Vice Presidency of Sectors and Knowledge
Research Department

Towards a "New" Inflation Targeting Framework in Latin America and the Caribbean

RG-K1198

1. Motivation

The Region now includes nine countries with an inflation targeting (IT) regime, including countries that are transitioning to this regime (Brazil, Chile, Colombia, the Dominican Republic, Guatemala, Mexico, Paraguay, Peru, Uruguay). Frequently, theoretical expositions of inflation targeting consider that the stabilizing instrument is the short-term interest rate and the principal objective is to meet an inflation target. In practice, however, inflation targeting Central Banks use interest rates and a set of other tools to meet inflationary and other objectives. These tools include liquidity and reserve requirements on banks and interventions in international flows of non-residents or residents. In what follows these are referred to as direct or non-conventional tools. At times the interest rate and these direct policy tools are used as substitutes, and at other times they have been used as complements.

Indirect tools may be used as complements if there is reason to believe the interest rate may not be fully effective or that the transmission mechanism in relation to that instrument is slow. In particular, Central Banks in emerging economies have been reluctant to increase interest rates greatly to contain booms in capital flows, as this could potentially trigger further capital inflows, appreciating real exchange rates and harming the export sector. Hence monetary authorities may complement increases in interest rates with the use of direct tools to contain any inflationary pressures. Moreover, as spreads between the policy rate and lending rates may be large in smaller and less developed financial systems, the interest rate may simply be a less effective or slower tool thanin economies with very large financial systems.

However, direct tools may also be considered as substitutes for the use of a policy interest rate. For example, at the start of the recent global financial crisis, commodity prices remained high, and there remained concern regarding upward inflationary pressures in the Region. At the same time, however, the collapse of Lehman Brothers led to a liquidity shock. These different shocks provoked different responses. Several Central Banks maintained policy rates at more elevated levels and some, given the negative liquidity shock, even increased policy rates (a tightening) at the same time as they reduced liquidity or reserve requirements (a loosening of monetary policy).

A further consideration is that Central Banks generally have more than one mandate or, put another way, inflation targeting in Latin America and the Caribbean has not always been characterized only by a strict adherence to an inflation target. Hence the use of direct instruments may simply be a reflection of the importance of other objectives, including output and financial stability.

For example, financial imperfections may imply that management of a policy rate may be insufficient to stabilize inflation or output, and that other instruments may be needed at times. When net capital inflows stop and suddenly become outflows, the transmission mechanism of monetary policy via price signals might be disrupted, and hence lowering interest rates counter-cyclically may be akin to the old adage of "pushing on a piece of string." Again, other tools may be more effective in this context and might be used as substitutes.

This research project is particularly important given the well-documented high levels of economic volatility in the Region. One strand of the literature argues that large swings in capital flows emanating from developed countries are a main driver of this volatility. A second strand indicates that many developing countries, particularly in LAC, have had policies (monetary and fiscal) which have exacerbated rather than ameliorated these swings. In the recent global financial crisis there was some evidence that countries were able to enact countercyclical policies, in contrast to previous crises. This research project will address whether the switch to inflation targeting in several countries in the Region—and within that, the use of direct measures as well as the interest rate as policy tools—may have allowed for greater countercyclicality and improved countries' ability to reduce economic volatility. It is hoped that recommendations for the use of different tools in different circumstances will follow in order to further enhance countercyclical policies and assist in diminishing the amplitude of economic cycles in the Region.

2. Objective, Content and Methodology

The research network project will focus on countries with or transitioning to an inflation targeting regime and aims to deepen the understanding of how such regimes are working in the Region; the project further aims to develop recommendations. The research project will:

1. Collect information on the stated monetary policy framework in an inflation targeting country (or countries) of the Region for the period before, during, and after the global crisis.
2. Collect information on the monetary policies implemented in the period before, during, and after the global crisis by an inflation targeting country (or countries) in the Region. In particular:
    - 2.1 Where possible provide the explanations given—by both officials and other private analysts—for the different policy actions taken;
    - 2.2 Consider the different shocks countries experienced and how different policies were used as a function of the shocks received.
3. Collect time series information at monthly or quarterly frequency for macro-prudential policy tools such as reserve requirements, taxes on capital flows, LTV or leverage constraints, etc., that have been relevant in accounting for monetary policy decisions in each country.
4. Conduct a quantitative exercise regarding the impact of different policy tools. Such an exercise can take the form of an empirical evaluation of the effectiveness of those policy tools either in the time series or in the cross-section dimension, and/or the estimation of policy rules and their implications depending on the nature of shocks or the phase of the economic cycle. Alternatively, the quantitative exercise can take the form of a theoretical model rationalizing the way that alternative tools have been employed in practice. Ideally, the quantitative exercise would measure whether and how the effectiveness of alternative tools has depended on particular circumstances (e.g., crisis versus non-crisis periods) or economic characteristics (such as the relative size of the financial system).

We plan to commission 5-7 papers, depending on the proposals received and the available budget. It is likely that each project will focus on one country, although proposals comparing more than one country would also be acceptable; the latter option may be appropriate for countries in transition to inflation targeting.

