

## Inflation Targeting Lite

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### Introduction

Many emerging market countries use, but cannot maintain, an inflation target as the defining objective of their monetary policy.<sup>1</sup> This framework is called here Inflation Targeting Lite (ITL). Countries choose “lite” because a fixed exchange rate would leave them vulnerable to speculative attack, while a monetary target is not practical owing to instability in money demand. Moreover, Full-Fledged Inflation Targeting (FFIT) is not feasible because of their weak fiscal positions and insufficiently developed financial sectors. ITL practitioners are different from central banks such as the Federal Reserve or the European Central Bank (ECB), which do not make a clear commitment to an inflation target yet can maintain low inflation owing to their high credibility.

This paper assesses the monetary policy of ITL countries with a view to identifying the important, unresolved central bank policy questions. ITL is not usually thought of as a monetary framework in the same way as exchange-rate peg or FFIT, probably because it is a transitional regime aimed at monetary stabilization while structural reforms are implemented in support of a single nominal anchor. In addition, ITL is not amenable to theoretical models, which almost always assume a single monetary objective. Nevertheless, ITL is widely practiced, so its policy challenge warrants careful analysis. The emphasis here is on the design and implementation of monetary policy, because this is largely under the control of the central bank. However, other crucial elements of policy credibility, such as the fiscal position and structural reforms, are also touched upon.

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Identification of the main policy questions is based on the structural and institutional features of ITL countries. In general, ITL countries have a lower level of measurable credibility compared with other emerging market countries, reflecting a relatively weak fiscal position, shallow financial systems, and vulnerability to economic shocks. As a result, ITL countries probably aim to bring inflation into the single digits and maintain financial stability, including through relatively interventionist exchange rate policies. Further, ITL countries employ fewer market-oriented monetary targets and instruments, and they are relatively nontransparent in the operation and objectives of monetary policy owing to shallow financial markets.

The assessment of ITL central bank monetary policy raises several important, unanswered questions. First, is greater transparency with respect to the operation of monetary policy advantageous? Second, is greater transparency of objectives of monetary policy beneficial under the appropriate circumstances? Third, how can the central bank use its special vantage point to accelerate financial reform? Fourth, when should the ITL central bank announce long-term commitment—given sufficient credibility—to either a hard exchange rate or FFIT so as to benefit from a single-anchor monetary regime? Finally, how much credibility is sufficient to adopt a single nominal anchor?

The first section of this paper identifies 19 ITL countries. In order to understand the revealed preference for and the objectives of ITL, the second section compares ITL countries with other medium and large emerging market countries. The third section discusses the policy challenges for a central bank operating under ITL. The switch from ITL to a hard exchange-rate target or FFIT is examined in the fourth section. The fifth section draws tentative policy conclusions, though more importantly, it points to unresolved issues that warrant further discussion and analysis.

## **Selection of the Inflation Targeting Lite Countries**

Nineteen ITL countries were selected in four steps from the 184 IMF member countries, as described in detail in Carare and Stone (2003). The process was as follows:

First, small and less developed countries (GDP less than US\$4 billion and per capita GDP less than \$720) were eliminated because they operate under a specific set of policy constraints. Their high degree of trade openness and limited integration into world capital markets largely precludes their opting for a fixed exchange rate. In addition, Belarus, Paraguay, Trinidad and Tobago, and Tunisia were dropped for

lack of data. This left 87 industrial and medium and large emerging market countries.

Second, the remaining countries were next divided into fixed and flexible exchange rate countries, with the latter classified as inflation-targeting countries. The countries that were eliminated have the following fixed exchange rate arrangements: no legal tender, currency board arrangements, other conventional fixed peg arrangements, a pegged exchange rate within horizontal bands, or a crawling peg. This left 42 central banks (the 11 EMU countries are subsumed under the European Central Bank), with some form of floating exchange rate. All but one of these central banks announced an inflation objective or forecast; while none—at least not formally—gave explicit targets for the exchange rate (Carare and Stone, 2003). Although those countries have inflation targeting in common, they are obviously extremely diverse with regard to determinants of the monetary regime, including size of the economy, level of development, and vulnerability to shocks.

Third, the 42 inflation-targeting practitioners were separated into those that did and did not make a clear commitment to the inflation target. The clarity of the commitment was defined by means of the central bank's public description of its policy objective as of 2001, together

**Table 7.1. Inflation Targeting Central Banks:  
Countries with Clear Commitment, late 2001**

|                | Inflation target                                     |
|----------------|--|
| Brazil         | 2–6 percent  |
| Canada         | 1–3 percent  |
| Chile          | 2–4 percent  |
| Colombia       | 8 percent for 2001; 6 percent for 2002               |
| Czech Republic | 2–4 percent  |
| Hungary        | 5–7 percent  |
| Iceland        | 2.5 percent, with $\pm 1.5$ percent tolerance limits |
| Israel         | 1–3 percent from 2003 onward                         |
| Korea          | 2.5 percent  |
| Mexico         | 6.5 for end-2001; 4.5 for end-2002                   |
| New Zealand    | 0–3 percent  |
| Norway         | 2.5 percent  |
| Poland         | 5.4–6.8 percent                                      |
| South Africa   | 3–4 percent  |
| Sweden         | 1–3 percent  |
| Thailand       | 0–3.5 percent core inflation target range            |
| United Kingdom | 2.5 percent underlying inflation target              |
| Australia      | 2–3 percent on average over business cycle           |

Source: Carare and Stone (2003).

with the transparency of the institutional framework. Institutional transparency was gauged by the central bank's communication vehicles. This included the release of inflation reports, the frequency and detail of these reports, the announcement of monetary policy changes via press releases, published reviews of inflation performance and changes in monetary policy, publication of inflation forecasting models, and the bank's use of media and other public presentations. These communication vehicles are documented in Schaechter and others (2000) and were updated by Carare and Stone (2003).

Eighteen inflation-targeting countries made an explicit commitment to an inflation target to a transparent framework to ensure central bank accountability for the target. (Table 7.1). The other 24 countries did not explicitly commit to an inflation target, and some have other announced objectives as well (Table 7.2). The combination of imprecisely defined multiple targets rendered the second group's commitment to the inflation target much less clear than that of the first.

