# A POST-KEYNESIAN PROPOSAL FOR A FLEXIBLE INSTITUTIONAL ARRANGEMENT OF INFLATION TARGETING REGIME IN EMERGING ECONOMIES

WORKSHOP "INFLATION TARGETING: IS THERE A CREDIBLE ALTERNATIVE?"
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*Luiz Fernando de Paula*
*Gabriel Coelho Squeff*
University of the State of Rio de Janeiro, Brazil
*José Luís Oreiro,* Federal University of Parana, Brazil

# Objectives

- This paper aims at:
- (i) discussing whether inflation targeting regime ITR is compatible with Post-Keynesian approach;
- (ii) defining an institutional arrangement of ITR more appropriate for emerging economies with long-term history of high inflation.
- We show that ITR can be compatible with Post-Keynesian approach and that a flexible institutional arrangement for ITR is required for emerging economies to conciliate the objectives of price stabilization and sustainable economic growth.

# Structure of the paper

- Section 2 focuses on the theoretical compatibility between ITR and Post-Keynesian economics.
- In section 3 we discuss the main components of institutional arrangements of ITR.
- Section 4 is dedicated to macro analysis of emerging economies under ITR.
- In section 5 we present a Post-Keynesian proposal for flexible institutional arrangement of ITR in emerging economies.
- Section 6 concludes the paper.

# New consensus on macroeconomics

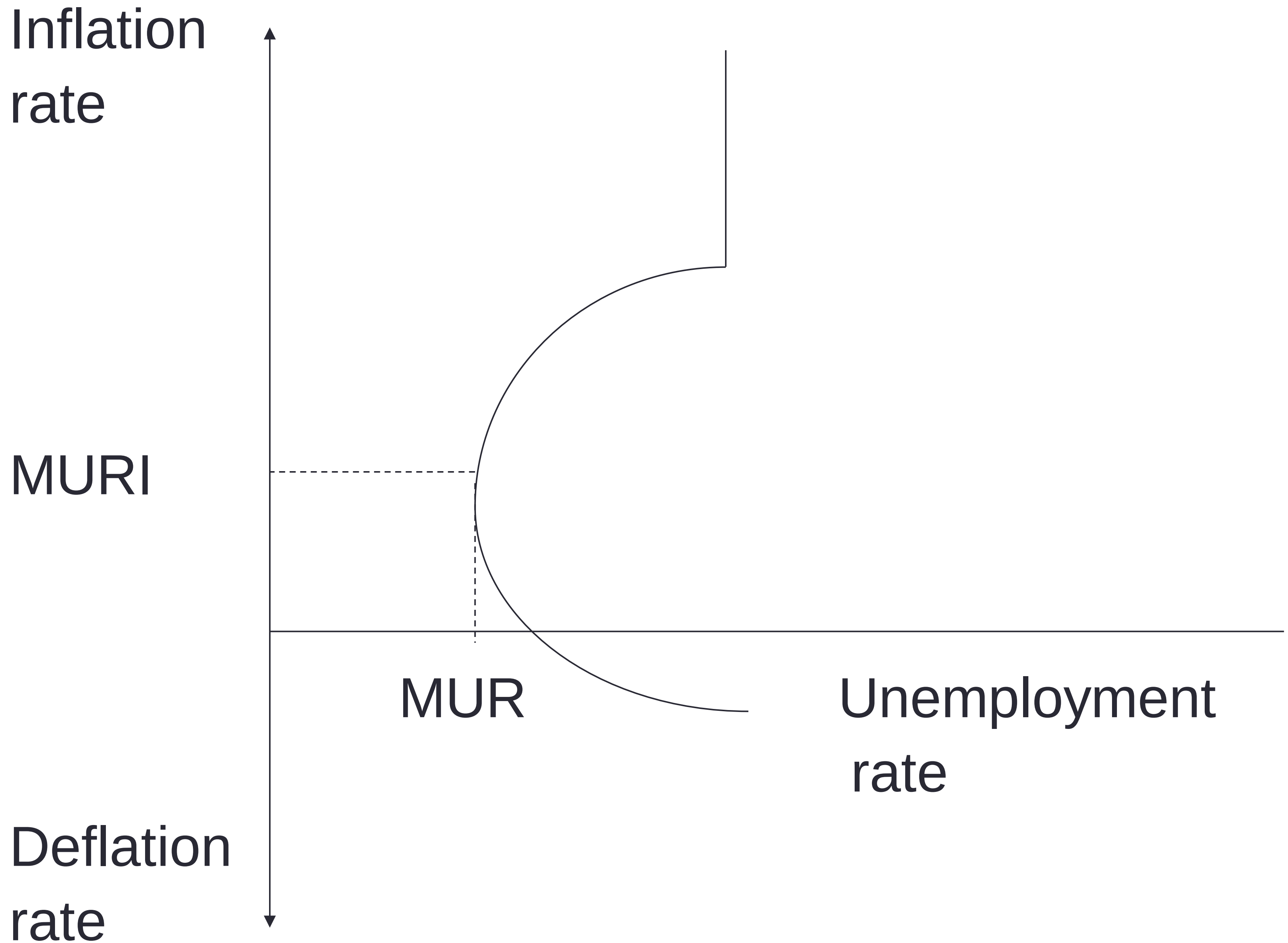
- No long-term trade-off between inflation and unemployment.
- Low and stable inflation is of paramount importance for long-run economic growth.
- Central banks discretion should be restricted to reduce inflationary bias problem.
- ITR is the best institutional framework to assure low rates of inflation and minimize output fluctuations – constrained discretion

