ECONOMIC COMMENTARY
Federal Reserve Bank of Cleveland

Free Markets and Price Stability: Opportunities for Mexico

by Jerry L. Jordan

Mexico has been making important progress on several economic fronts, moving toward less inflation, increased reliance on privately owned capital and companies, and greater integration of its economy with those of other nations. At times of transition such as this, there are many choices to be made. There is also less resistance to change. That puts Mexico in a position to select policies and shape institutions that will affect its prosperity for decades to come.

The key mechanism underlying this progress is the nation's increased reliance on market forces and institutions. This shift in economic philosophy has enhanced Mexico's attractiveness to foreign investors while unleashing more of the creative abilities of its own entrepreneurs. The result is that the country is now on a path toward greater economic efficiency and prosperity.

Mexico has also made important improvements in its approach to trade over the last few years. As a new member of the General Agreement on Tariffs and Trade, it is undertaking to comply with international standards for the conduct of foreign trade. Furthermore, the Mexican government has implemented a dramatic unilateral reduction of trade barriers and was a major catalyst behind the North American Free Trade Agreement (NAFTA).

Most recently, Mexican authorities have launched an initiative to provide autonomy for the nation's central bank. If their effort is successful, it will greatly improve the prospects for price stability and sustainable economic growth.

Thus, Mexico is standing on the threshold of decisions about international commerce and central banking that will have a profound effect on its future.

■ Outlook for NAFTA

I strongly support NAFTA and am hopeful that the U.S. Congress will enact the legislation necessary to implement it as scheduled on January 1, 1994. I believe that by encouraging free trade in goods, reducing barriers to trade in services, and easing limitations on international investment, the accord will enhance competition, efficiency, and productivity and thereby increase the prosperity of all three North American nations.

There are some groups in the United States that fear the additional competition NAFTA would bring about, and they are lobbying vigorously for its defeat. Opponents recently won a decision in a U.S. district court that requires federal officials to prepare an environmental impact statement estimating the agreement's likely effect on such things as air and water quality.[1] Initial reports said that the study would take months to compile and that it would have to be completed before NAFTA-related legislation could be sent to Congress — a delay that would represent a serious

Mexico's economy has been thriving of late because of an increased reliance on competition and private enterprise. This *Economic Commentary* is based on a recent speech in which Federal Reserve Bank of Cleveland President Jerry L. Jordan explained that Mexico could further enhance its economic progress by implementing the provisions of NAFTA—unilaterally, if necessary—and by following through on its initiative to make the central bank autonomous.

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obstacle to implementation. More recently, administration officials have stated that the legislation can be submitted prior to completion of the study and that the study could be ready in 45 to 60 days.[2] Nevertheless, the administration plans to appeal the decision and believes that the lower court's ruling will be overturned.

Despite the current uncertainty surrounding NAFTA's fate in the United States, I believe that Mexico can be clear about what decision it will make. Reductions in barriers to trade and investment do not have to be reciprocated to be valuable. Most of the added prosperity Mexico is now enjoying stems from its recent unilateral moves toward a more open economy. Even if the United States fails to enact NAFTA, Mexico can, if it wishes, choose to implement the provisions on its own, setting an example for its neighbors in Central, North, and South America and reaping the rewards that are available to any nation with the wisdom and the will to reduce its interference with commerce.

Just as Mexico's decisions on NAFTA will have a substantial impact on the country's future prosperity, so too will its actions regarding the Banco de Mexico's charter.

■ A Central Bank's Charter and National Prosperity

The ability of a central bank to perform its functions depends on many things, one of the most important of which is the bank's charter. By charter, I mean the laws and practices that specify the bank's goals and establish its relationship to the legislative and executive branches of government.

The most important function of a central bank is to stabilize prices. Price stability is necessary because it eliminates the need for households and firms to use real resources to forecast inflation and to hedge against losses (and seek gains) caused by inflation-induced redistributions of income and wealth. It also increases the clarity with which changes in relative prices can be discerned, helping firms to make better decisions about production and investment and helping households to make better decisions about consumption patterns. In these ways, price stability raises not only the *level* of real economic output, but also the *growth rate* of output.[3]

Because a central bank determines the price level, or the value of money, its charter should make it effectively independent of the legislative and executive branches of government. This doesn't mean that the bank should not be held accountable for achieving price stability, nor does it mean that its independence should be irrevocable. Clear objectives and accountability for attaining them would help to ensure independence of action. Central bankers should have enough freedom from government interference to allow them to choose and implement monetary policy for a substantial length of time without concern that their authority will be rescinded.

