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Inflation Targeting and Real Exchange Rates in Emerging Markets

Comments*

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** The comments do not necessarily reflect the views of the OECD or of its member countries.*

Some intuitive results…

- Self-proclaimed IT emerging markets actually follow a hybrid IT strategy, where both inflation and real exchange rates determine policy interest rates (even though real exchange rates don't predict future inflation).

- However, the response to changes in real exchange rates (and forex reserves) is much stronger in non-ITers.

- Among ITers, significant commodity exporters respond more to real exchange rate shifts, as they are more vulnerable to the latter.

- Interest rates in non-ITers adjust little in the face of inflation.

… and one surprise

- Among ITers, only commodity-intensive ones adjust interest rates when inflation changes.

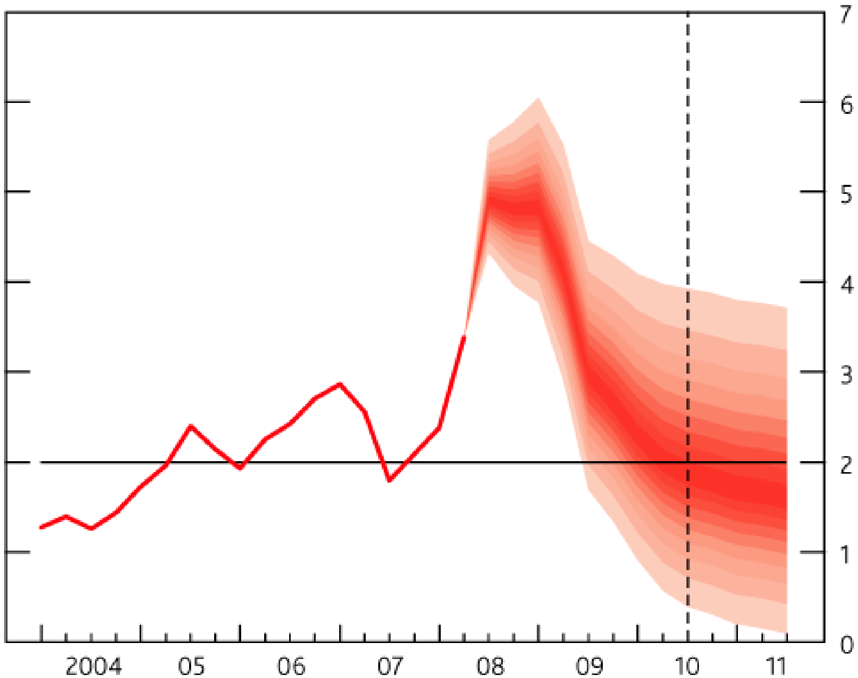
Putting the discussion in perspective

Contrasting with the glowing assessment in Rose (2007), who sees the entire OECD membership converted to inflation targeting (IT) soon, IT central banks are currently going through a real-world stress test, with:

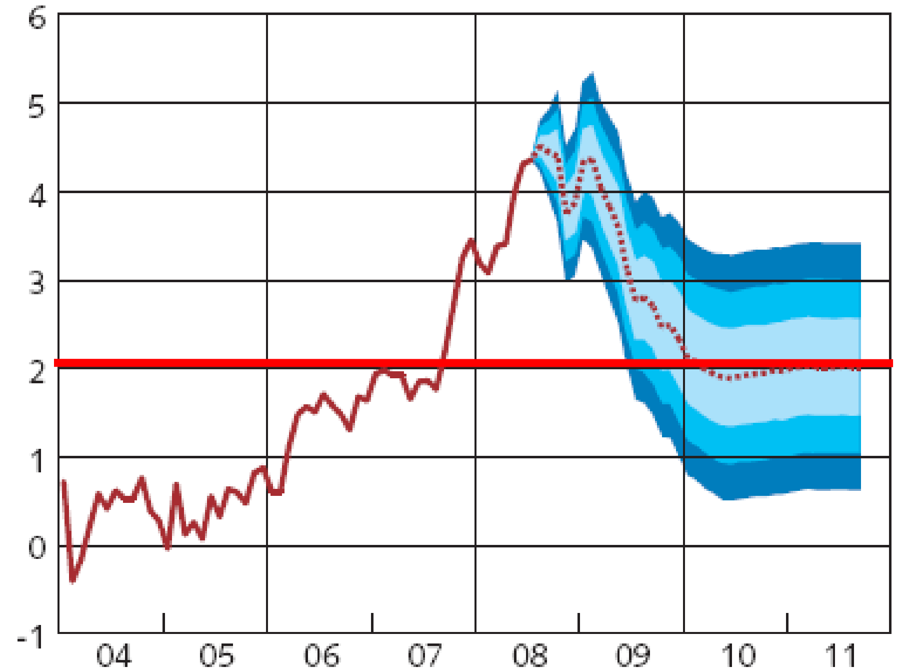
- Massive inflation overshooting in many advanced and emerging market IT economies.

