

Remarks by

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I. INTRODUCTION

Thank you for that kind introduction. And thank you (the audience) for that warm welcome. It is a pleasure for me to be in Mexico and to meet with this group.

I feel honored to have the opportunity to speak in this important forum. Ludwig von Mises recognized the superiority of a market economy, the shortcomings of government interference in economic affairs, and the futility of central planning. Since I share those views, I am pleased to have been invited to speak at a conference hosted by an Institute that bears his name.

As a foreigner and a guest in your country, I am flattered to have been invited to talk about matters that are internal to Mexico and that are so important to your country's pursuit and achievement of national prosperity.

This is a time of exciting opportunities and great progress for Mexico. Your nation is moving toward more economic freedom, increased reliance on privately owned capital and companies, and greater integration with the economies of other nations. At times of transition such as this, there are many choices to be made, and changes are more easily accomplished. So, Mexico is now in a position to choose policies and shape institutions that will importantly affect the nation's prosperity in the years and decades ahead.

II. MEXICO LEADS THE WAY TOWARD OPEN BORDERS AND FREE TRADE

Mexico has been making dramatic progress in several economic areas. The root cause of this progress, and the seed for future progress, has been increased reliance on market forces and institutions. These changes have increased the attractiveness of Mexico to foreign investors and have unleashed more of the creative abilities of Mexico's entrepreneurs. Greater use of market forces has put Mexico on a path toward greater economic efficiency and prosperity.

Your nation has also made important changes in its approach to international trade. Mexico has joined the General Agreement on Tariffs and Trade (GATT) , bringing Mexico into compliance with international standards for the conduct of international trade. You have undertaken a dramatic unilateral reduction of trade barriers. In addition, your government was an important catalyst for the negotiation of the North American Free Trade Agreement (NAFTA).

I strongly support NAFTA. I believe that the encouragement of free trade in goods, the reduction of barriers to trade in services, including banking, and the easing of limitations on international investment called for in NAFTA will enhance competition, efficiency, and productivity and thereby increase the prosperity of Mexico, Canada, and the United States. I am hopeful that the U.S. Congress will enact the legislation necessary to implement NAFTA as scheduled on January 1, 1994.

There are some groups in my country who fear the additional competition that NAFTA would bring about, and they are lobbying vigorously for its defeat. They recently won a decision in a U.S. District Court that requires the preparation of what Americans call an "environmental impact statement," on NAFTA. An environmental impact statement would be a study and report of the effect that NAFTA would have on such things as the purity of air and water. Initial reports said such a study would take many months to prepare, and would need to be completed before NAFTA legislation could be sent to the U.S. Congress, a delay that would be a serious obstacle to U.S. implementation of NAFTA. More recently (*Investors Daily*, 7/9/93), officials have said that (1) the legislation can be sent to Congress before the environmental impact study is completed, (2) the study could be completed in 45 to 60 days, and (3) therefore this requirement wouldn't delay Congressional action on NAFTA. Moreover, the U.S. government plans to appeal to a higher court and believes that the court decision requiring the environmental impact statement will be overturned.

Despite the current uncertainty about U.S. implementation of NAFTA, I think that Mexico can be clear about what it will do with NAFTA. Reductions in barriers to trade and investment do not have to be reciprocated to be valuable. Most of the added prosperity that Mexico is now enjoying is the result of its recent unilateral moves toward greater freedom in its economy. Further gains can be achieved by further moves toward the use of market forces. So, even if the U.S. were to fail to implement NAFTA and further open its own borders, Mexico can, if it wishes, choose to unilaterally implement NAFTA on January 1, 1994, setting an example for all its neighbors in Central, North, and South America, and benefiting from the gains open to any nation that has the wisdom and the will to reduce its interference with commerce.

III. THE CENTRAL BANK'S CHARTER AND NATIONAL PROSPERITY

I want to turn now to a discussion of the contribution that a central bank, such as the Banco de Mexico or the U.S. Federal Reserve System, can make to a nation's prosperity. President Salinas has proposed an important measure of independence for the Banco de Mexico. This could be as important as NAFTA to the ultimate prosperity of Mexico.

The ability of a central bank to help a nation increase its prosperity depends on many things, and one of the most important is the central bank's charter. By the central bank's charter, I mean the laws and practices that establish the relationships of the central bank to the legislative and executive branches of government, and that specify the goals of the central bank. I'll talk first about those relationships, and second about goals.

Central banks perform many services for their nations, and the list of those functions differs from one nation to another. The most important function of a central bank is to achieve a condition of price stability.