# PK economics

- Money is non-neutral in the short and long-run.
- The dynamic of the economy cannot be understood without reference to the level of aggregate demand.
- The current level of unemployment is determined by the dynamics of aggregate demand.
- Changes in nominal short-term interest have permanent effects over investments.
- Inflation is mainly the result of distributive conflict and of cost factors – raw materials.
- The use of monetary policy is implicitly indorsing an income policy based on *fear* of loss of jobs and sales revenues.

# Is ITR compatible with PK economics?

- Palley (2006) postulates the existence of a *backward bending* long-run Phillips curve, based on the idea that for very low levels of inflation, workers have some kind of “money illusion”, as inflation can help grease the wheels of labour market adjustment by facilitating relative wage and price adjustment in sector with unemployment.
- This creates a negative relation between inflation and unemployment over a limited range of the long-run Phillips curve.
- For this range of the long-run Phillips curve, monetary policy should be conducted in order to achieve that rate of inflation that minimizes the unemployment rate. In order words, monetary policy should be guided by M.U.R.I (minimum unemployment rate of inflation), that represents the point where the overall labour market greases effect of inflation is greatest.



Inflation rate
MURI
Deflation rate
MUR
Unemployment rate

# Is ITR compatible with PK economics?

- Setterfield (2005) elaborated a macroeconomic model with Post-Keynesian features, where output is demand determined, inflation results from a distributive conflict between workers and capitalists and Central Bank defines an explicit target for the rate of inflation as well as a target for real output.
- In this framework it is possible to show that the long-run equilibrium of the system is stable what demonstrates the potential desirability of an ITR for the stability of an economy with Post-Keynesian features. A policy implication of this approach is that (i) it is high rates of inflation (in excess of 10% or more) that policy should seek to address, and (ii) real economic performance should be given priority by monetary authorities.

# Institutional arrangements of ITR

a) The definition of the  objectives of central banks;

the numerical definition of the inflation target;

b) the definition of which price index will be used, including the escape clauses;

c) the definition of the convergence period of the current inflation to the target;

d) the definition of the *modus operandi* of the interest rate setting – rules versus discretionary;

e) the degree of independence of central bank;

f) the accountability and transparency procedures;

g) the discussion about the necessity to adopt complementary instruments to the monetary policy.