- The biggest financial meltdown in decades in the US and the problems faced by the BoE, one of the “textbook” IT central bank, and other central banks.

Overshooting in OECD ITers



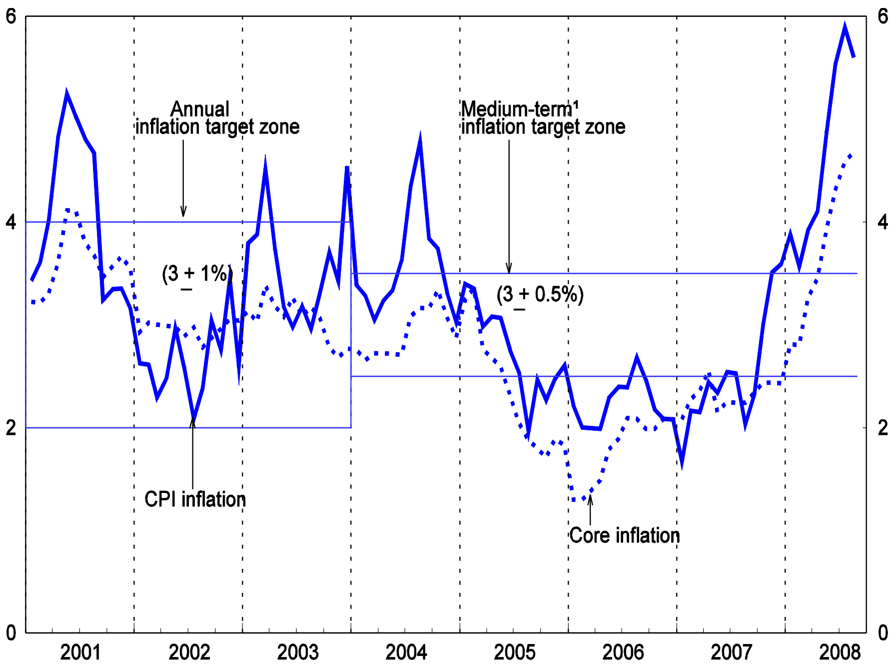
UK



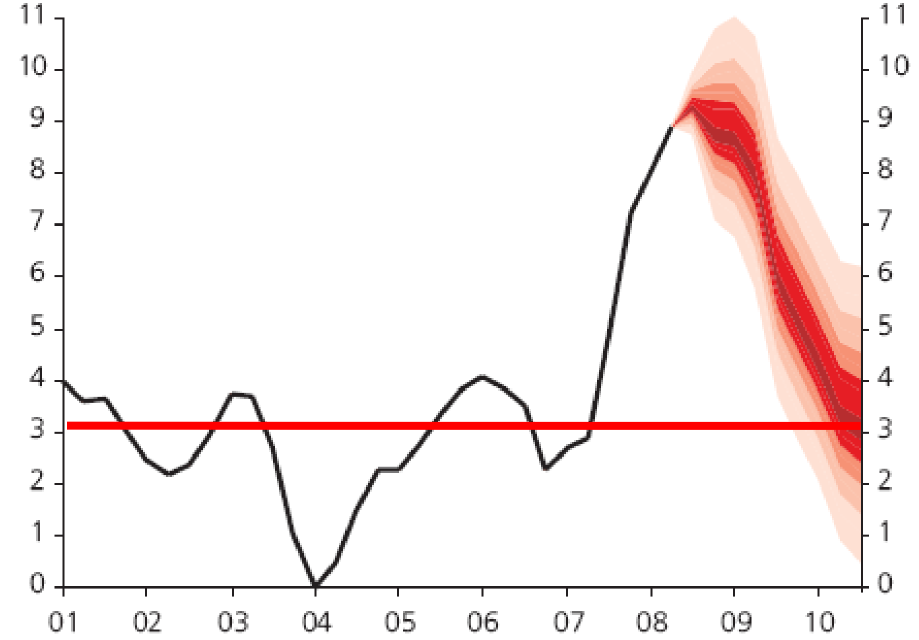
Sweden

Sources: Bank of England, August 2008 *Inflation Report*; Riksbank, September 2008 *Monetary Policy Update*.

