Remarks by Alejandro Díaz de León, Governor of Banco de México, at the Conference on Central Bank Independence, Mandates and Policies, "Institutional mandates, policy tools and policy coordination", organized by the Faculty of Economics of Universidad de Chile.[1]

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Central banks are unique institutions. They all share the responsibility of providing our countries with national currency. Money is an essential public good that needs to be an effective medium of exchange, store of value, and unit of account.

Societies have found that the best form of money is not that which provides intrinsic value, but that which, although immaterial –fiat Money–, given the rules and strategies followed by its issuer, ensures the issuer's commitment to pursue societies' long-term goals.

The mandate, goals and objectives defined by society for central banks determine the strategies and terms and conditions by which they provide money to their national economies. This clearly represents an issue of

[1] The opinions and views expressed in this document are the sole responsibility of the author and do not necessarily represent the institutional position of the Banco de México or of its Governing Board.

sovereignty and social contract of utmost importance. Countries may set different priorities or take specific elements into consideration. To a certain extent, central banks' mandates are usually influenced by the most adverse monetary episodes previously experienced by each country. For example, Germany's 1920s hyperinflation must have influenced their society's search for price stability, as the Great Depression may have raised employment considerations in the US Federal Reserve's dual mandate.

In the case of many central banks in Latin America, between the late 70's and early 90's many economies in the region experienced periods of high inflation. Since that time, concerns have been that central banks under political influence, tend to set expansionary policies to finance governments and stimulate short-term economic growth, regardless of the medium- and long-run consequences. This was the main reason why it was necessary to isolate monetary policy-making from direct political influence.

Many central banks in Latin America and in other regions were thus granted independence, with mandates set mainly on pursuing price

stability. In this context, Chile was one of the first economies to modernize its monetary policy framework with this objective.

Central bank independence requires an institutional set-up that sometimes involves making politically unpopular decisions, but which are intended for the long-run benefit of the country. Its key features are:

1. A clear legal mandate and specific objectives.
2. Limiting the governments' discretionary power of appointing central bank governing board members.
3. Limiting the ability of any government authority to use the central bank as a source of financing.
4. Consolidate collegiate decision-making bodies, with proven technical capacity and the guarantee to act independently.
5. Allowing the central bank to choose the best means to achieve the objectives set by law.

The paradigm of autonomous, flexible inflation-targeting central banks, was the result of society's recognition that central banks' best contribution to long-term growth was to maintain sustained price stability. And that monetary policy should deliver long-run inflation around a

specifically defined target, with non-persistent fluctuations in inflation. This clearly recognizes the notion that there is no exploitable trade-off between inflation and real variables.

Even though most central banks have price stability mandates, the sharp contractions in economic activity experienced during the global financial crisis of 2008 and the current Covid-19 pandemic have led to the revision of the adequate monetary policy mandate and frameworks.

Theoretically, economic models point towards optimal monetary policy strategies that minimize fluctuations around the inflation target and potential output. The key question is which central bank legal and institutional framework, mindful of political economy considerations and domestic conditions, delivers such outcome.

In this regard, when an economy faces inflationary pressures from aggregate demand, monetary authorities with a single or dual mandate operate to stabilize inflation and output gaps. However, more challenging scenarios in which these gaps move in opposite directions may take place. In this context, central banks would face a complex

trade-off, regardless of their mandates. Under a dual mandate, these institutions are likely to face strong pressure to prioritize economic activity concerns, in spite of the presence of a positive inflation gap.

In this regard, the ECB, whose primary objective is to maintain price stability in the euro area, when facing supply-related disturbances, conducts monetary policy aimed at achieving a gradual and orderly convergence of inflation to its target, while avoiding a sharp fall in economic activity and employment.

In advanced economies, inflation dynamics are strongly anchored around their targets and they are mainly driven by aggregate demand dynamics. This may reduce the circumstances when the central bank faces more complex policy tradeoffs.

Emerging economies face a more challenging environment:

1) While they have strengthened their macroeconomic policy frameworks and improved their economic fundamentals over the last decades, and despite their great advances in controlling inflation, many of them have not fully consolidated an environment

of low and stable inflation and medium and long-term inflation expectations are not fully anchored at the target. Monetary policy is still in the process of attaining this goals.

