Capital Flows and the Design of Monetary Policy Frameworks

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Central Bank Governance

- There is a broad consensus that monetary policy decisions need to be insulated from fiscal constraints and political pressures.
- Therefore, the central bank should have a clear legal mandate and a sufficient degree of operational independence.
- However, operational independence does *not* imply autonomy; the central bank must remain fully accountable to elected officials and to the public.

The Rationale for Transparency

- There is a broad consensus that monetary policy should be systematic and transparent.
- Therefore, the central bank should have clear objectives & operating procedures and should clearly explain the rationale for its monetary policy decisions.
- Transparency also fosters broad-based public support, which is crucial for preserving the central bank's operational independence.

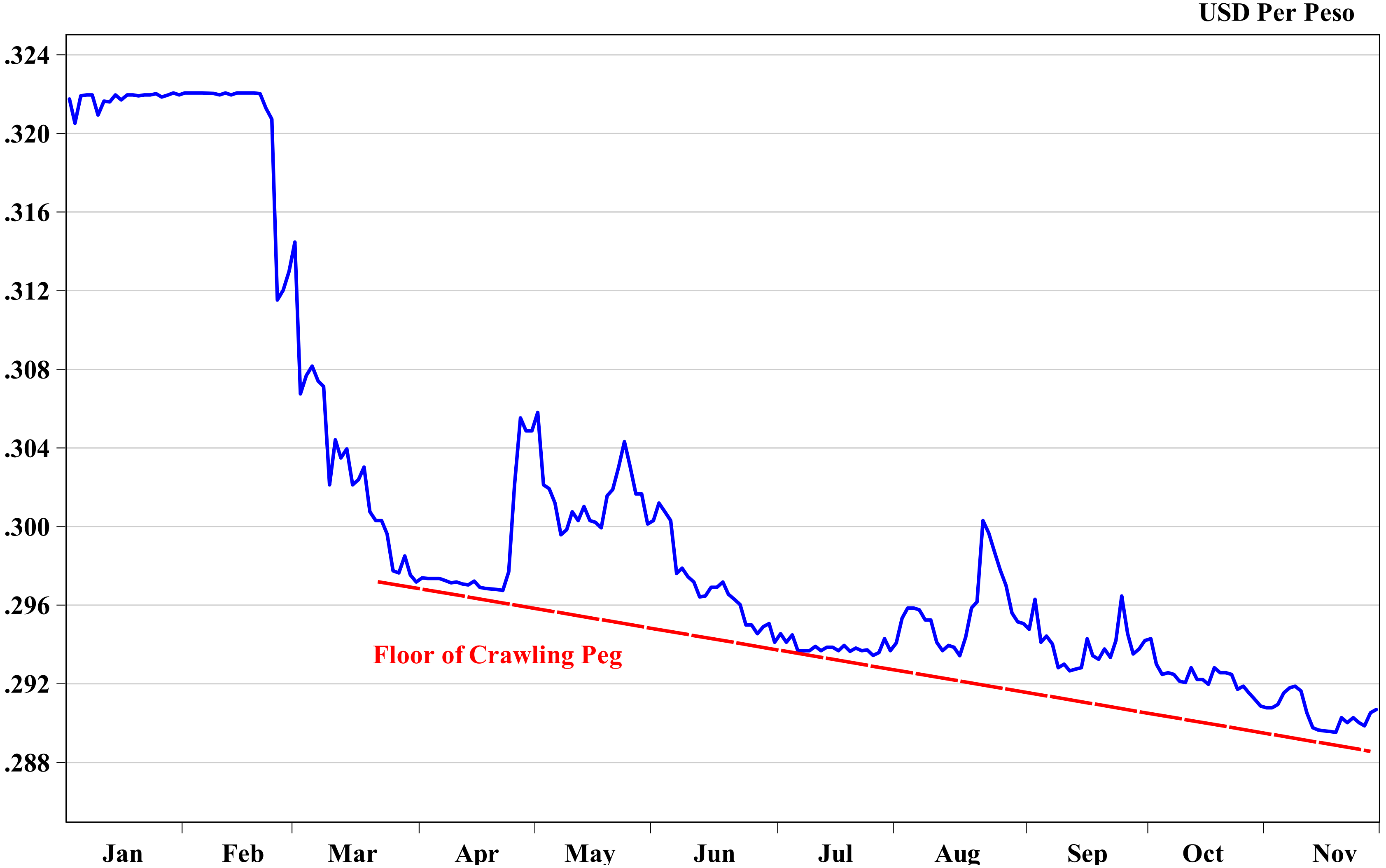
Three Basic Principles

- The central bank's paramount task is to foster price stability by keeping inflation expectations firmly anchored.
- Interventions in FX markets should be rare and limited to mitigating transitory bouts of market instability.
- Macroprudential tools are crucial to ensure that capital flows do not threaten the stability of the financial system.

