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Abstract

Developing countries should learn two lessons, one positive and one negative, from this ambiguous response by the rich countries' macro-policy response to the financial crisis. The positive lesson is that, like the Federal Reserve, Bank of England and European Central Bank, developing country central banks can play a larger role in meeting the challenges of development and transformation if they eschew the flawed advice to pursue inflation targeting with one instrument, and instead identify the key developmental and transformational challenges facing their economies and broaden their goals and instruments to help meet those challenges. The second, and more negative lesson, is that the broader government and fiscal authorities must do their share to develop their economies. There should be monetary and fiscal cooperation and an attempt to achieve coherence between macroeconomic and development objectives by the monetary and fiscal authorities. This suggests that there needs to be a re-thinking of the traditional advocacy of so-called "central bank independence".

Keywords: developmental central banking, inflation targeting, employment targeting, monetary policy

JEL codes:
E58, N10, O23

I. Introduction

In the aftermath of the Great Financial Crisis of 2007-2008, the United States and Europe are stuck in a state of political paralysis that is leading to a new norm of fiscal austerity, high unemployment, and in the case of Europe, economic stagnation. With fiscal policy orientated around austerity it is the central banks – the Federal Reserve (the Fed), the Bank of England (BOE) and the European Central Bank (ECB) – that remain as the only macroeconomic authorities with the authority and political power to try to revive these struggling economies.

As in previous severe economic crises these central banks find that they have to engage in policy experimentation and innovation to try to extract their economies from the jaws of crisis (IMF, 2013). The Federal Reserve created multiple new mechanisms and facilities to carry out "lender of last resort" activities and engaged in three rounds of quantitative easing (QE); the Bank of England also implemented QE and instituted special facilities to promote home mortgages; the ECB has been more constrained by the perceived opposition of Germany and certain constitutional strictures, but, nonetheless, has instituted special small business loan facilities and has also implemented QE.

Moreover, at the Fed, under both Janet Yellen and Ben Bernanke, there has been a shift from inflation targeting to employment targeting, as the jobs crisis is ongoing and inflation is securely in check.

These attempts to develop new instruments with which to implement monetary policy, and sometimes emphasize new targets have been endorsed even in some unlikely bastions of orthodoxy. In a highly publicized presentation Olivier Blanchard, Chief Economist at the IMF insisted: "Before the crisis, mainstream economists and policymakers had converged on a beautiful construction for monetary policy. … we had convinced ourselves that there was one target, inflation. There was one instrument, the policy rate. And that was basically enough to get things done. If there is one lesson to be drawn from this crisis, it is that this construction wasn't right, that beauty is unfortunately not always synonymous with truth. The fact is that there are many targets and there are many instruments." Blanchard (March, 2011). While Blanchard was referring primarily to the need for central banks to also target financial stability, his point is actually more general than that. The need for central banks to adopt multiple instruments and targets –however belated its current recognition- is a hallmark of the challenges facing not only central banks in the throes of crisis, but also of central banks in economies that are grappling with the long term challenges of economic development.

However important it is for central banks to take on these broader roles and adopt an innovative array of instruments to implement them, it is important to emphasize that central banks cannot "do it alone". Far from it. This is one of the key lessons of the mismanaged response in the U.S., the U.K. and Europe to the financial crisis. Fiscal policy has abandoned the economy and as a result, all the onus of recovery has been placed on monetary policy. And monetary policy cannot

carry all the weight. Expansionary monetary and credit policy has left interest rates stuck at the lower zero bound, and QE and other modest experiments have failed to revive the economy, however much they may have placed a floor on dramatic, further decline.

Developing countries, then, must learn two lessons, one positive and one negative, from this ambiguous response by the rich countries' macro-policy makers. The positive lesson is that, like the Fed, BOE and ECB, developing country central banks can play a larger role in meeting the challenges of development and transformation if they eschew the flawed advice to pursue inflation targeting with one instrument, and instead identify the key developmental and transformational challenges facing their economies and broaden their goals and instruments to help meet those challenges. However, the second, and more negative lesson, is that the broader government and fiscal authorities must do their share to develop and expand their economies. In other words, there must be monetary and fiscal cooperation and an attempt thereby to achieve coherence between macroeconomic and development objectives by both the monetary and fiscal authorities. This suggests that there needs to be a re-thinking of the traditional advocacy of so-called "central bank independence".