There are two reasons why central bank independence is important. First, elected officials of any nation may resort to monetary stimulus of the economy to respond to purely political considerations, including their own reelection, regardless of the long-run implications. Certainly, any government that can spend money created by a central bank will be tempted to do so to please voters in the months preceding an election.

The disadvantage of expanding the money supply in this way is that it will eventually lead to inflation, and inflation hurts the economy in the long run. There is a correlation between inflation rates and the degree of control that governments have over the creation of money. Countries with independent central banks tend to have less inflation than those whose central banks are closely controlled by the government.[4]

The second reason that independence is important is to prevent the government from using central bank credit as a substitute for taxing or borrowing from the public to finance its expenditures. This is especially true in countries that do not have efficient tax collection systems or strong financial markets. Taxes make the cost of government expenditures more explicit to the public, which can lead a nation to wiser use of its limited resources. In countries with a weak or inefficient system of tax collection, central bank financing can be used as a crutch to avoid the need to develop better procedures. Borrowing from the public rather than from the central bank makes the cost of borrowing more explicit, because the government will have to pay a market-determined rate of interest.

In addition to independence, the central bank's charter should specify the goals it is to pursue and designate which among them should be given top priority. I have come to believe that price-level stability should be a central bank's primary objective. It is, after all, the only goal likely to be achievable.

It would be nice to be able to pursue price stability, full employment, rapid economic growth, a stable exchange rate, and low interest rates simultaneously. However, in the short run some of these objectives are likely to be inconsistent with price stability, and that is when it is critical for monetary policymakers to know that preserving the purchasing power of the currency is their first obligation. In the long run, price-level stability is not only consistent with full employment, maximum sustainable growth, and low interest rates, but it makes a significant *contribution* to their achievement. Indeed, it is the most important contribution the central bank can make.

This is not to say that price stability *ensures* the attainment of those other worthy goals. Many government policies, as well as other internal and external conditions, help to determine a nation's unemployment rate, growth rate, and interest rates. The central bank cannot ensure prosperity. What it can do, by achieving price stability, is to be sure that it is not an *obstacle* to national economic growth.

■ Independence Is No Substitute for Clear Objectives and Accountability

The U.S. central bank is structured in a way that appears to give it substantial independence. Although governors of the Federal Reserve System are appointed by the President of the United States, they serve 14-year staggered terms, and there is no direct government involvement in the appointment of the 12 district bank presidents.[5]

This is not an oversight. The writers of the Federal Reserve Act set out to design a central bank that would be largely insulated from political pressures. Subsequent revisions to the Act, particularly those passed in 1935, have served only to increase that insulation.[6] Congress has often considered proposals to revise the Federal Reserve System, but has essentially made no change in its structure for nearly 60 years.

The absence of direct government input into the selection of Reserve Bank presidents is a key issue in the current debate about the Fed's accountability and independence. Some recent proposals would require direct government involvement in their selection or would rescind their authority to vote in monetary policymaking meetings of the Federal Open Market Committee (FOMC).[7] That approach seeks to make the Federal Reserve more accountable to the current government. In contrast, I believe that the Fed should be accountable for achieving a specific objective, namely, preserving the purchasing power of the dollar. Indeed, accountability for achieving a specific goal may be more important than independence.[8]

Although the U.S. inflation rate was fairly low during most of the 1950s and early 1960s, it increased dramatically from 1965 to 1980. Despite a marked reduction in the rate since then, inflation still rose throughout the 1980s at an average pace that would double the price level every 14 to 18 years. Today, surveys show that most Americans expect a 3 to 4 percent inflation rate over the next year or two.

The reason for this uneven and sometimes unsatisfactory inflation performance in the presence of apparent Federal Reserve independence is that the government has assigned multiple objectives to the central bank, but it has not given any one of them top priority. This ambiguity has resulted in shifting objectives in response to changes in economic theories and political imperatives.