**Figure 1. Range of Flexibility for Institutional Arrangements of ITR**

| | | | |
|---|---|---|---|
| Target | Single point | ........................................................ | Wide range |
| Price index | Headline | ........................................................ | Core |
| Convergence period | 1 year | ........................................................ | Long term |
| Interest rate setting | Rules | ........................................................ | Discretionary |
| Is ITR enough? | Yes | ........................................................ | No |
| | **Less Flexible Arrangements** | **Intermediate Arrangements** | **More Flexible Arrangements** |

**Table 1. Institutional Arrangements of Inflation Targeting Regime, 2007**

| Country | Target | Inflation measure | Commitment horizon |
|---|---|---|---|
| South Africa | 5% +/-2% | CPI excluding mortgage interest cost | 12 months after its announcement |
| Brazil | 4.5% +/-2.0% | CPI | Calendar-year |
| Chile | 3% +/-1% | CPI | 2 years |
| Korea | 3% +/-0.5% | Core CPI | 3 years in long-term and 12 months in short-term |
| México | 3% +/-1% | CPI | 4 years in long-term and 12 months in short-term |
| Thailand | 0 a 3.5% | Core CPI | Long-term |
| Turkey | 4% | CPI | 3 years with annual intermediate targets |

Source: Farhi (2007)

# Macro-institutional environment of ITR in emerging countries

- Exchange rate volatility is higher in emerging countries than in developed ones as the former ones have small and less liquid foreign exchange markets that make such economies more vulnerable to one-way expectations and herd behaviour.
- Emerging economies tend to be relatively more vulnerable to the consequences of exchange rate fluctuations than are developed economies.

# Macro-institutional environment of ITR in emerging countries

Ho and McCauley (2003) show evidences that:

(i) income is negatively and significantly correlated with *pass-through* as lower-income economies have a larger portion of traded goods in the consumption basket;

(ii) “exchange rate pass-through has tended to be stronger in Latin America than in Asia even though Latin American are not necessarily more open than their Asian counterparts” (p.6).

-> From 22 target misses by emerging countries in 1998-02, 10 (45%) were associated to exchange rate moves.

-The explanation for such difference is that countries with histories of high inflation are more sensitive to exchange rate fluctuations, probably due to the existence of an inflationary memory (Eichengreen, 2002)

# Two lessons from emerging economies experience….

- The first one is related to the fact that emerging countries in general are more vulnerable to external shocks than developed countries. As a result, such economies are more prone to face issues related to cost-push inflation.

- The second lesson is that exchange rate considerations can be expected to play a more prominent role in emerging countries, considering the important influence of the exchange rate on domestic inflation in these countries.

# Proposal for a flexible ITR for emerging economies

- Moderate use of interest rate policy requires the distinction between temporary and permanent situations of excess demand.
- This requires the use of some sort of core inflation index instead of headline inflation and longer horizon of convergence to inflation target to smooth temporary demand shocks.

# Proposal for a flexible ITR for emerging economies

- Emerging economies requires a high level of inflation for growth purposes and also interest rate policy is less effective (credit channel) – prudential credit controls can be necessary.

-> Padilha (2007): minimum rate of inflation for emerging countries is 5.1% and developed countries 2.1% p.y.

- To face problems related to exchange rate volatility: reserve accumulation policy, official intervention in the foreign exchange maket, and-or capital controls.

# Conclusions....

- In this paper we showed that ITR is compatible with Post-Keynesian approach and a flexible institutional arrangement for ITR is required for emerging economies to conciliate the objectives of price stabilization and sustainable economic growth.
- This flexible institutional arrangements includes the use of core inflation, a larger convergence horizon to target inflation, and a numerical target higher for emerging economies than developed ones, and also includes the use of complementary instruments, according to the circumstance, such as the use of prudential credit controls as an instrument of demand management and ‘capital management techniques’ as a tool to reduce exchange rate volatility.