The Mexican Crisis of 1994

- **Political Background**
  - **Institutional Revolutionary Party (PRI) had ruled since 1929 *("the perfect dictatorship")***
  - **The PRI's presidential candidate was assassinated in March 1994.**
- **Monetary & Exchange Rate Regime**
  - **Mexico adopted a "crawling peg" in 1989 to foster gradual disinflation.**
  - **The central bank (Banxico) had insufficient operational independence.**
  - **Political instability led to FX outflows in 1994, and Banxico ceased publishing reserve data.**

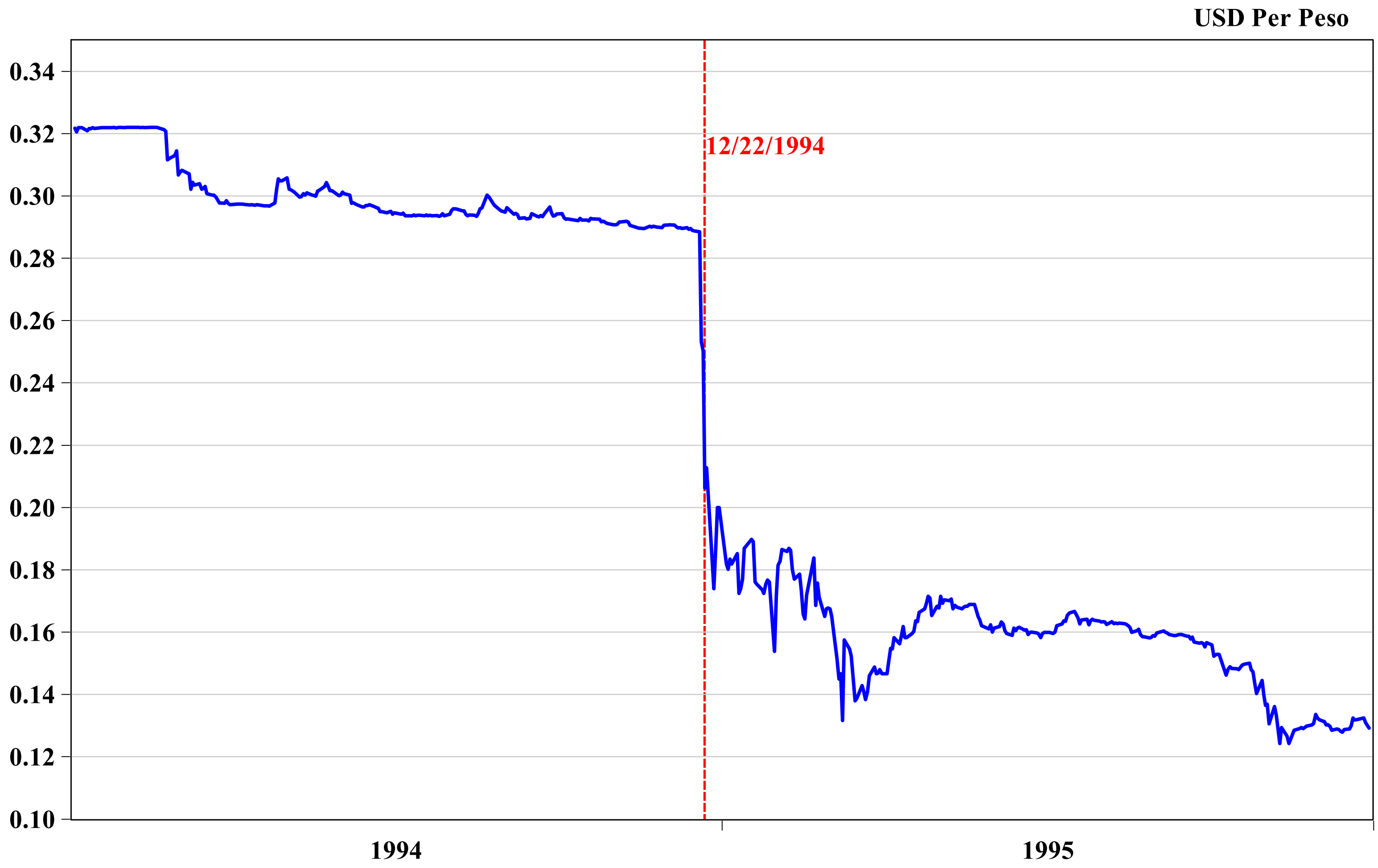
Mexico’s Exchange Rate, Jan-Nov 1994



Mexico's FX Reserves, 1993-94

December 1993	**$28 billion**
August 17, 1994	$17 billion
December 1, 1994	$9 billion
December 15, 1994	$7 billion
December 22, 1994	**$3 billion**