Fourth, the countries in the second nonexplicit group of 24 inflation-targeting countries were further divided by the credibility of the commitment to low inflation (Table 7.3). "Credibility" was measured using two gauges—first, simply the rate of inflation (January 1999–May 2002), on the grounds that countries with relatively low inflation are more credible with respect to inflation targets. The wide dispersion of inflation indicates that credibility varies significantly among countries with less clear commitment. Second, credibility is gauged using Standard & Poor's long-term local currency government debt ratings for 2001. Again, the dispersion of this gauge of credibility of inflation-targeting countries without an explicit commitment is quite wide.

High and low credibility groups emerge naturally when the 24 inflation-targeting countries are ranked by averaging their inflation rank and their S&P rating rank (Table 7.3, last column). The distinction between low and high credibility would seem to help explain the broad diversity among countries that practice inflation targeting without an explicit commitment, with corresponding policy implications in regard to design of the monetary framework.

Taken together, examination of the clarity and credibility of the 42 inflation-targeting countries leads to their classification into three distinct regimes. Countries in the first regime practice *Full-Fledged Inflation Targeting* (FFIT), which is the best-known form. FFIT countries have medium to high levels of credibility, clearly commit to their inflation target, and institutionalize this commitment in a transparent monetary framework that fosters central bank accountability to the target. For these countries, an FFIT monetary regime seems to ameliorate the central bank time-inconsistency problem that can result in higher

**Table 7.2. Inflation Targeting Central Banks: Countries Without a Clear Commitment, late 2001**

|                       | Inflation targets and other monetary policy objectives   |
|-----------------------|--|
| Albania               | 2–4 percent inflation target. Aims to adopt formal inflation targeting.  |
| Algeria               | The ultimate monetary policy objective is low inflation in the medium term; the level is not specified but is considered to be 3 percent.  |
| Croatia               | Monetary policy is primarily focused on price stability.   |
| Dominican Republic    | No stated inflation target. Objective: maintain low inflation.   |
| European Central Bank | The primary objective of the ECB is to maintain price stability over the medium term, as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) of below 2 percent.   |
| Guatemala             | Monetary program with inflation target is 4–6 percent and international reserves to maintain the value of the domestic currency.   |
| Honduras              | Disinflation is a principal objective: 10 percent in 2001; 8 percent in 2002; 6 percent in 2003. Other objectives: moderate growth, external competitiveness.  |
| Indonesia             | 9–11 percent, to keep real interest rates at adequate position levels to sustain and build market confidence. Achieved through reducing base money growth by 12.5 percent a year.  |
| Jamaica               | IMF program, multiple targets: net domestic assets (NDA), net international reserves (NIR), and foreign short-term borrowing. Inflation: 5 percent for 2001/02.  |
| Japan                 | The Bank of Japan is easing policy until the consumer price index (excluding perishables) registers stably at zero percent or shows an increase year on year.  |
| Kazakhstan            | Price stability and avoidance of excessive real exchange rate appreciation. Interpreted as future inflation at approximately 10–12 percent.  |
| Mauritius             | The medium-term objective is to keep inflation in line with that of trading partners. For 2001/02, the target is 4.5–5 percent. Price stability is not the primary objective of the Bank of Mauritius. The central bank does not have an exchange rate target. |
| Peru                  | Price stability is main objective. The end-year inflation target range and average rate of growth of base money are set annually. For 2001, the inflation target is 2.5–3.5 percent.   |

**Table 7.2. (concluded)**

|                 | Inflation targets and other monetary policy objectives   |
|-----------------|--|
| Philippines     | Announced inflation targeting in December 2001, starting 2002. 5–6 percent for 2002; 4.5–5.5 percent for 2003.   |
| Romania         | Mixed objective: inflation target 22 percent at year-end 2002, in the context of a managed float. The National Bank of Romania will attach more weight to the inflation objective, while not putting the viability of external accounts at risk. |
| Russia          | Main objective: protect and ensure stability of the ruble. The central bank presents the monetary program for each year. The primary monetary objective is disinflation. In 2000, the inflation target was 18 percent.                           |
| Singapore       | Price stability as sound basis for sustainable growth.   |
| Slovak Republic | Each year the central bank presents the monetary program. The primary objective is disinflation. For 2002, the central bank's expected inflation rate is 4.1–4.9 percent; the inflation rate approved by the state budget is 6.7 percent.        |
| Slovenia        | Monetary policy has a formal long-term inflation target, that is, the European level of inflation by date of accession to the EMU at the latest (4 percent by the end of 2003).  |
| Sri Lanka       | The central bank is bolstering price stability as its main objective. Inflation is expected to be 6.5 percent in 2002 and 5.5 percent in 2003 if strong reforms are implemented—otherwise, 8.5 percent in 2002 and 7.5 percent in 2003.          |
| Switzerland     | Price stability defined as consumer price index inflation of less than 2 percent per year.   |
| United States   | Maximum sustainable growth with low inflation.   |
| Uruguay         | Crawling band of 15 percent. Economy is highly dollarized; therefore, primary objective of monetary policy is to keep currency stable.   |
| Venezuela       | Monetary policy is anti-inflationary in orientation. For 2000: 15–17 percent target. Uses the exchange rate as the nominal price anchor, thereby promoting order within the framework of floating exchange bands.                                |

Source: Carare and Stone (2003).

inflation for a given level of output. Some 7 industrial and 11 emerging market countries were practicing this regime as of 2001.<sup>2</sup>

*Eclectic Inflation Targeting* (EIT) countries enjoy so much credibility that they can maintain low and stable inflation without full transparency and accountability with respect to their inflation target. Their record of low and stable inflation and high degree of financial stability affords the flexibility to pursue the objective of output stabilization, as well as price stability. Five developed country central banks are classified here as practicing EIT, including the ECB and the U.S. Federal Reserve.

*Inflation Targeting Lite* (ITL) countries announce a broad inflation objective, but they are unable to maintain it as their foremost policy objective because of relatively low credibility. Low credibility reflects their vulnerability to large economic shocks, financial instability, and weak institutional frameworks. There are 19 ITL countries; all are emerging market countries.

The inflation-targeting regimes can be viewed as corresponding to different welfare maximizing combinations of policy objectives, each conditional on a country's "endowed" level of credibility (Carare and Stone, 2003). The ultimate purpose of monetary policy is to maximize social welfare by attaining high and stable growth in the long run. Monetary policy can support long-run growth through a combination of inflation in the low single digits, financial stability, and output stabilization. The welfare-maximizing combination of these three objectives in the policy framework depends on a country's level of credibility. Empirical analysis suggests that the different levels of credibility for the 42 countries across the three inflation-targeting regimes correspond to GDP per capita and the level of financial development, which are highest for EIT countries and lowest for ITL countries.