In the 1960s, the Federal Reserve responded to the Keynesian view that monetary policy and fiscal policy should be coordinated and used to fine-tune the economy into a state of continuous growth. In the late 1960s and early 1970s, monetary policy also sought to defend U.S. gold reserves and the international value of the dollar. After the gold window was closed in 1971 and fixed exchange rates were abandoned in 1973, the use of monetary policy for countercyclical purposes led to ever-increasing rates of inflation. By late 1979, inflation had become so virulent that the Federal Reserve shifted its attention to reining it in, an effort that has benefited from the backing, or at least the tolerance, of elected officials through much of the period since then. However, because many officials now consider inflation to be under control, there is a risk that political pressure increasingly will seek to direct monetary policy to the achievement of goals other than price stability. The ambiguity of multiple goals thus might again deny monetary policy the anchor it needs to avoid being pushed by changing political tides toward the reefs of what are, for monetary policy, unachievable and therefore inappropriate objectives.

In contrast to the situation in the United States, the laws governing the central banks of Germany and New Zealand specify that price stability is to be given first priority whenever any other objective conflicts with it.[9] In its move toward a new central bank charter, Mexico appears to be following these nations' lead. Price-level stability, if attained, would contribute to exchange-rate stability between the peso and the currencies of nations that are achieving substantial price-level stability of their own.

■ A New Charter for the Banco de Mexico

Last May 17, Mexican President Carlos Salinas de Gortari proposed a constitutional amendment that would substantially alter the Banco de Mexico's charter. The amendment was approved by the required two-thirds majority of the legislature in June.[10]

The most important provisions of the amendment are as follows: The bank will be responsible for its own administration. It will be governed by a board of directors who are appointed by the President and confirmed by the Senate. The directors will exercise their duties independently and can be removed from office only if convicted of a serious crime. The primary objective of the bank will be to maintain the national currency's purchasing power. The government will no longer be able to compel the central bank to provide financing to the government or to anyone else.[11]

The amendment does not spell out how many directors will constitute the governing board, how long their terms of office will be, or whether their terms will be staggered. These details, which are still being negotiated and which will need to be specified in additional legislation, will help to determine the extent of the central bank's independence.

Furthermore, the amendment does not specify what "maintaining the purchasing power of the currency" means. Does it mean international purchasing power, as indicated, perhaps, by the peso's exchange rate against the U.S. dollar, some other currency, or a basket of currencies; or does it mean domestic purchasing power, as indicated, perhaps, by the Consumer Price Index (CPI)? How much annual change in purchasing power is to be considered stability: 0 percent, 5 percent, 10 percent? One might argue that 10 percent is stability, compared to some previous changes in the exchange rate and the CPI, yet at that rate the currency would lose half its purchasing power in about seven years. Should the effects of extraordinary events on the CPI or the exchange rate be ignored? These questions are important because ambiguity in the goal will make it harder to resist political pressures for inflationary policies.

Banco de Mexico President Miguel Mancera explained the need for central bank autonomy three years ago, when he noted: "Politicians are subjected to many pressures to spend liberally, which they simply cannot often resist, even though in many cases they are fully aware of the consequences of excessive spending. This inability to exercise the necessary restraint seems to be a justification for an independent central bank."[12]

Some observers in the United States have said that the reason Mexico should legislate central bank autonomy is to reassure foreign investors that it will not revert to inflationary policies during the next presidential term. It seems to me, however, that such reassurance will also make an impression on domestic investors. Moreover, if central bank autonomy and the mandate to preserve the purchasing power of the peso lead to stable prices, the economy will benefit in all of the ways I have already discussed.

■ The Changing Role of Central Banks in Other Nations

Mexico's move toward a central bank with greater independence and a mandate to preserve the currency's purchasing power should increase the likelihood of a better inflation performance. That has been the experience of other countries that have traveled a similar path. Moreover, the European Community (EC) has endorsed the concept of central bank independence as a necessary step toward price stability and monetary union, and several of its members are moving in that direction.

New Zealand is a prime example of a country that has made recent changes in the charter of its central bank in an effort to stabilize prices. Prior to passage of The Reserve Bank of New Zealand Act of 1989, the monetary authorities were instructed to pursue several objectives at once. Not surprisingly, the nation had high and variable rates of inflation: From 1971 through 1987, annual consumer inflation ranged from 6 to 17 percent and averaged 12.7 percent. Now, inflation has fallen to near zero.