Mexico's Exchange Rate, 1994-1995



Mexico's Post-Crisis Framework

- **Inflation Targeting**

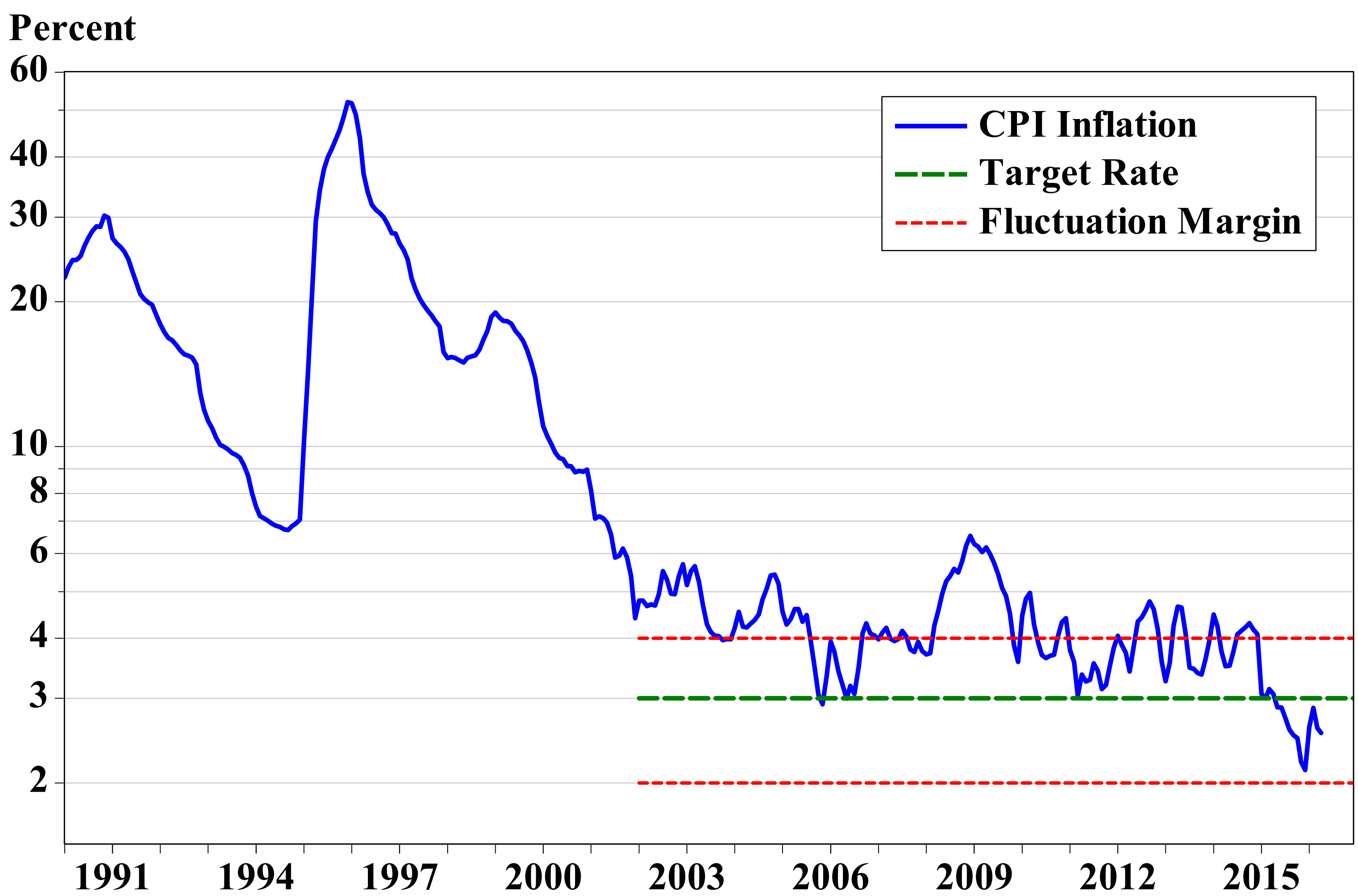
  1996-1998: annual inflation targets

  1999-2001: inflation target for 2003

  2002-Present: fixed long-term inflation target

- **Exchange Rate Regime**
  - Strong commitment to floating exchange rate.
  - FX intervention limited to a small number of occasions, mostly in 1997-1998 (Asian crisis) and 2008-2009 (global financial crisis).
  - Empirical evidence indicates that interventions have reduced bid-ask spreads in FX market; *cf. García-Verdú and Zerecero (BIS, 2013)*.

Mexico's CPI Inflation, 1990-2016



Mexico's Exchange Rate, 1996-2016

Concluding Remarks

- **Central banks need to devote more resources to educating and informing the general public, *not* just economists & market participants.**
- **Central banks need to identify material risks and to communicate their contingency plans for mitigating and addressing those risks; i.e., *"stress tests for monetary policy."***
- **The deployment of macroprudential tools is crucial for ensuring that monetary policy can be focused on fostering price stability and sustainable economic growth.**