Overshooting in selected emerging market ITers



Korea



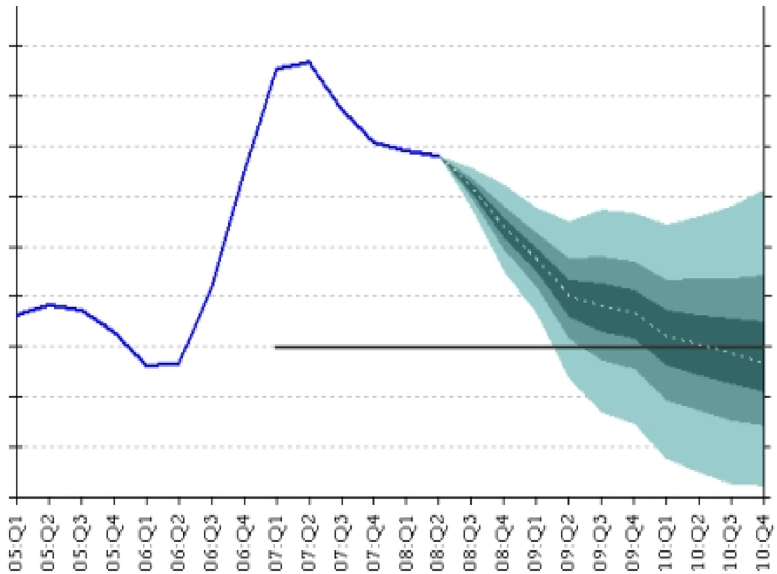
Chile

1. In 2004, the Bank of Korea changed the target to a medium-term objective. In 2007, the target was changed from core to overall CPI.

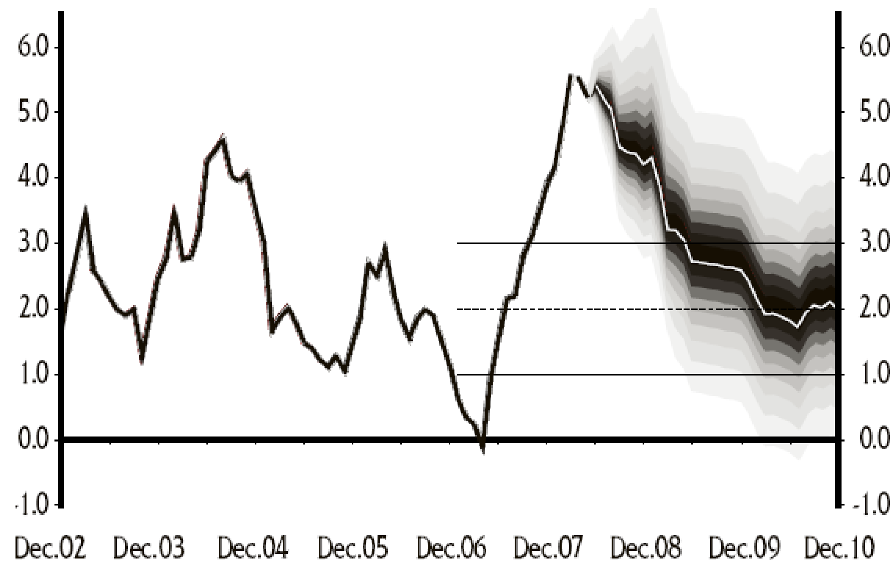
Sources: OECD, Korea desk; Banco Central de Chile September 2008 *Monetary Policy Report*.