Under the new charter, price stability is specified as the central bank's primary objective. Moreover, the governor of the bank and the Minister of Finance have an explicit employment contract, called the Policy Targets Agreement, that specifies a target range for inflation. Currently, that range is zero to 2 percent year-over-year consumer price inflation. If actual inflation exceeds the target, the Finance Minister must either take public responsibility for the outcome or dismiss the governor.

The Bank of Canada also has improved that nation's inflation figures recently. Although the bank is legally under the control of the Minister of Finance, it has apparently been able to make a de facto change in its charter by publicly announcing that price stability is its sole objective. This posture seems to have given the bank freedom to pursue that objective free from government interference, at least for the present. In 1992, Canada's inflation rate dropped to less than 2 percent, well below the U.S. rate and under 4 percent for the first time in many years.

Germany's central bank, the Bundesbank, has a legislated mandate to make price stability its number-one priority. That probably explains why from 1962 to 1991, Germany had only half as much inflation as the United States. And in France, the new center-right government recently proposed legislation to free the central bank from government control. In issuing the proposal, the Minister of the Economy, Mr. Edmond Alphandery, said that "those countries which enjoy the greatest monetary stability are those which have entrusted the conduct of monetary policy to an independent central bank."[13] It is noteworthy that France is pursuing this course even though inflation there has been relatively low in recent years.

The French proposal, announced in May, provides for the monetary policy of the Bank of France to be determined by a nine-member committee dominated by people appointed for nine-year terms. Such long terms of office are intended to give committee members freedom to go against the government's wishes, a technique that parallels the U.S. approach.

The effort to release the Bank of France from government control was necessary to bring the nation into alignment with the Maastricht Treaty. That agreement, negotiated by the EC, is a blueprint for member countries to achieve full monetary union by the end of the decade. The treaty requires all EC countries to have independent central banks as a step toward establishing an independent European central bank, which will also have price stability as its primary goal. Belgium complied last March, and it is likely that some other nations will soon do likewise.[14]

Thus, Mexico joins the ranks of several forward-looking countries that have changed, or are in the process of changing, their central bank's charter to a form that is better designed for the pursuit of price-level stability. The available evidence suggests that if Mexico follows through on its current initiative, it should be easier to stabilize the purchasing power of its currency.

■ Conclusion

The greater the freedom with which markets are permitted to operate, the better the job they can do of releasing people's creative energies. Mexico is making significant progress in this area by relaxing its restrictions on international trade, on investment, and on the private operation of businesses. Some of the benefit of those changes is already visible in the nation's increasing standard of living. Additional gains will result if Mexico implements NAFTA's provisions, regardless of whether the United States does the same.

Stabilizing the price level is critical because it improves the efficiency of the economy and encourages investment, which together can raise the level and the growth rate of real output. Mexico is making great strides in this direction, not only through recent actions that have reduced the inflation rate to single digits for the first time in two decades, but more important, through its efforts to institutionalize both central bank independence and a mandate for the bank to maintain the purchasing power of the peso.

Free markets and price stability are related themes because each contributes significantly to the achievement of prosperity. Mexico is making important progress on both fronts, for which the nation is to be commended — and envied.

■ Footnotes

1. See "Greens Win a Review of Trade Agreement: Judge Says NAFTA's Environmental Effect Must Be Weighed," *Financial Times* (London), July 1, 1993.

2. See "Commerce Secretary Sees NAFTA in Place by Jan. 1 Despite Ruling," *Investor's Business Daily*, July 9, 1993.

3. See Mark A. Wynne, "Price Stability and Economic Growth," *The Southwest Economy*, Federal Reserve Bank of Dallas, May/June 1993.

4. See Alberto Alessina, "Macroeconomics and Politics," in *Macroeconomics Annual*, MIT Press for the National Bureau of Economic Research, 1988, pp. 38–43 and table 9. See also King Banaian, Leroy O. Laney, and Thomas D. Willett, "Central Bank Independence: An International Comparison," Federal Reserve Bank of Dallas, *Economic Review*, March 1983, pp. 1–14.

5. The government does have *indirect* input into the selection of the Federal Reserve Bank presidents. Each is chosen by the district bank's Board of Directors, but the selection requires the approval of the Federal Reserve Board of Governors, whose members are nominated by the President of the United States and confirmed by the Senate.

6. For a discussion of how the Federal Reserve was designed to be independent within government, see "Central Banking in the United States: A Fragile Commitment to Price Stability and Independence," Federal Reserve Bank of Cleveland, *Annual Report*, 1991, pp. 4–17.