The sections will focus on the following specific aspects:

a) Description of the institutional arrangements for monetary, prudential, and exchange rate policies, including sovereign wealth funds and the financial stability authority.
b) Summary description of the main characteristics of the financial system (limited to those aspects considered important to understand the role of macro-prudential tools).
c) Description of the main policy tools and the institutions in control of those tools.
d) Description of the shocks during the period 2007-to date, focusing on terms of trade and capital flows but including others when considered relevant.
e) Description of the policy responses in relation to the shocks and objectives, and of stated explanations of policy actions taken.
f) Further analysis of why certain policies were implemented and their effectiveness in achieving their goals, with particular reference to consistency (or lack thereof) with IT.
g) A quantitative exercise to be determined in each case.

3. Selection Criteria

Research institutions only may present proposals. The IDB seeks to produce up to seven (7) studies and will contribute up to **US$30,000** for each study.

Proposals will be evaluated based on the following criteria:

a) Quality and feasibility of the proposed case (60%).
b) Empirical study of effectiveness of macro-prudential policies (40%).
c) Higher points will be given to studies that look beyond reserve requirements and compare alternative instruments. Data quality and statistical techniques fall under this criterion. Proposals to conduct multi-country studies will be accepted if the econometric exercise, adequately defined, involves analysis that cannot otherwise be investigated through a single-country study.

To be considered for the project, the research proposal should include the following:

a) A brief survey of previous studies on this topic conducted on the country or countries (1 page).
b) Data templates for the description and analysis of macro-prudential policies and assessment of data availability. Individual country studies should refer to the IT and transition countries listed in Section 1 above. Proposals must additionally provide a description of strategy for collecting relevant data, including regulatory data.
c) A detailed description of the methodologies to be used in the quantitative exercise.

Final papers will be considered for dissemination as IDB working papers or technical notes depending on quality. For studies with IDB funding, other forms of dissemination or publication should be explicitly approved by the coordinators until the end of the contract. Proposals may include suggestions for further dissemination of the final version of the paper and its policy implications.

4. Proposal Submission

Research institutions interested in submitting a proposal should submit a proposal no later than **September 21, 2012** using the Web Submission Form . Please note that there are two options within the submission form: one for institutions and another one for teams of individual researchers. Please make sure to choose the institutions option. If unable to submit by this means, please send an email to red@iadb.org**.**

The following information will be required for submitting your proposal:

- The proposal with all the technical aspects involved in the development of the study, based on the Terms of Reference outlined in this Call for Proposals.
- A budget indicating the time and resources that will be used within the context of the research work plan. The budget is requested as a separate file and should not be included in the proposal. The budget proposed should disaggregate items financed by the IDB contribution and those financed by the research institution. The budget should distinguish among amounts assigned to professional honoraria, "overhead" and other major categories of research expenditures.
- The name and Curricula vitae (two pages maximum) of the technical coordinator and other researchers involved. The research team should demonstrate its ability to meet the objectives of the project, including relevant experience. Please note that for proposals submitted by institutions, subsequent substitutions for researchers originally specified in the proposal may be made with prior approval from the project coordinators, but the technical coordinator should lead the entire project until its full completion.

If an institution submits the proposal, it must provide the name and contact information of the legal representative, with authority to sign contracts with the IDB, if selected to conduct the study.

Proposing research institution should register as Research Network members (contact Elton Mancilla at res@iadb.org) and should be based in the Latin America and Caribbean region. U.S. and European institutions do not qualify as members of the Research Network. However, researchers from the United States and Europe can participate with research teams from proposing institutions"

Note: All proposals and research papers should be submitted in English.

5. Coordination and Schedule

The project will be administered by the Research Department (IDB/RES), and the team consists of Andrés Fernández (IDB/RES), Andrew Powell (IDB/RES) and Alessandro Rebucci (IDB/RES). Roberto Chang (Rutgers University and NBER) will act as the External Advisor for the research project.

The tentative schedule of activities is as follows:

- **September 21, 2012:** Due date for **receiving proposals.**
- **October 1, 2012:** Announcement of **selected research proposals**.

- **October 22-23, 2012: First Discussion Seminar** in Washington, D.C., to discuss selected proposals.
- **December 12, 2012:** Due date for receiving a **first draft** of research papers, including the narrative, the database and preliminary results on the quantitative exercise.
- **January 31, 2013:** Due date for receiving a **second draft** of research papers and delivery to the IDB of complementary support documents utilized in the study.
- **June 30, 2013:** Deadline for delivery to the IDB of a **final version** of research papers, including a summary that discusses policy lessons and delivery of the datasets utilized by the study.
- **July 30, 2013:** Deadline for a **final edited version** of the research papers, following the **IDB Manual of Style** for working papers.

6. Financial Contribution and Payment Schedule

The IDB will contribute up to **US$30,000** for each study, depending on the scope of the work proposed. The payment schedule is as follows:

- **35 percent** within 30 days of signing the formal agreement between the IDB and the respective research center.

- **30 percent** within 30 days of presenting and approving the first draft of the research paper.

- **15 percent** within 30 days of presenting and approving the second draft of the research paper.

- **20 percent** upon approval by the Bank of the final research paper and delivery to the IDB of the databases utilized in the study.