In what follows I first critique the standard, conventional wisdom regarding central bank policy in developing countries: inflation targeting carried out by so-called "independent" central banks. I argue that this approach is costly, inefficient and inappropriate for most developing countries. Even though advocates of traditional inflation targeting approaches to central banking argue that this approach will lead to "macroeconomic stability" I show that they in fact can often lead to broader instability. I then describe an alternative approach to central bank policy, namely "developmental central policy". I argue that this developmental approach both requires attention to a broader set of macroeconomic outcomes than simply low commodity inflation and that furthermore, it can contribute to broader macroeconomic stability.

In the final section I address several issues: I argue that the best way to achieve these goals is for there to be a broader coordination and fiscal and monetary policy along with other important institutions such as development banks. I then try to address possible objections to my argument: the most common are the argument that this approach will undermine central bank "independence" and that it will lead to financial instability.

II. What's Wrong with Inflation Targeting?

However much policy makers such as Olivier Blanchard are questioning "Inflation Targeting" (IT) in the rich countries, it is still widely seen as the current "Best Practice" for developing countries. Yet, IT has serious limitations as a framework for monetary policy in developing countries (Epstein and Yeldan, 2006; Anwar and Islam, 2011). In strict form, IT posits that central banks should have only one objective -- low and stable inflation – and should utilize only one policy instrument –usually a short term interest rate. As a corollary, the conventional wisdom usually promotes the idea that central banks should be "independent" of the government, in order to enhance its ability to reach the inflation target. This is usually justified on the basis of

avoiding “time inconsistency” and restricting pressures from governments to finance fiscal deficits.[1]

Even if one believes that this general approach is a good one, a key question arises: what is the appropriate inflation rate? The standard practice is that countries should try to maintain inflation in the “low single digits”. (Anwar and Islam, 2011). Where does this number come from? One would expect that a number designed to guide the making of monetary policy in many parts of the globe would come from rigorous research and a broad consensus that the optimal rate of inflation for developing countries is in the low single digits. However, nothing could be further from the truth.

The theoretical case for an optimal inflation rate in the low single digits, largely because inflation plays no central role in the fundamental general equilibrium models that underlie most welfare analysis. In terms of growth theory, the results are ambiguous with early work by James Tobin (1965) and Foley and Sidrauski (1971) showing that higher inflation can lead to higher economic growth by lowering the rate of return to financial assets relative to real capital and thereby leading to more investment. Under some model parameters or different model structures, though, the impact can go the other way. Hence the issue comes down to an empirical question.

And on the empirical front, there is no credible evidence that inflation in the low single digits is the optimal inflation rate for developing countries. Bruno and Easterly (1996) find little evidence of a negative relationship between inflation and growth with inflation rates less than 40%. More recent studies, including those that look at non-linearities and threshold effects find that, for developing countries, growth starts declining on average when inflation rates hit between 14 and 18%. (Pollin and Zhu, 2009; Anwer and Islam, 2011). This is a far cry from 4-6% or less which is a typical target range for developing countries.

This raises the question of why IT regimes identify such a low inflation rate as the optimal rate, even though there is no evidence that this is so for the case of developing countries? There is accumulating evidence that a long-standing suspicion about group preferences with respect to inflation– going back at least as far as Keynes -- is true: namely, that the financial sector has a stronger dislike of inflation than other groups in society (eg. Jayadev, 2008), and that this dislike of inflation helps to explain central bank behaviour (Epstein, 1994; Posen, 1995).

This inflation version of the financial sector also points to a problem with so-called central bank “independence”. In a democratic society, there is no such thing as political independence. All institutions are political in nature and need political constituencies to protect their authority and

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[1] Proponents of IT often distinguish between “goal independence” – who determines the inflation target itself - and “instrument independence” – who determines the means of achieving the target. The standard advice is that governments, in conjunction with the central bank should choose the goal (target) and the central bank should have the independence to determine and implement the means. This is often, however, a distinction without a difference: first of all, once the country adopts an IT regime, the social convention is for it to also adopt the range of inflation targets that are commonly promoted: these are in the low single digits. Second, once the basic framework is adopted in which the instruments are limited to only one major one (short term interest rates), the policy response is pretty much pre-determined. In this case, the global “norm/conventional wisdom” of IT as currently conceived imposes a strict framework that often gives the central bankers, who usually endorse this policy, the strong upper hand in the relationship.

prerogatives. “Independent” central banks typically nurture close relationships with finance for support, leading to a political and economic symbiosis. (Epstein, 1994). As Milton Friedman noted decades ago, independent central banks are likely to be too close the “commercial banking” sector rather than making policy in the public interest. (Friedman, 1962). As a result, independent central banks often tend to pursue excessively anti-inflationary policies.