## **The Revealed Preference of Emerging Market Countries for an ITL Regime**

This section compares key macroeconomic indicators of the ITL countries with other emerging market countries with a view toward understanding the motivation for and objectives of an ITL regime. Other emerging market countries are used as the comparators because the high credibility enjoyed by industrial countries means qualitatively different credibility constraints in the conduct of policy. All of the medium and large emerging market IMF member countries are included here. They are divided into ITL, FFIT, and Fixed Exchange Rate (FXR) regime groups.

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<sup>2</sup>The starting date for the adoption of inflation targeting is the date at which a country is deemed to have had in place most of the elements of a full-fledged inflation-targeting framework (Schaechter and others, 2000).





**Table 7.4. Inflation Targeting Lite (ILT) Monetary Regimes: Summary Statistics**

| Key indicators                                   | Average | Median | Maximum | Minimum | Standard deviation |
|--|---------|--------|---------|---------|--------------------|
| S&P local currency government debt rating (2001) | 5.1     | 5.0    | 13.0    | 1.0     | 3.4                |
| GDP in billions of U.S. dollars (2000)           | 48.1    | 19.2   | 251.1   | 4.0     | 63.5               |
| Per capita GDP in U.S. dollars (2000)            | 2,702   | 1,720  | 9,170   | 728     | 2,191              |
| Money to GDP (2001)                              | 41.3    | 40.7   | 79.2    | 15.4    | 18.4               |
| Stock market capital to GDP (2000)               | 20.8    | 15.0   | 69.0    | 2.9     | 19.8               |
| Equity flows to GDP (2000)                       | 0.11    | 0.00   | 0.41    | 0.00    | 0.17               |
| Private external debt to GDP (2000)              | 1.8     | 0.6    | 6.7     | 0.00    | 2.1                |
| Trade flows to GDP (1999–2002)                   | 80.2    | 78.3   | 149.7   | 34.7    | 32.4               |
| Government balance to GDP (1996–2002)            | –3.3    | –2.6   | 2.3     | –10.2   | 2.9                |

Sources: IMF, *International Financial Statistics* and *World Economic Outlook* databases; and Bankscope.

exceeded 25 percent. For the FXR and FFIT countries, 93 percent and 87 percent of the inflation observations fell below 10 percent, respectively.

- Exchange rate stability for the ITL countries is between that of their FXR and FFIT counterparts (Fig. 7.2.a.–Fig. 7.2.c.; see end of chapter). The exchange rate for the FXR countries does not change year over year for over half the observations. About 54 percent of the observations for the FFIT countries are in the plus or minus 10 percent range, compared with 63 percent for the ITL countries.
- The ITL countries have the lowest levels of per capita GDP and GDP. Median GDP per capita for the ITL countries at \$1,720 is less than one half that of the FXR countries, and nearly one third that of FFIT countries (Table 7.4). The median GDP level of ITL countries is about the same as that of FXR countries. The ranges for both groups is quite wide, and the median GDP of FFIT countries is larger than the other two groups by a factor of six.

**Table 7.5. Fixed Exchange Rate (FXR) Monetary Regimes:  
Summary Statistics**

| Key indicators                                   | Average | Median | Maximum | Minimum | Standard deviation |
|--|---------|--------|---------|---------|--------------------|
| S&P local currency government debt rating (2001) | 7.1     | 8.0    | 15.0    | 1.0     | 5.2                |
| GDP in billions of U.S. dollars (2000)           | 76.5    | 16.4   | 1,079.8 | 4.6     | 189.4              |
| Per capita GDP in U.S. dollars (2000)            | 7,571   | 3,799  | 34,880  | 855     | 8,702              |
| Money to GDP (2001)                              | 71.2    | 49.7   | 288.2   | 12.7    | 56.7               |
| Stock market capital to GDP (2000)               | 59.0    | 36.4   | 383.3   | 5.1     | 80.6               |
| Equity flows to GDP (2000)                       | 0.25    | 0.00   | 2.06    | -0.55   | 0.57               |
| Private external debt to GDP (2000)              | 1.3     | 0.4    | 5.3     | 0.0     | 1.6                |
| Trade flows to GDP (1999–2002)                   | 94.0    | 90.2   | 281.9   | 25.8    | 53.0               |
| Government balance to GDP (1996–2002)            | -2.2    | -2.1   | 18.9    | -20.4   | 6.0                |

Sources: IMF, *International Financial Statistics* and *World Economic Outlook* databases; and Bankscope.

- The ITL countries tend to have shallower financial systems (Table 7.4). The ratio of broad money to GDP is more than 50 percent lower for the ITL group compared with the two other regimes. Further, median stock market capitalization of the ITL countries is about half that in the FFIT (Table 7.5) and FXR (Table 7.6) groups.
- ITL countries are less integrated into international capital markets. In particular, portfolio equity inflows are much higher for the FFIT than the other groups (Tables 7.4–7.6). The limited integration with capital markets may well reflect capital controls.
- ITL countries have a higher level of government debt. The fiscal balances during 1996–2002 across the three groups are broadly comparable. However, ITL countries have median government debt one-third higher than the FFIT countries. Further, the FFIT countries have much tighter restrictions on central bank financing of the government compared with the ITL countries (Tables 7.4–7.6).

**Table 7.6. Full-Fledged Inflation Targeting (FFIT) Monetary Regimes: Summary Statistics**

| Key indicators                                   | Average | Median | Maximum | Minimum | Standard deviation |
|--|---------|--------|---------|---------|--------------------|
| S&P local currency government debt rating (2001) | 10.0    | 11.0   | 12.0    | 6.0     | 2.1                |
| GDP in billions of U.S. dollars (2000)           | 217.1   | 122.2  | 593.7   | 48.4    | 213.8              |
| Per capita GDP in U.S. dollars (2000)            | 5,673   | 4,728  | 18,289  | 1,920   | 4,702              |
| Money to GDP (2001)                              | 62.9    | 57.2   | 108.0   | 25.2    | 30.5               |
| Stock market capital to GDP (2000)               | 45.7    | 26.3   | 162.8   | 11.8    | 44.2               |
| Equity flows to GDP (2000)                       | 0.65    | 0.64   | 1.69    | 0.00    | 0.54               |
| Private external debt to GDP (2000)              | 3.4     | 3.6    | 8.4     | 0.7     | 2.3                |
| Trade flows to GDP (1999–2002)                   | 76.4    | 64.4   | 133.9   | 25.6    | 34.8               |
| Government balance to GDP (1996–2002)            | –3.2    | –3.6   | 0.2     | –6.6    | 2.0                |

Sources: IMF, *International Financial Statistics* and *World Economic Outlook* databases; and Bankscope.

