | 100 | 1.8 | 71% |
| Transp./Commun. | 63.4 | 1.7 | 76% |
| Manufacturing | 27.8 | 1.5 | 65% |
| Construction | 43.6 | 1.4 | 53% |
| Hotels/Rest. | 34.2 | 1.3 | 72% |
| Energy | 100 | .7 | 36% |

# Two Complementary Strategies:

Enhance domestic linkages by using credit to help develop more domestic linkages

Enhance productivity by using credit and access to finance to help improve access to credit for small businesses and household and building infrastructure in key sectors.

# Micro-Credit and Macro-Credit

- Micro-credit a common strategy

  Problems

  – Small amounts

  – Expensive

**Commercial Banks have Significant Capital But are not deploying it**

**Solution: Use Carrots and Sticks to motivate banks to play bigger and better role in allocating funds for employment generation and structural transformation.**

# Financial Strategies for Supporting Decent Employment Generation

- Asset Based Reserve Requirements

- Loan Guarantees

- Direct On-lending by Central Banks or other government financial Institutions to financial institutions supporting decent employment generation.

# Asset Based Requirements for desired investments

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# Monitoring is Crucial to Avoid Corruption and Inefficiency

Monitoring Mechanisms:

*EXTERNAL BASED*

- Inspectors + SERIOUS PENALTIES FOR CHEATING

*INCENTIVE BASED*

- Escrow Accounts

- Whistleblower Incentives

# Whistleblower Incentives

Pay significant re-ward to those who report on (verifiable) significant corruption.

# New Target of concern: Financial Stability

- Increasing Consensus that Central Banks must be concerned about Asset Bubbles and Financial Stability

# Central Bank Tools for Financial Stability

REGULATORY POLICIES

- liquidity provisioning
- capital requirements
- Limits on leverage
- restrictions maturity mismatches
- restrictoins forex mismatches
- prohibit or severely limit opaque and dangerous instruments creating counterparty risk (as in India, strict controls over OTC derivatives)
- (a precautionary principle for dangerous financial products?)

# Central Bank Tools for Financial Stability

Monetary Policy tools to limit asset bubbles:

-- margin requirements

- asset based reserve requirements
- progressive/countercyclical capital requirements
- capital management techniques to limit excessive capital inflows

# Thank you….