2) Emerging economies face larger and more frequent inflationary shocks and thus have historically registered higher levels of both inflation and its expectations.
3) They are predominantly small open economies, whose terms of trade are strongly influenced by commodity prices. They are also open to capital flows, and thus subject to variation in investor sentiment and global risk aversion.

For these reasons, they are highly exposed to fluctuations in global economic and financial conditions which, in turn, is reflected in a large exchange rate volatility and in frequent inflationary shocks. Moreover, consumer price indices in these economies have larger weights on the prices of volatile items such as food and energy. As a result, inflation is, on average, more volatile and more difficult to forecast than in advanced economies.

To illustrate this point, let me highlight the recent research at Banco de México suggests that, on average, shocks to the output gap have explained only about 10.2 % of the variation of core inflation across Latin American countries since the early 2000's. On the other hand, exchange rate shocks account for 23.7% of the variation, idiosyncratic inflationary shocks, originating from government-authorized prices, weather factors and so on, account for 61.2%, and commodity price shocks account for the remaining variation.

When there are insufficiently credible inflation targets and inflation dynamics are dominated by foreign exchange and supply-related shocks, a well-defined and broadly understood and communicated single mandate can better contribute to reduce uncertainty about the central banks' reaction-function and reduce term premium. In this case, the central bank can commit to a low and stable inflation around its target, while avoiding spillovers on economic activity and employment. For emerging economies facing these conditions, adopting a dual mandate could require a tighter monetary policy stance to compensate for the added uncertainty in the reaction-function and its effect on both inflation and the term premium.

When central banks in emerging economies face a complex policy trade-off because inflation and output gaps move in opposite directions, they have to ensure that monetary policy does not lead to increases in risk premia and induce a steeper yield curve. In this circumstance, a dual mandate could add uncertainty to the policy response and put pressure on inflation risk premium.

Under these circumstances, emerging economies could be better served by a well-defined single mandate centered on price stability, to directly contain inflation expectations and risk premia.

There is an additional challenge faced by emerging economies, especially in Latin America, where there is a significant economic growth deficit that over the last decades has resulted in a lower per-capita GDP relative to other emerging and advanced economies. In the case of Mexico, we have even seen a reduction of potential GDP over the last years. In this environment, political pressures seeking stimulus and higher growth will not be put to rest by the reasons behind the update of potential GDP, a non-observable variable. Thus, in these economies,

central banks are bound to face greater pressures to put aside long-term price stability concerns and provide a short-term stimulus to the economy.

Summing up, under the current setting, an institutional mandate that is attainable, time consistent, and allows society to make policymakers accountable for their actions by having them build credibility in their commitment to their goals is fundamental.

In the specific case of Mexico, monetary policy has been conducted to achieve a primary price stability mandate. This approach has led to direct benefits, such as lower inflation, a lower exchange rate pass-through, stable inflation expectations, and lower term premia and indirectly to other beneficial changes in the economy, such as the development of long-term financial instruments.

It is important to underline that a central bank by itself cannot achieve macroeconomic stability. Coordination and communication between both monetary and fiscal policies is crucial to achieve success. Mexico has had a successful experience of cooperation between Banco de

México and the Treasury while at the same time maintaining central bank independence.

Of utmost importance is that this approach has allowed Banco de México to remain a strong public institution and sustain its independence with legitimacy in the eyes of the public. In this regard, central banks, especially in emerging economies, must also play the role of an anchor, both economically and institutionally, and a clear, attainable mandate contributes to strengthen institutions.

Overall, while the ultimate goal of any central bank is and must be to contribute to the welfare of society, there is no unique institutional design that fits all economies at all times. Authorities and legislators have to consider multiple elements based on the historical experience of each country, the nature of the shocks faced by their economies, and any other likely pressures that institutions may face under diverse circumstances. In sum, long-term-oriented institutions, including central banks, now more than ever, need to be designed thoughtfully and, particularly, must have a clear time-consistent mandate that allows for good decision-making for the benefit of our societies.