

“Central Bank Independence is Worth Celebrating in Mexico”*

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In 2019, Banco de México is celebrating 25 years of independence. In this time its primary constitutional mandate has been the stability of the Mexican peso’s purchasing power. The central bank law also states that no government authority can demand credit from Banco de México, a feature that allows the central bank to have full control over the terms and conditions to supply base money.

These elements insulate the central bank from short-term political pressures. Governance frameworks play a key role in any institution and are critical for central bank independence, requiring a governing board free from external pressures. Banco de México’s board is composed of five members who are responsible for analysing and deciding on the monetary policy actions needed to attain its constitutional mandate of price stability, the best contribution the central bank can have to foster sustained economic growth and its development.

An important mandate

By having exclusive authority on the terms and conditions to supply fiduciary primary money, central banks play a key role in their economies and their tasks must be performed with a high level of responsibility and prudence. The usefulness of fiat money, as its name entails, relies upon the confidence that people have in its effectiveness as a medium of exchange, a unit of account, and as a store of value.

When the public anticipates that its money will lose value, instability permeates, with adverse effects on economic activity and on the population’s welfare. This emphasises the importance of fostering an environment of price stability that provides certainty for decision making and long-term planning in the economy. Such an environment, among other benefits, promotes investment in the most productive projects, increases employment and leads to better paid jobs, which are essential conditions for sustainable growth and development.

Past experiences show that when a central bank does not have a strong legal framework, sufficiently insulated from political pressures and with a clear mandate, its powers can be misused, leading to episodes of high inflation and crisis. In the 20th century, several countries, including Mexico, experienced episodes of high inflation associated with the implementation of unsustainable macroeconomic policies aimed at promoting economic growth through short-term approaches.

During the 1960s and 1970s some considered that there was a stable and exploitable trade-off between unemployment and inflation, and therefore that growth could be stimulated through monetary expansion. History and theory provided ample evidence that systematic monetary stimulus led economic agents to anticipate the central bank’s monetary actions and hence to increase their inflation expectations. In the end, the result was a high-inflation

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environment, and instead of permanent reductions in unemployment, major obstacles for growth were introduced.

In addition, fiscal dominance has been a challenge for monetary policy, as governments have tried to stimulate economic activity and employment by adopting unsustainable fiscal policies. In this context, high levels of fiscal deficit and public debt led governments to force central banks to adopt expansionary monetary policies to finance their fiscal needs, resulting in escalating inflation and, frequently, economic collapses. Empirical experience and theory shows that monetary policy can influence long-term inflation, but it is unable to stimulate long-term growth and development.

In the later years of the 20th century, a growing consensus among scholars and policy-makers regarding the benefits of having independent central banks with a price stability mandate led many countries, including Mexico, to change their central banks' legal statutes. Empirical studies have found strong evidence that central bank independence is associated with lower levels of inflation, in both advanced and emerging economies.

A history of independence

In 1993, the Mexican Congress amended the country's constitution in order to grant independence to Banco de México, setting price stability as its primary mandate. The central bank's law also established two additional functions: to promote the sound development of the financial system and the adequate functioning of the payment systems. These reforms came into effect in 1994. Thus, 2019 marks the 25th anniversary of Banco de México's independence.

In 2001, Banco de México fully adopted an inflation-targeting regime and since 2003 the inflation target has been 3% (headline consumer price index inflation), with a variability interval of plus or minus 1 percentage point. Inflation decreased from three-digit and two-digit figures in the 1980s and 1990s, to the consolidation of a low and stable inflation environment since the turn of the century, with inflation close to target. Central bank independence with an inflation-targeting framework and a floating exchange rate regime has significantly improved price formation, anchoring inflation expectations and promoting a more efficient functioning of the nominal system in the Mexican economy, with a lower exchange rate pass through to prices.

A low and stable inflation environment has been crucial for the development of financial markets in Mexico, allowing for lower inflation expectations and inflation risk premium, which has led to a reduction of interest rates across the yield curve, key for the development of a deep and liquid fixed-income market. The federal government has been able to issue 30-year nominal peso bonds continuously for more than 12 years, allowing for the development of a long-term peso funding market for households and corporates, with almost all mortgage financing done at fixed nominal 20- to 30-year interest rates. Also, Mexico's long and sustained strategy of an open capital account, with decades of no capital controls and a consistent floating exchange rate regime, have allowed the country to develop the second most deep and liquid foreign exchange market among emerging markets. Having an independent central bank, with a clear mandate of price stability, has played a critical role to attain these results.

Transparency and accountability

Central bank independence must be accompanied by greater transparency, accountability and better communication with the public and its legislative representatives than had previously existed, as these are essential for increasing monetary policy effectiveness, especially under an inflation-targeting regime, that requires more publicly available information on the central bank's objectives, strategies, instruments and results.

Since Banco de México was granted full autonomy there has been a clear awareness that communication, transparency and accountability are necessary to strengthen the credibility and effectiveness of its monetary policy actions. Accordingly, Banco de México has made continuous efforts to be more transparent and to improve its communication strategy, which in 2018 added the following new elements:

- i. The quarterly reports include headline and core inflation forecasts of the quarterly average inflation for the next eight quarters, thus helping to consolidate the monetary policy strategy and reaction function as an inflation forecast targeting regime.
- ii. The minutes of the monetary policy committee decisions include the identity of the voters and their reasons.
- iii. The full transcripts of the board's monetary policy meetings will be published after three years.
- iv. The monetary policy statement and the corresponding minutes are published simultaneously in Spanish and English.
- v. All speeches and public presentations of board members are available through the central bank's website.

Challenges ahead

In the past few decades, the key attributes and the need for independent central banks have remained essentially unchanged. But the main risks that could challenge their independence may be increasing. The polarisation of political and economic narratives has been on the rise, in both advanced and emerging economies. This has been associated in part with the effects of the rapid insertion of labour-abundant regions in the global economy, the great financial crisis, technological innovation, and the increasing gap between citizens' expectations and opportunities.

This environment has fostered short-term policies and approaches for political gains, such as protectionism and trade tensions. In this environment, multilateral and domestic institutions could be subject to heightened short-term political pressures. Under this polarised environment, much-needed structural reforms and adequate long-term policies have been absent while escalating geopolitical and trade tensions have put additional pressure on central banks' aggregate demand management responsibilities, increasing the challenges and trade-offs for monetary policy.

History is full of examples of the acute non-linear costs that economies and societies can suffer when central banks are oriented towards narrow, short-term objectives. Banco de México's recent history confirms the importance of central bank independence as a necessary

condition to achieve the institution's primary mandate of low and stable inflation, which is monetary policy's best contribution to promote investment, higher productivity and stronger and sustained economic growth and development. The constitutional reform that granted independence to the central bank 25 years ago is one of the most important economic reforms adopted in Mexico's contemporary history and we must continue working to preserve it for future generations.