- ITL countries are probably more exposed to economic shocks. Emerging market countries are more dependent on commodities and are thus more exposed to supply shocks than industrial countries (Agénor and others, 1999). ITL countries are probably more vulnerable to shocks owing to their relatively low development compared with FFIT and FXR countries.

The structural differences between the three regimes may help to explain why ITL countries have the lowest measured monetary policy credibility relative to emerging market FFIT and FXR countries. Their lower level of measured credibility can be attributed to their higher level of government debt, less developed financial systems, and vulnerability to economic shocks.

The indicators also suggest that ITL countries focus on the attainment of single-digit inflation, as well as financial stability. By definition, ITL countries do not have explicit numerical objectives.

However, ITL countries have tighter distribution of the exchange rate than do emerging market FFIT countries, reflecting their weaker integration with international capital markets and more interventionist foreign exchange policy. Further, the distribution of ITL country inflation is mostly in the single digits—though a significant share exceeds 25 percent, a much higher share than the other two regimes. This comparison suggests that price stability is an ongoing challenge for some ITL countries and that if there were a single general objective for ITL countries, it would be to keep inflation in the single digits. Finally, financial stability is likely to be crucial for ITL central banks, given their relatively less domestically developed financial system and vulnerability to shocks.

The low level of policy credibility and lack of an explicit single objective for ITL countries indicates that ITL can be viewed as a transitional monetary regime. Clearly, a monetary policy regime founded on a single nominal anchor is preferable to ITL. However, adoption of a single anchor regime—followed by its abandonment—would be costly to monetary policy credibility. Thus, ITL can be viewed as a transitional regime aimed at maintaining monetary stability while structural reforms are implemented in support of a single nominal anchor.

## **Monetary Policy for ITL Central Banks**

ITL banks face formidable challenges. Monetary operations for any central bank are aimed at smoothing the impact of temporary liquidity shocks and attaining the objectives of monetary policy. Monetary operations for an ITL central bank are complicated by multiple policy objectives and undeveloped financial systems. This section assesses the challenges in the operation of monetary policy. The emphasis is on those elements that are largely under the control of a central bank, with a view toward arriving at policy suggestions and addressing unresolved policy questions.

## **Domestic Operating Targets and Instruments**

Monetary operations are relatively straightforward for FFIT and FXR countries. The single policy anchor of FFIT countries logically leads to a single operating target implemented primarily by one monetary instrument. FFIT countries have financial markets sufficiently developed to allow open market operations. A short-term interest rate operating target is used by all but one FFIT central bank

to steer forecasted inflation to the inflation target (Carare and others, 2002).<sup>3</sup> Under FXR regimes, monetary operations are relatively passive. At one end of the exchange rate fixity spectrum is a currency board under which reserve money moves closely with international reserves and interest rates adjust in line with those in the reserve currency country (Baliño and Enoch, 1997). At the other end is a crawling exchange rate band whereby domestic interest rates are used mainly to keep the exchange rate within the band.

ITL countries employ a mixed bag of operating targets and instruments. These include short-term interest rates, the exchange rate, and quantity targets (not just bank balances with the central bank but also base money growth; see Table 7.7). Most ITL countries use a variety of market and nonmarket monetary instruments, including open market operations (OMOs) with repos and outright sales and purchases of government securities. Standing facilities and direct instruments of monetary policy (such as credit limits and interest rate controls) are also used. For several ITL countries, unsterilized foreign exchange operations are the main instrument.

This wide spectrum of operating targets and instruments reflects not only the multiple policy objectives of ITL countries, but also a general lack of key financial system elements needed for open market operation instruments. A deep and liquid interbank market reduces reliance on the central bank for intermediating transactions, and it ensures broad distribution of the issuance of central bank paper. Deep and liquid securities markets can be used by the central bank to conduct open market operations. A reasonable number of healthy commercial banks, serving as counterparties in central bank operations, facilitates smooth monetary operations by minimizing credit risk and enhancing market competition for the main instrument. The shallower financial systems and less market-oriented monetary operation procedures of the ITL countries entail real costs. Indeed, the median real interest rate from 1998–99 was 12.4 percent compared with 9.9 for the FFIT countries (Carare and Stone, 2003).

A more developed financial system benefits monetary operations, so it is in the interest of the central bank to do what it can to spur financial reforms. Many steps incur little or no budgetary or political costs. Central banks can educate the public on the benefits of reform, including lower fiscal costs and higher economic growth. In addition, central banks can push ahead with changes on a technical level, for example, improving coordination on treasury operations and public debt management, and establishing more efficient payment systems.

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<sup>3</sup>The exception is the Bank of Mexico, which targets the aggregate commercial bank current account balance (the *corto*).

**Table 7.7. Inflation Targeting Lite Countries:  
Operating Targets and Monetary Policy Instruments**

|                    | Operating target   | Main monetary policy instruments  |
|--------------------|--|---|
| Albania            | One-week repo rate   | One-week repos  |
| Algeria            | Amount of refinancing to state-owned commercial banks                | Rediscount facility, credit auctions, repo standing facility, open market operations (one operation carried out in 1996)                          |
| Croatia            | Exchange rate path, interest rates                                   | Repo auctions, domestic and foreign currency-denominated Croatian National Bank bills, reserve requirements, foreign exchange intervention        |
| Dominican Republic | Interest rates and exchange rate                                     | Reserve requirements, credit limits, induced sales of securities to banks, sporadic open market operations  |
| Guatemala          | Short-term interest rates and monetary aggregates                    | Open market operations with central bank securities   |
| Honduras           | Reserve money growth   | Open market operations and some indirect instruments  |
| Indonesia          | Base money growth  | Open market operations with central bank paper and foreign exchange intervention  |
| Jamaica            | Reserve money growth   | Open market operations  |
| Kazakhstan         | Exchange rate path and reserve money growth                          | Open market operations, credit facility and official rate regulation, refinancing of banks through registered bills                               |
| Mauritius          | Lombard rate   | Open market operations  |
| Peru               | Average monthly current account balance of banks at the central bank | Open market operations with central bank certificates of deposit, monetary regulation credit and purchases of foreign exchange in the spot market |
| Philippines        | Repo rate  | Open market operations with repos   |
| Romania            | Interest rate and exchange rate paths                                | Open market operations, standing facilities, foreign exchange operations  |

Source: Carare and Stone (2003).