Overshooting in selected emerging market Iters

(continued)



Hungary



Peru

Sources: Magyar Nemzeti Bank, Banco Central de Reserva del Perú.

Overshooting in the sample

	Inflation in August 2008	Target	
Brazil	6.2	4½	
Columbia	7.9	4	
Czech Republic	6.5	3	(moving to 2)
Hungary	6.5	3	
Indonesia	11.9	5	(for 2008)
Israel	5.0	2	
Korea	5.6	3	
Mexico	5.6	3	
Peru	6.3	2	
Philippines	12.5	4	(for 2008, moving to 3½ in 2009)
Poland	4.8	2½	
Thailand	2.7	0-3½	(core CPI)

Sources: central bank websites, via http://www.bis.org/cbanks.htm .

Sample coverage, IT starting dates

- 16 countries based on MSCI Emerging Market Index (as against 13 IT and 29 non-IT emerging markets in IMF, 2005).

- Leaves out Chile, a prominent IT country, South Africa and Turkey, both IT, as well as Russia, a major commodity exporter. Includes Indonesia, but as a non IT, whereas it adopted IT mid-2005.

- As a result, the “control sample” of non-IT countries is very small (4 countries).

- Some starting dates may be a bit off (*e.g.* Brazil 99Q2 rather than Q1; Philippines 02Q1 rather than 01Q1; Poland, 99 rather than 98).

- 1989Q1-2006Q4: leaves out the more recent and interesting period of overshooting…

Using an (augmented) Taylor rule

- Same equation used for all countries in the sample, but in some instruments other than the headline policy rate may have been used (out of sample, that would have been the case in China for instance) .

- Thailand: the central bank targets core rather than headline inflation. Is that taken into account in the regressions?