7. Voting authority in the FOMC is held by the seven members of the Federal Reserve's Board of Governors, the president of the New York district bank, and a rotating group of four of the other 11 Reserve Bank presidents. Senator Paul Sarbanes (D–Md.) and Representative Lee Hamilton (D–Ind.) have introduced a bill to remove Reserve Bank presidents from the FOMC, and Representative Henry Gonzalez (D–Tex.) has introduced legislation that would make them presidential appointees.

8. For a discussion of the complications that can arise when central banks have multiple responsibilities, see Mark Swinburne and Marta Castello-Branco, "Central Bank Independence: Issues and Experience," International Monetary Fund Working Paper WP/91/58, June 1991, especially pp. 24–27.

9. See Manfred Willms, "The Monetary Policy Decision Process in the Federal Republic of Germany," in Donald R. Hodgman, ed., *The Political Economy of Monetary Policy: National and International Aspects*, Conference Series No. 26, Federal Reserve Bank of Boston, July 1983, p. 36. See also David J. Archer, "Organizing a Central Bank to Control Inflation: The Case of New Zealand," paper presented at the 67th Annual Western Economic Association International Conference, San Francisco, July 10, 1992, p. 12.

10. To become effective, the amendment must also be approved by the legislatures of a majority of Mexico's states. See the translation of Article 135 of the Constitution of Mexico in Albert P. Blaustwin and Gisbert H. Flanz, eds., *Constitutions of the Countries of the World*, Dobbs Ferry, NY: Oceana Publications, April 1988, p. 115. President Salinas' party dominates the state legislatures, so ratification seems assured.

11. The proposed amendment is included in *Iniciativa de Reforma Constitucional Para Dotar de Autonomia al Banco de Mexico*, issued by President Salinas on May 17, 1993. For a discussion in English of the legislation's intent, see *The Mexican Economy 1993*, Banco de Mexico, June 1993, pp. 108–09.

12. See Juanita Darling, "Mexico's Main Pillar of Economic Stability," *Los Angeles Times*, July 13, 1993.

13. See David Buchan and Alice Rawsthorn, "Paris Plan to End Its Control of Central Bank," *Financial Times* (London), May 12, 1993.

14. See David Buchan, "France Gets Its Bundesbank, but a Gallic One," *Financial Times* (London), May 12, 1993.

President Jordan presented this speech on July 20 at a conference sponsored by the Instituto Cultural Ludwig von Mises, A.C., Mexico City.

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What Monetary Policy Can and Cannot Do
May 15, 1992

Here, President Jordan lays out his views on the essential principles underlying monetary policy, describes what monetary policy can and cannot accomplish, and discusses what a central bank's primary focus should be.

The Importance of Structure in Decisionmaking
November 1, 1992

President Jordan's answer to critics who assert that the economics profession should be judged on its ability to predict the economy's ups and downs. He argues that although economists cannot eliminate the uncertainties of the marketplace, their real contribution lies in providing a proper framework for discussing and evaluating those uncertainties.

Skepticism about the Direction of Inflation: Causes, Costs, and Cures
December 1, 1992

Even though the Federal Reserve has been able to keep inflation in check over the last few years, and despite its avowal to continue targeting price-level stability as its top priority, most Americans are still making financial decisions conditioned on the belief that inflation is likely to be higher in the future than it is today. In this article, President Jordan discusses the reasons for this public skepticism about price stability, the real economic costs entailed, and the ways in which Congress, the Federal Reserve, and the administration can help.

A Market-Based Approach to Regulatory Reform
May 15, 1993

Compliance with current regulatory requirements in the banking industry entails significant costs that reduce the efficiency of the financial system and thus the real growth potential of the economy at large. In this *Economic Commentary,* President Jordan outlines a four-point program to refocus bank regulation to a market-based system that would result in improved bank safety, soundness, and stability, with less dependence on the federal financial safety net.

On the Political Economy of Trade Restraints
April 15, 1993

Economists advocate free trade not because private markets function perfectly, but because the alternative, allocating resources through the political arena, poses a far greater threat to individual freedom and economic performance than do market imperfections. Here, President Jordan expounds on this idea, explaining that only free trade has the potential to enhance the welfare of all nations simultaneously.

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