### Exchange Rate Intervention

ITL countries tend to intervene in foreign exchange markets more often than FFIT countries (Table 7.8), though less often than FXR countries. Most FFIT countries intervene at least occasionally (Table 7.9). Most do so, they say, to smooth fluctuations and offset the impact of exchange rate changes on inflation, rather than to adhere to an

**Table 7.8. Central Banks' Foreign Exchange Market Interventions in Full-Fledged Inflation Targeting (FFIT) Countries, 2001**

| Publicly reported central bank interventions |   |
|--|---|
| Brazil                                       | The Central Bank of Brazil may intervene on a regular basis to adhere to the inflation target or in exceptional situations.   |
| Chile  | The Central Bank of Chile has the authority to intervene in exceptional circumstances; these interventions must be publicly announced and justified.  |
| Colombia                                     | The central bank does not intervene in the exchange market to define a particular exchange rate, although auctions of foreign currency sale options are used to accumulate international reserves.  |
| Czech Rep.                                   | Interventions only to moderate large fluctuations in the exchange rate.   |
| Hungary                                      | The National Bank of Hungary intervenes to maintain the forint in a plus or minus 15 percent band.  |
| Israel                                       | The Bank of Israel has not intervened since 1997, allowing market forces to determine the appropriate level of the exchange rate within the confines of the exchange-rate band. The width of the band against a basket of currencies is 39.2 percent. |
| Korea  | The Bank of Korea has intervened in the foreign exchange market in recent years.  |
| Mexico                                       | The Bank of Mexico lets the peso float freely.  |
| Poland                                       | A pure floating exchange rate regime has been in place since April 2000.  |
| South Africa                                 | The Reserve Bank did not intervene in the foreign exchange market during 2000 except to buy foreign exchange to lower the net open foreign exchange position.   |
| Thailand                                     | Direct foreign exchange intervention is limited.  |

Sources: Central bank websites, annual reports, and publicly available IMF documents.

exchange rate objective. Obviously, FXR countries intervene quite actively in support of their anchor.

ITL countries are likely to intervene more often because they are smaller and have thin foreign exchange markets, and are thus more susceptible to foreign exchange fluctuations. Some ITL central banks report intervention only to limit exchange market volatility, while others state that they intervene with a view to influencing the exchange rate to maintain external competitiveness. The volatility of international

**Table 7.9. Central Banks' Foreign Exchange Market Interventions in Inflation Targeting Lite (ILT) Countries, 2001**

| Publicly reported central bank interventions |   |
|--|---|
| Albania                                      | The Bank of Albania undertakes limited foreign exchange interventions to help smooth excessive fluctuations.  |
| Algeria                                      | The Bank of Algeria manages the exchange rate float in a flexible way to safeguard competitiveness and dampen external shocks.  |
| Croatia                                      | The Central Bank of Croatia intervenes on the foreign exchange market through foreign exchange auctions, but does not defend any predetermined exchange rate or band.   |
| Dominican Republic                           | The Central Bank of the Dominican Republic increased exchange rate flexibility during 2000 (adjusting it weekly) in response to high private sector demand for foreign exchange. The exchange rate spread widened to 2 percent, followed by a devaluation of the same amount.   |
| Guatemala                                    | The Bank of Guatemala intervenes to maintain stable currency.   |
| Honduras                                     | The National Bank of Honduras intervenes to maintain external competitiveness of the currency.  |
| Indonesia                                    | Sterilized increases in the supply of foreign exchange to the market are undertaken to control base money and to mitigate depreciation pressure and exchange rate volatility.   |
| Jamaica                                      | Intervention to smooth demand pressures.  |
| Kazakhstan                                   | The Central Bank of Kazakhstan intervenes to keep the currency within a certain band because of large capital inflows.  |
| Mauritius                                    | The Bank of Mauritius intervenes, as and when necessary, mainly to signal perceived misalignments of the exchange rate.   |
| Peru   | The Central Reserve Bank of Peru undertakes foreign exchange operations to restore financial market confidence in conditions of high foreign exchange rate volatility.  |
| Philippines                                  | The central bank of the Philippines occasionally enters the foreign exchange market, largely to maintain order and stability in the foreign exchange market to dampen sharp fluctuations in the exchange rate.  |
| Romania                                      | The National Bank of Romania has intervened regularly to maintain the exchange rate within a band.  |
| Russia                                       | During 2000, the Bank of Russia bought foreign exchange in the domestic market to replenish international reserves, took timely and purposeful steps to smooth sharp exchange rate fluctuations in the domestic foreign exchange market caused by transient factors, and prevented the ruble from getting too strong in real terms. |



**Table 7.9. (concluded)**

| Publicly reported central bank interventions |   |
|--|---|
| Slovak Republic                              | The National Bank of Slovakia may intervene in the event of excessive volatility in the crown exchange rate through foreign exchange transactions.                        |
| Slovenia                                     | The Bank of Slovenia has intervened recently in the foreign exchange market to offset the impact of exchange rate changes on prices and complement interest rate actions. |
| Sri Lanka                                    | The Central Bank of Sri Lanka participates actively in the foreign exchange market, through buying and selling foreign exchange at or near market prices.                 |
| Uruguay                                      | Crawling band of 15 percent, economy highly dollarized, therefore primary objective of the monetary policy is to keep the currency stable.                                |
| Venezuela                                    | The Central Bank of Venezuela promotes orderly behavior of the exchange rate within the framework of a scheme of floating exchange bands.                                 |

Sources: Central bank websites, annual reports, and publicly available IMF documents.

reserves also demonstrates that ITL countries have more active intervention practices compared with the FFIT countries (data available from the author).