Choosing the wrong target would not matter if undershooting had no negative impacts on important economic variables, such as employment, wages and growth. But this does not seem to be the case. Excessively restrictive monetary policy can lead to excessively high real interest rates, and, with open capital markets, can lead to capital inflows, over-valued real exchange rates, and harm exports and reduce employment and growth (Epstein and Yeldan, 2009; Rodrik, 2008).

In practice, targeting inflation with increases in interest rates might be a startling incorrect assignment of instruments to targets. Much inflation in developing countries is due to supply or external “shocks” (Heintz and Ndikumana, 2010; Anwar and Islam, 2011). Responding to a supply shortage or to an external price increase with a policy designed to reduce domestic demand can sometimes play the role of adding “insult to injury”: it might worsen the problem by reducing capacity further or, in the case of external shocks, create collateral damage by leading to an over-valued exchange rate.

These examples illustrate a key flaw in the conventional arguments for inflation targeting: the idea that by delivering a low and stable inflation rate, inflation targeting central banks will help deliver both macroeconomic stability and economic development objectives to developing economies. The conventional argument is that stable prices will be sufficient to provide macroeconomic stability; and that if there is macroeconomic stability (and other appropriate market institutions such as appropriate property rights) then private investment will flourish and economic development is likely to follow. (In the extreme version of this argument, inflation targeting and appropriate property rights enforcement is sufficient to deliver both macroeconomic stability and economic development.)

But, as the previous examples illustrate, inflation targeting central banking does not deliver macroeconomic stability: in developing economies with liberalized domestic financial markets and with economies integrated into the global capital markets, inflation targeting can be associated with de-stabilizing capital flows and outflows (sudden stops), cycles of over-valued exchange rates and crashes, destabilizing allocation of credit to real estate and other types of speculation, and consequent short-term investment cycles that hinder long term investment in industries associated with dynamic comparative advantage, upgrading and long-term employment generation. (Epstein and Yeldan, 2009; Ros and Galindo, 2009).

In other words, macroeconomic policy focused on inflation targeting is likely to deliver neither macroeconomic stability nor economic development.

Partly as a result of these problems with inflation targeting, numerous central banks implement inflation targeting more in the breach than in the practice. Missed inflation targets have become commonplace even in countries that claim they are strict inflation targeters. While some take this

as evidence that central banks are losing discipline, it might be more accurately taken to reflect that inflation targeting is an inappropriate framework for macro-policy guidance for countries trying to navigate the treacherous waters of a financialized global economy.

What is the advantage of pretending to adhere to strict inflation targeting when, in fact, like their counterparts in the developed world, developing country central banks are innovating and experimenting out of necessity to deal with the economic problems they face?

Wouldn't it be better for these central banks to admit that reaching a moderate level of inflation is an important goal, but it is only one of several important problems facing their economies? In that case, central banks could play a more active role as part of government initiatives to confront major macroeconomic challenges facing their economies.

III. Developmental Central Banking: Achieving Coherence Between Macroeconomic and Development Objectives

The question, then, is what kind of macroeconomic framework is likely to achieve coherence between macroeconomic and development objectives? Of course, the answer may differ from country to county. It is unlikely that "one size" will "fit all". At the same time, we can learn important lessons from history with respect to what kinds of central bank frameworks have been tried and what kinds have been successful in achieving macroeconomic stability and economic development. (Epstein, 2007, 2013)

Historically, central banks in both developed and developing have done as Olivier Blanchard suggested above: they have focused on multiple targets and, following the rules of Tinbergen, utilized multiple instruments to achieve these targets. (Tinbergen, 1952).[2] Following the second World War, central banks in the Europe and Japan utilized interest rate ceilings , subsidized credits and other credit allocation policies to facilitate economic reconstruction and industrial upgrading (Hodgman, 1973; U.S. Congress, 1972, 1981; Zysman, 1983). Developmental central banking also played a supporting role in many of the great industrializing success stories of the later 20th century, as described by Alice Amsden as the "Rise of the Rest", where development banks, credit allocation and close performance monitoring were key supporters of industrial policy and industrial upgrading.

