Comment on Manuel Ramos-Francia and Alberto Torres

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This is a very interesting and well-written paper that describes the Mexican experience since the floating of the peso after 1994, focusing on the implementation of the inflation-targeting framework. In general, one could split the paper into two interrelated parts. In the first part, the authors describe the evolution of monetary policy in Mexico since the peso crisis at the end of 1994, showing that the adoption of inflation targeting was a gradual process, where Banco de México needed first to restore credibility in the financial system and its ability to conduct monetary policy. In the second part of the paper, the authors identify the source of inflationary shocks that hit the Mexican economy after 1998 and concluded that the conduct of monetary policy has been consistent with the general guidelines of an inflation-targeting regime.

My comments will follow the general structure of the article, i.e., first I would like to comment on the Mexican experience and compare it with the experiences of other emerging market inflation targeting countries, especially Brazil, which is the case I am most familiar with. The second set of comments will deal with the more empirical part of the paper.

It is difficult to summarize all the Mexican experience in a couple of paragraphs. As the paper summarizes in a very comprehensive manner, the three years following the peso devaluation posed very difficult tasks for the monetary authority. Banco de México needed to prevent a systemic crisis in the financial system and, at the same time, impede the formation of a dollar-inflation spiral in an environment of significant change in relative prices as a result of the exchange rate depreciation and the realignment of public prices necessary for an increase in government revenues. As the authors explain, both the problems in the financial system and a sort of fiscal dominance limited the ability of the central bank to control inflation in the first three years after the adoption of the floating exchange rate regime. During these first years, the main operating guideline for the monetary policy was to establish a limit to the expansion of net domestic credit. Also, in 1996, the central bank began intervening in the foreign exchange rate market through previously announced rules, initially to accumulate reserves and, after 1997, to provide liquidity to the market, reducing exchange rate volatility.
Only in 1998, after the government fulfilled all its obligations and the current account was adjusted, could monetary policy concentrate on its goal of achieving price stability in the long run and move towards a full-fledged inflation-targeting regime. This process began in 1998 and led to more and more transparency. The main steps involved the release of the discussions justifying the changes in the monetary policy instrument—the “corto”—since 1998; the definition of a medium-term inflation target for CPI inflation in 1999; the publication of quarterly inflation reports after 2000; the formal announcement that Banco de México was adopting an inflation-targeting regime in 2002; and, last but not least, the decision to make monetary policy announcements at preestablished dates in 2003. As the authors concluded, autonomous monetary policy—as opposed to an exchange-rate-pegged regime—has become an effective nominal anchor of the economy, being successful in curtailing inflationary pressures. This performance is largely attributed to the following of the main guidelines of an inflation-targeting regime, namely, enhancing transparency and adequate responses to inflationary shocks.

I believe there are three important lessons from the Mexican experience that, to some extent, are shared by other emerging market economies that adopted inflation targeting regimes. The first one, as is largely stressed in the paper, is the possibility for an inflation-targeting framework to perform the role of nominal anchor of a small open emerging market economy. The second message is that inflation targeting, by itself, cannot be a panacea for achieving low and stable inflation. Some preconditions, which include a stable financial system and sound fiscal accounts, are necessary for the success of the regime. Third, a point mentioned but not stressed in the paper, inflation targeting does not mean absence of intervention in the foreign exchange rate market, although the nature of intervention is completely different from the one observed in pegged exchange rate regimes.

The second issue raised above may explain the difference between the Brazilian and Mexican experiences. Unlike Mexico, Brazil adopted a formal inflation-targeting regime a few months after abandoning the currency peg. Although there was much uncertainty at that time, Brazil fulfilled three important preconditions that were apparently absent in the Mexican experience. The first one is that there was no threat of a financial crisis. The Brazilian banking system went through an important reorganization in the middle of the 1990s and was fully hedged against currency depreciation. Second, Brazil was already under an IMF support package when the real was allowed to float. Besides, Brazil could rapidly reach an informal agreement with the international financial community that ensured maintenance of credit lines in the first months following the depreciation. Finally, the fiscal accounts were already being adjusted when the pegged regime was abandoned.