### Policy Formulation

Policy formulation under ITL is more opaque than under FFIT and FXR regimes. Since FFIT countries essentially use an inflation forecast as the intermediate guide to monetary policy, they will employ all available inflation information when formulating policy. The policy stance of FXR countries is basically driven by the deviation of the exchange rate from its target.

In practice, ITL policy formulation depends on the relative weights given to the exchange rate, inflation and other objectives, policy transmission channels, the horizons over which objectives are pursued, and the duration of shocks to the objectives. A central bank that aims to influence the exchange rate to maintain export competitiveness during long-term disinflation may therefore undertake frequent foreign exchange intervention to maintain the exchange rate in the desired range and conduct monetary operations less frequently so that the level of liquidity stays consistent with the downward path of inflation.

A central bank with a preannounced annual inflation objective—but lacking most elements of the FFIT framework—can undertake frequent monetary operations to keep domestic monetary conditions supportive of the inflation target while reacting to exchange rate shocks with intervention in the foreign exchange markets.

### Transparency

The less sophisticated monetary operations of ITL countries can impose real costs if companies and households cannot anticipate policy decisions that impact their economic decisions. What can the central bank do in the context of multiple objectives and an undeveloped financial system?

One option may be to improve operational transparency. As noted above, ITL countries are not very transparent in either the objectives or operations of monetary policy. In particular, the use of nonmarket instruments by many ITL countries and the thin markets of those who do make it more difficult for the markets to understand and anticipate policy changes. In addition, foreign exchange interventions seem less transparent for ITL than FFIT central banks. In this light, the central bank could consider letting the markets know when it is intervening to influence the exchange rate, inflation, or to smooth temporary shocks. Transparency may help reduce confusion by clarifying for the markets what the central bank is doing—intervening in domestic and foreign exchange markets to smooth liquidity shocks, to influence inflation, or affect the exchange rate. Another advantage of transparency is to provide an incentive for consensus on difficult operational issues within the central bank. On the other hand, greater operational transparency could also increase confusion—because in the absence of explicit objectives, the markets may not believe the stated reasons for intervention.

Consideration of operational transparency raises the broader issue of greater ITL central bank transparency with respect to its policy objectives. Transparency is indispensable to FFIT because lags in policy transmission impede ongoing public monitoring of the inflation target. Under an FXR regime, transparency is less of an issue because adherence to the exchange rate target is easily observed. It may not be in the interest of an ITL central bank to clearly commit to an inflation target because such a commitment could raise output variability and financial instability in the context of the economy's vulnerability to shocks and less-developed financial system. Further, inflation will be driven by factors beyond the control of the central bank, such as the strength of the country's fiscal position.

## Financial Stability

The central banks of ITL countries seem to put more emphasis on financial stability than those of FFIT countries, but less than FXR central banks (Table 7.10). Financial stability can be defined as low vulnerability to systemic crisis (that is, a severe disruption to the financial markets) that by impairing markets' ability to function has large, adverse effects on the real sector. Countries with the credibility to commit to FFIT will generally enjoy a high level of financial stability. Conversely, many FXR central banks are potentially exposed to a speculative attack on their currency. The relatively flexible exchange rate of ITL countries leaves them less exposed to crisis-inducing one-way bets (compared with the FXR countries), and their financial sectors are relatively small. Still, relatively shallow financial markets and the lack of hedging instruments do leave ITL countries exposed to systemic crises.

Interestingly, the lower transparency of the ITL monetary policy framework might be an advantage in dealing with financial crises. Constructive ambiguity is needed in the lender-of-last-resort role of the central bank. This addresses the contagion and moral hazard problems inherent in potential bailouts of banks that can be deemed "too big to fail" (Goodhart and Huang, 1999; Goodfriend and Lacker, 1999; Enoch and others, 1997). FFIT countries face a potential conflict between inflation and financial stability objectives in that the clarity they need to hold themselves accountable to the inflation target may lead to the moral hazard problems of bank bailouts. The generally greater financial stability of FFIT countries could reduce this conflict and allow them to commit explicitly to an inflation target (Carare and Stone, 2003).

**Table 7.10. Emerging Market Country Central Banks:  
Self-Reported Monetary Policy Objectives<sup>1</sup>**

|  | Inflation<br>focus | Financial<br>stability<br>focus | Multiple<br>objectives |
|--|--------------------|---------------------------------|------------------------|
| Inflation targeting lite (12) <sup>2</sup> | 44.0               | 37.5                            | 47.0                   |
| Full-fledged inflation targeting (9)       | 88.0               | 33.0                            | 28.0                   |
| Fixed exchange rate (18)                   | 10.0               | 42.0                            | 36.0                   |

Source: Fry and others (2000).

<sup>1</sup>Central bank frameworks that aim at the objectives receive a higher score.

<sup>2</sup>Number of countries with available data in parentheses.

## **Life After ITL: The Transition to a Single-Objective Monetary Regime**

This section reviews the transition from ITL to a hard exchange rate target or FFIT regime. The disadvantages of a multiple objective framework suggest that ITL countries should switch to a single-objective monetary regime. However, by definition ITL countries lack the credibility to simply do so.

There are good reasons why ITL countries should begin the transition as soon as credibility permits. First, a credible announcement of a commitment to an anchor may generate some of the benefits of a single-objective policy. Second, public discussion of the benefits of a single anchor can help motivate the fiscal and structural reforms needed for credibility. Third, a period of transition may be needed to lay the institutional groundwork for the new regime.

Monetary regime choices range along a spectrum defined at each end by hard commitments to an exchange rate and inflation targets:

1. Dollarization,
2. Currency board arrangement (CBA),
3. Pegged exchange rate,
4. ITL,
5. EIT, and
6. FFIT.

Most ITL countries are likely eventually to adopt either a hard exchange rate or FFIT regime. Dollarization imposes such a great loss of national currency that it is usually appropriate only under special circumstances such as a severe financial crisis or political union. The declining popularity of exchange rate pegs for emerging market countries reflects the loss of independent monetary policy for offsetting economic shocks, as well as greater vulnerability to a speculative attack.<sup>4</sup> Exchange rate pegs are more viable with capital controls, but controls that allow sufficient exchange rate autonomy for a relatively developed and sizable emerging market country are in most circumstances not conducive to economic prosperity. Finally, high credibility precludes EIT as an option for ITL countries. Therefore, this section focuses on the adoption of a Currency Board Arrangement or FFIT regime.