A key supporting role was played in these economies by capital controls, which played a number of complementary roles: they served to help preserve a stable and competitive real exchange rate by limiting speculative capital inflows; they helped to limit destabilizing leverage on domestic balance sheets by limiting currency and maturity mismatches by companies, governments and households; and they helped to protect the apparatus of subsidized credit and credit allocation mechanisms by limiting capital outflows and cross-border arbitrage. (Nembhard, 1986; Epstein, Grabel, Jomo, 2003). Similar policies have been successfully employed as complements to

[2] As I discuss more fully in the next section, in most of the successful cases, central banks have not acted alone: they have been part of a broader policy apparatus that has included the fiscal authorities and complementary institutions such as development banks to achieve developmental objectives.

industrial development by numerous countries, including China, South Korea, Taiwan, and others.

In response to the financial crisis of 2007-2008, interest in capital controls has become more widespread as a prudential management tool. More commonly termed capital management techniques (CMTs), or capital account regulations (CARs), these tools have become increasingly recognized, even by institutions previous opposed to them such as the IMF, to be useful parts of the macroeconomic stability toolkit (Grabel, 2013; Gallagher and Ocampo, 2013; Erten and Ocampo, 2013).

However, it would be incorrect to draw a clear distinction between these "short-term" stabilization aspects of capital account regulations and the longer term impacts on development and structural transformation. Reducing hot money flows, limiting excessive currency and maturity mismatches on balance sheets, limiting capital account driven speculative investments and maintaining a competitive and stable real exchange rate, can be crucial to maintaining both macroeconomic stability, and the policy space required to achieve economic development and economic transformation (Epstein and Yeldan, 2009; Ocampo, Rada and Taylor, 2009).
An increasing number of central banks around the world are finding that they must adopt much more direct developmental targets in order to achieve key social and economic objectives. (Epstein, 2013). These include, for example, the Central Bank of Bangladesh, which has pioneered a variety of policies to partner with domestic commercial banks and local cooperative institutions to provide subsidized credit for small businesses, to improve renewable energy use in agriculture while increasing assets for small farmers, to help develop agricultural assets for landless farmers and other initiatives. (Epstein, 2013). The Central Bank of Argentina has adopted a new set of developmental mandates as well. In South Africa, in conjunction with the planning ministry, new initiatives are being developed whereby the Reserve Bank can support development banks in the generation of employment generating schemes. These developing country examples are occurring at the same time as developed country central banks are developing new initiatives to expand lending to small business, and households.

Still, at this point, these initiatives are small and still concentrated in a relatively few countries. To some extent, these have been limited by the continued strength of the extant conventional wisdom concerning the need for inflation targeting and central bank independence as key bulwarks of macroeconomic stability and prudent macro-economic governance.

IV. Central Bank Independence, Macroeconomic Stability, and Macro -Development Coherence

The upshot of our discussion so far is that the Great Financial Crisis has generated some cracks in the "new monetary consensus" of one target – inflation – and one instrument – the policy interest rate with a recognition that it is not sufficient to meet the macroeconomic and development challenges that many countries face. These cracks are broad ranging and include: discussions at the centers of macro-policy orthodoxy, such as the IMF; debates over central bank mandates that highlight the dual-mandate of the Federal Reserve (high employment and price stability); the emphasis from the Bank for International Settlement (BIS) and elsewhere of the need for central banks to take into account financial stability as well as price stability; the

monetary experimentation at core central banks; creation of developmental central bank mandates in several countries including Bangladesh, Argentina and others; and finally, the flagrant violation of inflation target strictures by many central banks that claim to engage in IT or "IT Lite".

Still, central banks and policy makers more generally have been reluctant, to put it mildly, to embrace a new consensus that central banks should become integral partners in a macroeconomic initiative to confront key challenges. The consensus, at most, is that there can be some tinkering around the edges of inflation targeting. There is therefore a reluctance to recognize the broad changes that are actually being taken in monetary policy management in response to the crisis.