Price stability is important because it avoids the need for households and firms to use real resources to forecast inflation, and to hedge against losses and seek gains from the redistributions of income and wealth that are caused by inflation. Price stability also increases the clarity with which changes in relative prices can be discerned, helping firms to make better decisions about production methods, production quantities, and investments, and helping households make better decisions about consumption patterns. Price stability raises not only the level of real economic output, but also the **growth rate** of output.

Because a central bank determines the price level or the value of money, the central bank's charter should make the bank effectively independent of the legislative and executive branches of the government. I don't mean that the central bank should not be accountable for the achievement of price stability, nor do I mean that its independence should be irrevocable. Clear objectives and accountability for achieving them would help assure independence of action. But, the central bank should have enough independence from the government to enable the bank to decide and implement monetary policy for a substantial length of time without concern that control of monetary policy will be taken from it.

There are two reasons why central bank independence is important. First, elected officials are often tempted to use monetary stimulus of the economy to increase their chances of being reelected. Faster money growth can drive down short-term interest rates temporarily, which might give a transitory boost to economic activity in the period just before an election. Certainly, any government that can spend money created by a central bank will be tempted to use such spending to please voters before an election. The disadvantage of such an expansion of the money supply is that it will lead to inflation, and inflation will hurt 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 nations whose central banks are closely controlled by the government.

The second reason for the importance of central bank independence is to prevent the government from using central bank credit as a substitute for taxing and/or borrowing from the public to finance the government's expenditures. This is especially important in nations that do not have efficient tax collection systems and/or 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 for collecting taxes, central bank financing can be used as a crutch to avoid the need to develop a strong, efficient tax collection system. 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, assuming that the public is not forced to lend to the government [as in China today--see *Wall Street Journal*, July 12, 1993].

In addition to independence, the central bank's charter should specify the goals that the central bank is to pursue, and designate which of those goals is the most important. I have come to believe that price level stability should be a central bank's primary objective. It is, after all, the only one achievable.

It would be nice to be able to simultaneously pursue price stability, full employment, rapid economic growth, a stable exchange rate, and low interest rates. But, in the short run, some of these objectives will be inconsistent with price stability, and at those times it is important to have price stability clearly specified as the primary objective. In the long run, price level stability is not only consistent with full employment, maximum sustainable economic growth, and low interest rates, but price stability makes an important contribution to their achievement. Indeed, it is the most important contribution to their achievement that the central bank can make, which is the reason why price level stability should be the central bank's primary goal. This is

not to say that price level stability assures the achievement of those worthy goals. Many other 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 assure prosperity. What it can do, by achieving price stability, is to be sure that it is not an obstacle to achieving national prosperity.

IV. INDEPENDENCE WITHOUT CLEAR OBJECTIVES AND ACCOUNTABILITY

The U.S. central bank is structured in a way that appears to give it substantial independence. Governors of the Federal Reserve System are appointed by the government for fourteen-year, staggered terms, and there is no direct government involvement in the appointment of Presidents of the Federal Reserve Banks.

Although the U.S. central bank is independent, it lacks clarity of objective and is not accountable for achieving the specific single goal of price stability. Therefore, the inflation record of the central bank has been very uneven. Although the U.S. inflation rate was fairly low during much of the 1950s, it increased dramatically from 1965 to 1980. Despite a substantial reduction in the rate since then, the price level still rose throughout the 1980s at an average rate that would double the price level every 14 to 18 years. Indeed, today we have a 3% to 4% inflation rate expected by most people over the next year or two.

The reason for this sometimes-unsatisfactory inflation performance in the presence of apparent independence is that the United States has assigned multiple objectives to its central bank, with none specified as having the highest priority. Without one objective being assigned first priority, the central bank has shifted among these objectives in response to changing political pressures.

In contrast to the situation in the United States, the law establishing the central bank of Germany specifies that price stability is to be given priority whenever any

other objective conflicts with price stability. Similarly, New Zealand law specifies price stability as the highest priority of the central bank. Mexico would do well to follow the examples of Germany and New Zealand and decide firmly on one achievable goal for monetary policy. Price level stability would be a good choice and, if achieved, would lead to exchange rate stability between the peso and the currencies of nations that are achieving substantial price level stability of their own.

V. GREATER INDEPENDENCE FOR THE BANCO DE MEXICO

On May 17, President Salinas proposed a constitutional amendment that would make the Banco de Mexico autonomous. The amendment was approved by the legislature last month and, as I understand it, will become effective when it has been ratified by the States. The legislation provides for staggered terms of office for members of the governing board, who cannot be removed from office before their terms expire, prevents government agencies from requiring the central bank to lend them money or buy their securities, and mandates that the central bank preserve the purchasing power of the peso.