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<sup>4</sup>Indeed, according to Fischer (2001), "economies open to international capital flows have been and are in the process of moving away from adjustable peg exchange rate systems, some towards harder pegs, more towards systems with greater exchange rate flexibility."

## The Transition to a Currency Board Arrangement

In mid-2001, five medium and large emerging market countries adhered to a CBA.<sup>5</sup> Established CBAs have the advantages of high credibility and more resistance to speculative attack (Baliño and Enoch, 1997). Disadvantages include the central bank's loss of ability to offset economic shocks and to serve as the lender of last resort. Countries adopting a CBA seem to have had a favorable macroeconomic performance (Ghosh, Gulde, and Wolf, 2000). They adopted CBAs either to reduce high rates of inflation or for country-specific institutional reasons.

The preconditions for a CBA are demanding. First, a strong fiscal position is needed for the inherent discipline to back a credible switch to a CBA. Second, the foreign reserve position of the central bank must be sufficient to back most or all of the monetary base. Third, the banking system should be strong enough to have depositors' confidence, so that withdrawals do not force the central bank to provide banks with liquidity, which is especially problematic under a CBA. Finally, a political consensus must support of the move to a CBA.

Adopting a CBA entails a series of often contentious policy and technical decisions and institutional changes (Enoch and Gulde, 1997). A currency peg must be designated, and the initial level of the peg must be decided. Legal changes are required, including a new CBA law. Some countries have set up a separate institutional entity to hold the foreign reserves underlying the CBA. Most have taken measures to improve the quality of bank supervision and have made special lender-of-last-resort arrangements. Restrictions are imposed on government financial operations to preclude borrowing from the CBA and to facilitate liquidity management.

In the transition to a CBA, the first step is to announce a realistic timetable. It must allow a realistic period for implementing the requisite operational and institutional changes. At the same time, an overly long transition period could reduce credibility and increase the odds of an exchange rate misalignment, complicating the all-important decision on the level of the peg. Once the transition process is well along, the level of the peg can be determined and announced. Thereafter, a floating exchange rate can be expected to move toward the level of the peg. In the meantime, exchange rate volatility can be limited by a preannounced band that narrows as the CBA adoption date approaches.

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<sup>5</sup>The medium and large emerging market countries with a CBA are Brunei (1967), Bulgaria (1997), the People's Republic of China, Hong Kong SAR (1983), Estonia (1992), and Lithuania (1994).

### Transition to FFIT<sup>6</sup>

FFIT is fast gaining popularity with emerging market countries. From 1997 to 2001, the number of emerging market countries with FFIT rose from none to 11. During 2002, Peru and the Philippines adopted this framework, and other emerging market countries are considering its adoption. FFIT has been adopted in the wake of exchange rate crises, high inflation, poor overall economic performance, and prospective accession to the European Monetary Union. Most emerging market countries switched from a crawling exchange rate band to FFIT. FFIT has not been used to engineer major disinflation from a starting point of high inflation, although Turkey may yet prove to be a test case. The relatively large number of emerging countries recently adopting FFIT have provided a good experiential base for ITL countries considering the switch.

As with a CBA, the switch to FFIT may be risky if the central bank begins, or even announces, the beginning of a transition period without supporting structural changes. First, a strong fiscal position and limits on central bank financing of the government are essential for successful operation. Emerging market countries undergo significant financial deepening before adopting FFIT. Typically, the adoption of FFIT is part of broad and successful policy reforms that facilitate price stability over and above monetary policy. Indeed, the adoption of FFIT can itself serve as a mechanism to improve long-run credibility.

Many countries moving toward FFIT slowly introduced market-based instruments of monetary policy. Furthermore, most FFIT central banks have made important organizational changes to promote decentralized information gathering from a variety of sources. In particular, many central banks have had to enhance their analytic capacities and reorient their economic analysis and data management activities toward gathering data and building the models to generate regular inflation forecasts. Identifying the main transmission channels from the policy short-term interest rate to inflation is a major challenge.

Emerging market countries must be especially careful in timing the adoption of FFIT. When FFIT is motivated by a crisis or high inflation, time must pass to allow the buildup of sufficient credibility. Thus, most emerging market countries undergo a transition period prior to adopting FFIT. The transition begins by announcing the intention to adopt inflation targeting, often by choosing an inflation target in the context of an exchange rate band. The transition ends when most elements of the FFIT framework are in place.

<sup>6</sup>This section draws on Schaechter and others (2000) and Carare and Stone (2003).

Emerging market countries have made both slow and fast transitions to FFIT. The choice between gradual or fast-track transition reflects the initial level of inflation. Emerging market countries usually adopt FFIT during periods of recession and disinflation, presumably to enhance credibility.

The central bank can play a key role in signaling an imminent commitment to FFIT. It should push for legal framework reform to establish price or currency stability as the central bank objective. It needs instrument independence, and ideally, goal dependence in the form of a government commitment to the inflation target and limits on central bank financing of the government. A joint government/central bank announcement of a long-term inflation target and an interim path greatly facilitates disinflation. Interestingly, emerging market countries tend to make these changes before or at the adoption of FFIT, while industrial countries have sufficient credibility to make the necessary changes after switching to the new regime. Finally, the central bank can take the lead in educating the public about the workings and benefits of FFIT.

### **Implications of the Switch to a Single Nominal Anchor for ITL Monetary Policy**

What are the implications of the imminent adoption of a CBA or FFIT regime for an ITL country? A view on which regime works best under what circumstances is not offered here. However, imminent adoption of a CBA or FFIT regime has important similarities and differences for ITL monetary policy.

Announcing the intention to adopt either CBA or FFIT can bring important benefits. Most important, articulation of the specific prerequisites for the success of either can focus public discussion and political will on fiscal and structural reforms. The announcement of a single objective eases the problems that multiple objectives cause for monetary policy. For example, the setting of a single operating target and main monetary instrument in support of the objective should reduce uncertainty.

Some countries have used announcement of the intention to adopt an FFIT to begin a period of disinflation (Mahadeva and Sterne, 2002). Chile and Israel, for example, distinguished between the long-run inflation goal and interim inflation targets. By using annual targets to adjust the speed of disinflation and by taking advantage of unexpected disinflation opportunities, they probably moderated the real costs of reducing inflation while maintaining their strong commitment to long-run control.