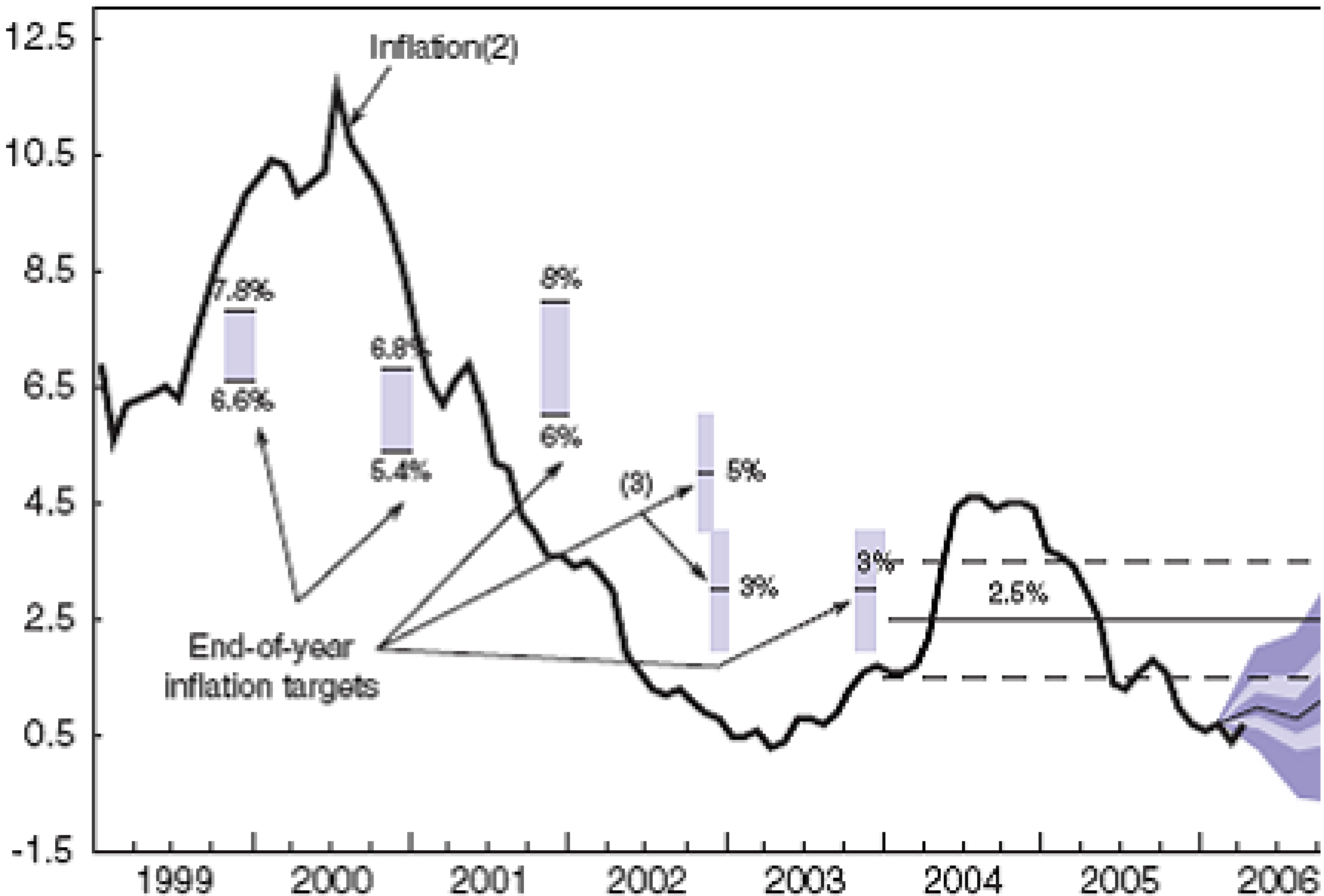
The constant *π** assumption

- The authors assume that the targeted inflation rate is time invariant for each country.

- In practice, this is not necessarily the case. Often, there are two phases: 1. convergence; 2. “steady state”.