Banco de Mexico President Miguel Mancera explained the need for central bank autonomy three years ago when he said: "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."(quoted in the Los Angeles Times, July 13, 1993)

Some observers in my country have said that the purpose of legislating central bank autonomy is to reassure foreign investors that Mexico will not revert to inflationary policies during the next presidential term. But, it seems to me that the reassurance will also be important to domestic investors. Moreover, if central bank autonomy and the mandate to preserve the purchasing power of the peso lead Mexico to

achieve price stability, it will benefit the entire economy in all of the ways that I have already discussed.

VI. OTHER NATIONS

Mexico's move toward a central bank with greater independence and a mandate to preserve the currency's purchasing power is similar to developments in several other nations where institutional changes are being made to increase the likelihood of achieving better price level performance.

New Zealand is a prime example of a nation that has made recent changes in the charter of its central bank to increase the likelihood of achieving price stability. Prior to passage of The Reserve Bank of New Zealand Act of 1989, New Zealand's central bank was instructed to pursue several objectives, but no priorities were set amongst these objectives, and the nation was experiencing high and variable rates of inflation. Now, with the new charter for the central bank in place, New Zealand's inflation rate has fallen to near zero.

Under the new charter, price stability is specified as the primary objective of the Reserve Bank of New Zealand. Moreover, the Governor of the central bank has an explicit employment contract with the Minister of Finance, called a Policy Targets Agreement, which specifies an explicit target for inflation. If the inflation target is not achieved, the Minister of Finance must take public responsibility for the outcome or dismiss the central bank Governor.

Canada's central bank, The Bank of Canada, has also improved its inflation performance recently. Although the Bank of Canada is legally under the control of the Finance Minister, the Bank 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 has apparently given the Bank the freedom to pursue price stability free from government interference, at least for the present time. In 1992, Canada's inflation rate was less

than 2 percent, well below that of the United States, and the first time in many years that it has been below 4 percent.

In France, the new center-right government recently proposed legislation to free the central bank from government control. When proposing this legislation, France's 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" (London *Financial Times*, May 12, 1993). France is doing this even though they have had relatively low inflation in recent years.

The new legislation, proposed by the French government in May 1993, provides for the monetary policy of the Bank of France to be determined by a nine-person committee dominated by people appointed for nine-year terms. Such long terms of office are intended to give the committee members freedom to go against the current government's wishes. That technique parallels the U.S. approach.

The effort to make the Bank of France independent of the government was necessary to bring France into alignment with requirements of the Maastricht Treaty. That treaty, negotiated among the European Economic Community nations, is a blueprint for those nations to achieve full monetary union by the end of the decade, including establishment of an independent European Central Bank. The treaty requires that European Economic Community member countries must establish independent central banks as a step toward establishing the independent European Central Bank. Belgium did so last March, and it is likely that some of the other European nations will also be moving toward greater independence for their central banks.

Even in China and Russia one can see bits of evidence of increased concern about the central bank's role in generating inflation. The government of China recently dismissed the head of its central bank because there was too much inflation. Russia is pressuring its central bank to produce less inflation, rather than follow its old pattern of

funding state enterprises. This is a battle between Russian reformers and the old Communists. Despite these hopeful signs, both of those governments are a long way from giving their central banks independence and a clear mandate to achieve price stability.

VII. CONCLUSIONS

In my remarks today I have stressed two related themes: free markets are valuable and price stability is valuable.

The greater the freedom with which markets are permitted to operate, the better the job they can do of releasing the creative energies of the people. Mexico is making important progress in this direction by reducing its restrictions on international trade, on investment, and on private operation of businesses. Some of the benefit of those changes is already visible in Mexico's increasing prosperity. Additional prosperity will result when NAFTA is implemented, and it is important to remember that Mexico can benefit from implementing NAFTA regardless of whether the U.S. has the wisdom to do the same.

Price stability is important because it improves the efficiency of the economy and encourages investment, which together can raise both the level and the growth rate of real output. Mexico is making important progress toward price stability, not only by recent actions that have reduced the inflation rate, but, much more importantly, by the recent actions to institutionalize central bank independence and to institutionalize a mandate for the central bank to maintain the purchasing power of the peso. Regarding institutional changes to enhance the prospects for price stability, it is important to note that a mandate to achieve price stability is often even more important than central bank independence.

Free markets and price stability are related themes because both contribute importantly to the achievement of prosperity. Mexico is making important changes on

both fronts, for which your nation is to be both commended and envied. I wish you well.

Thank you, again, for the opportunity to speak in this important forum.