Here are some possible objections that have been raised to a more developmental approach to central banking and some responses to these objections. First, why isn't the "assignment problem" the most efficient solution to this problem. Tinbergen said there should be as many instruments as targets. So why not just assign the central bank to macroeconomic stability and the fiscal authority to "development"? There are many problems with this solution. First, as discussed above (and some more below), even achieving macroeconomic stability itself requires more than simply targeting "inflation". In addition, there is too much uncertainty in macroeconomic policy making so that there needs to be genuine coordination and learning by doing. Finally, as Tinbergen himself noted, policy instruments are often not independent of each other. This means that changes in one instrument, say the interest rate, will not only affect inflation, but will also affect employment and the real exchange rate, which have a big impact on development. It has been known for decades that these instrument interdependencies can render a decentralized "assignment problem" costly and even unworkable.

The second objection is that there is a trade-off between developmental central banking and macroeconomic stability. It is true that in the past, some countries in developing countries that had central banks with broad powers and little distance from governments were part and parcel of macroeconomic regimes that were associated with failed macroeconomic policies. At the same time, there are many examples, as described above, where central banks that were partners in developmental oriented macroeconomic policies led to more economic growth and macroeconomic stability, rather than less. In these cases, such as the industrializing Asian countries and in Europe and Japan after the Second World War, directing credit to rising industries rather into commodity or real estate speculation actually contributed both to macroeconomic stability and to economic development. Here macroeconomic stability and development were complementary results of developmental central banking, not substitutes. The lesson then is simple: we need good policies and appropriate policy coordination, along with checks and balances, so that central banks can play a positive role in fostering both macroeconomic stability and development. Pretending that a singular focus on inflation control will lead to either macroeconomic stability or economic development is not a winning policy, as we have discovered.

A third and related concern is that if central bank policy becomes too highly coordinated with government policy, including fiscal policy, then the some governments will try to abuse its powers with respect to central bank, by putting inappropriate pressure on the central bank to fund

fiscal deficits, or even to support cronyism or corruption. In some countries, or even in all countries at some times, these worries may be legitimate. It may be wise, then, for there to be checks and balances, including a certain degree of operational independence, to give the central bank some insulation from direct control by the government. At the same time, it is often important for the Central Bank's policies to be coordinated with the developmental plan of the government. For example, even corrupt governments usually have development plans. The Central Bank could usefully orient its policies around promoting the key macroeconomic goals of the development plan, even when the corrupt government is failing to try to achieve the plan it has created. In this case, of course, this might entail the central bank leaning against the wind with respect to the actual policies of the government, though not the government's publicly announced development plan. In the more common, general case, the central bank's policies would be coordinated with those of the government.

A fourth objection is that central banks do not have the knowledge to generate employment, or support investments in key industries, or target the real exchange rate. While there might be some truth to this, rather than supporting a continued focus on IT, it points to a key reason why a broader mandate is useful and even necessary in many countries. Central banks in developing countries often have one of the largest pools of highly trained and skilled economists and technicians. In an IT regime, this collection of highly scare human resources is being utilized to learn everything that can be possibly learned about movements in commodity prices and their connection to monetary policy, and are spending almost no time or energy learning how monetary and credit policy affects employment, skill upgrading, technological development, and sectoral growth. This is a profound waste of scarce skill and talent.

If central banks were given a broader mandate, then the staffs of central banks would have to learn more about the economies they operate it. They might have to talk to labor ministries, agricultural ministries, women's associations about how their policies affect women and children and environmental ministries about the impact of policies are on the environment. In this case, some of the skilled labor in central banks can be deployed to understand how monetary policy can affect these broader issues and this, I believe, would generate a great increase in their social productivity.

A final objection is that one should not ask central banks to do too much. Central banks cannot do everything; they are not a panacea.

I agree with this point. Central banks should be seen as one key macroeconomic and financial institution that must work in concert with other key financial and macroeconomic institutions. As discussed earlier, the late, late Asian country developers utilized development banks to help finance and coordinate their industrial policies. Today, development banks can once again play key roles in helping to mobilize long-term, patient capital, for development purposes. Central banks can play a supporting role in providing lines of credit, credit guarantees, and the like, for high quality projects. They can further help out by maintaining a stable, competitive real exchange rate. And they can help out by playing a coordinating role among various macroeconomic and sectoral agencies and private finance.

So yes: Central Banks cannot be the entire solution to the development challenge. But, if they abandon or at least strongly modify their current inflation targeting structure to become more developmentally oriented, they can become a much bigger part of the solution than they have been in recent years.

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