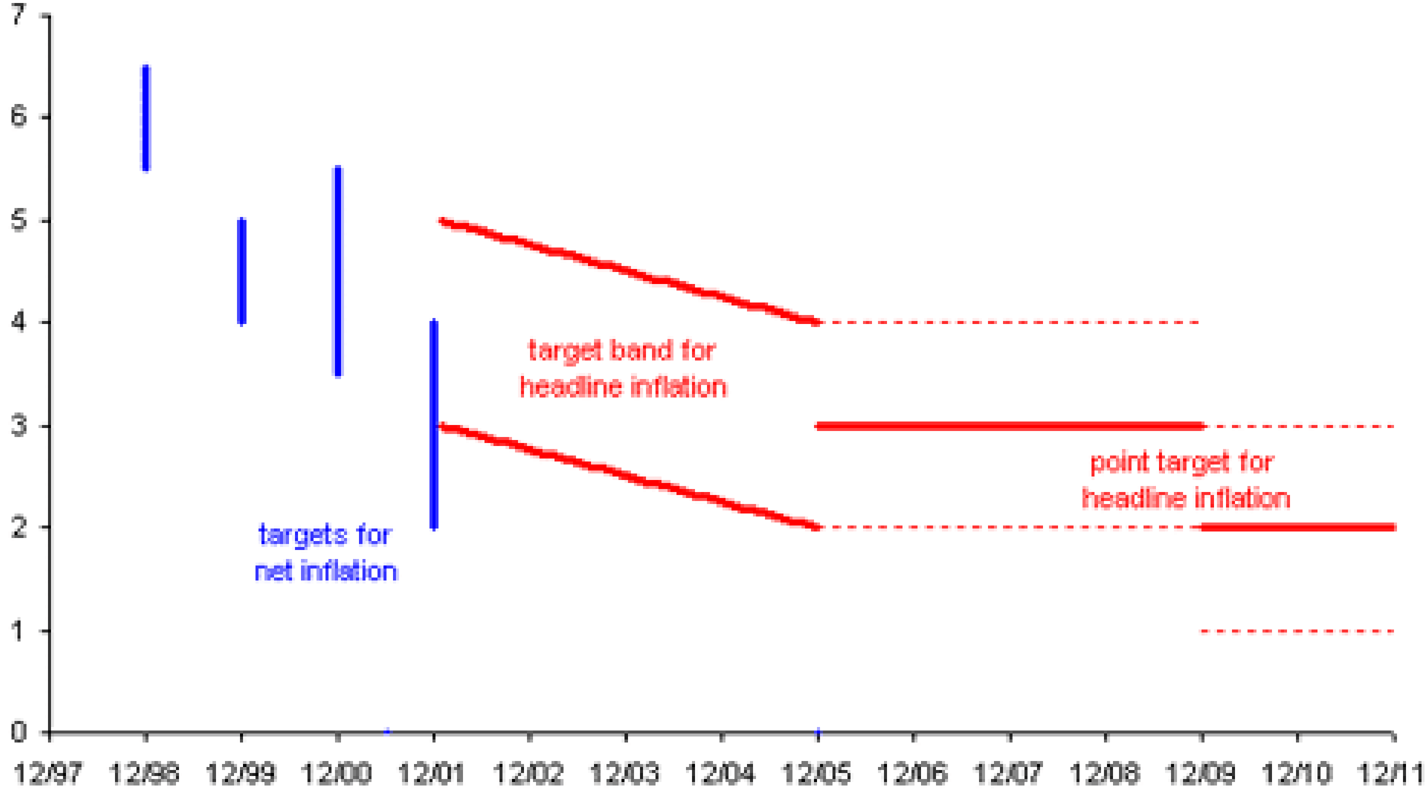
- Consider *e.g.*, within the sample, Poland and the Czech Republic, or out of sample, Chile.

The case of Poland



Source: *OECD Economic Survey of Poland*, 2006.

The case of the Czech Republic



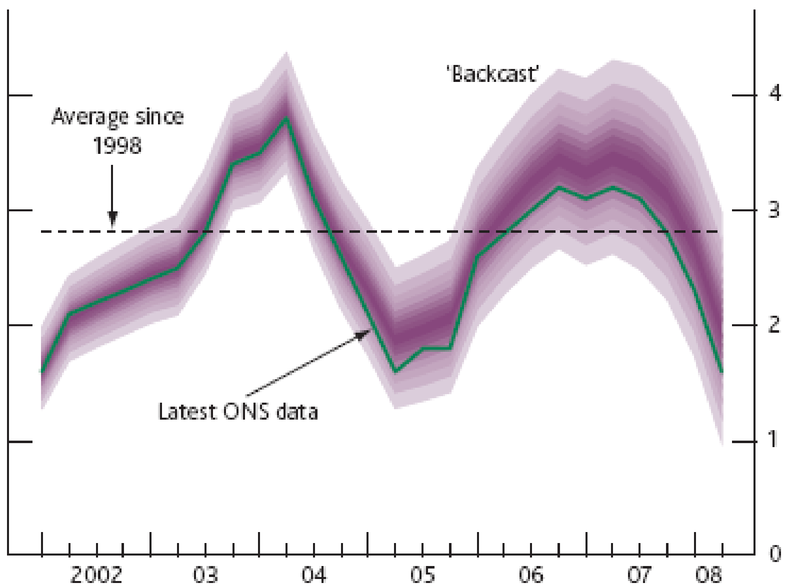
Source: http://www.cnb.cz/en/monetary_policy/inflation_targeting.html

Data reliability / real time vs ex post

- Caution regarding TOT data is indeed warranted.

- But quarterly GDP data are typically also very poor. Insofar as they are used by central banks in real time, this may not be an issue here. But if central banks rely on different measures to assess capacity (as in some OECD countries), it may be a problem.

UK, % change in real GDP



Bank of England, August 2008 *Inflation Report.*

- Real time versus *ex post* observations.

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