The greater loss of discretion under a CBA means that the central bank loses policy flexibility once it announces the switch. The transition period can thus be risky because the same factors prompting the ITL regime can undercut the precommitment to a CBA. This suggests a shorter CBA transition relative to an FFIT transition, and that the benefits of announcing the imminent adoption of a CBA could be less than that of precommitting to an FFIT.

## Conclusion and Policy Questions

Many emerging market countries use but are unable to maintain inflation targets as the foremost policy objective of their monetary policy framework. This paper assesses the monetary policy of ITL countries with a view toward identifying unresolved central bank policy questions. ITL countries are not clear in their commitment to an inflation target, and they have relatively low measurable credibility. They use an inflation target to define their monetary policy framework but are unable to fully subordinate other objectives to the inflation target. Although ITL is not usually considered a “monetary framework,” as is an exchange rate peg or FFIT, it is nevertheless widely practiced and therefore warrants careful analysis.

Comparisons suggest that countries’ revealed preference for ITL reflects their structural differences. The relatively low level of measurable policy credibility of ITL countries can be linked to shallow financial markets, high levels of government debt, and vulnerability to economic shocks. The data suggest that ITL countries focus on the attainment of single-digit inflation and financial stability, including through relatively interventionist exchange rate policy. Further, ITL can be viewed as a transitional regime that buys time to implement the structural reforms needed for a single, credible nominal anchor.

This lack of a single unifying policy objective and the less developed financial systems create unique monetary policy challenges for ITL central banks. The limited menu of targets and instruments complicates monetary operations. Exchange rate policies must contend with the unclear role of the exchange rate in the monetary framework. Financial stability also poses an important challenge.

Ideally, ITL countries move to a single nominal anchor once a sufficient level of credibility is established through fiscal, financial, and structural reforms. The main choices would seem to be a hard exchange rate (for example, a CBA) or an FFIT. Once a decision is made to formulate the transition to the new regime, many countries’ experiences can be drawn upon for guidance.



The purpose of this paper is to raise questions and stimulate analysis—and indeed, many unresolved central bank policy questions require answers.

*1. Should ITL central banks make monetary policy more transparent on the operational level?*

The operation of monetary policy under ITL is generally less transparent than under other regimes. Operational transparency could be boosted, at a minimum, by public description of the main operational targets and instruments. Transparency could be furthered by publishing detailed liquidity forecasts on, say, a one-month horizon. In addition, the central bank can tell the markets whether it is intervening in domestic and foreign exchange markets to smooth liquidity shocks or influence inflation or the exchange rate.

Clarification could help smooth the impact of short-term liquidity shocks by separating liquidity smoothing from policy-objective interventions. Greater transparency could also enhance information for more efficient financial markets. Transparency also provides an incentive for the formulation of a consensus on difficult operational issues within the central bank. Finally, transparency fosters a better understanding of how money markets and monetary policy work, educating both politicians and the public on the benefits of financial reform.

On the other hand, greater operational transparency can promote confusion. Lacking explicit objectives, the markets may not believe the reasons stated for intervention. In addition, greater operational transparency reduces the central bank's scope for discretion. Further, during disinflation, annual inflation targets on the downward path to the long-run inflation level may be state-contingent (in the sense that central banks may want to lock in unexpected inflation gains by moving to a lower-than-envisaged target). This state-contingency complicates the design of monetary operations by confounding the interest rate and inflation objectives. Thus, the timing of the enhancement of operational transparency would require that the central bank have sufficient credibility to be trusted by the markets on an operational level and be effectively able to adopt operational rules.

*2. Should the ITL central bank be transparent in its monetary policy objectives?*

Transparency with respect to the objectives of monetary policy varies widely among central banks, notwithstanding the trend toward increased transparency in recent years (Eijffinger and Geraats, 2002). The lack of transparency of ITL countries reflects their need for flexibility to smooth the output shocks to which they are highly susceptible,

and the disadvantages of transparency in maintaining stability of the financial system. However, the lack of transparency advantageous for output and financial stability conflicts with the high degree of transparency needed for a credible FFIT.

An argument can be made that ITL central banks should be transparent with respect to the *objective* of price stability. Of course, price stability is less precise and not so easily monitored as a numerical target. Still, a formal and regular (perhaps annual or quarterly) public central bank discussion of price stability *ex ante* and *ex post* may be beneficial. In addition, transparency may help insulate monetary policy from political pressures. These may be more pronounced for ITL countries, given their weaker fiscal positions (Debelle, 2001).

Beyond the price stability objective, transparency is probably more a matter of degree and judgment and is very much conditional upon the circumstances of the country. ITL countries with a high weight on either inflation or the exchange rate may have scope for a more transparent policy, especially if they aim to adopt an FFIT or a CBA monetary regime. In contrast, ITL countries with a fragile financial system may want to afford themselves more flexibility.

### *3. How can the ITL central bank motivate financial reforms in support of a more effective monetary policy?*

Central banks can take the lead in educating market players and households with a view to building the political support needed for broad financial reforms. A developed financial system not only improves monetary operations but lowers the cost of government financing and generally enhances economic growth. The central bank is the best-placed government institution to understand the benefits of a deep and broad financial system and can thus articulate the case for reforms. Of course, central banks can push only so far without backing from other government institutions, especially when it comes to reforms whose fiscal and other benefits are more subtle and are realized only over the long run—for example, paying market interest rates on government securities or recapitalizing the central bank.

Central banks should ensure that they identify and implement the more technical measures that have limited political and budgetary consequences. Less costly measures can be undertaken in the areas of liquidity forecasting and security market infrastructure. Measures in these areas can set the stage for the realization of the benefits of broader reform.

*4. Should ITL central banks announce a commitment to a CBA or FFIT in the long run to bring forward some of the advantages of a single-anchor monetary regime?*

A commitment to a single anchor could help motivate fiscal and structural reforms by focusing attention on the measures needed to gain the credibility for a single objective. Imminent adoption of a single anchor would help concentrate market expectations and could thus foster disinflation. Further, a commitment would allow the central bank to better focus monetary operations, for example, by adopting a single operating target and main instrument. Finally, imminent adoption of a single anchor would increase the scope for policy transparency. The commitment could take the form of a joint public announcement of an explicit inflation target by the government and the central bank.

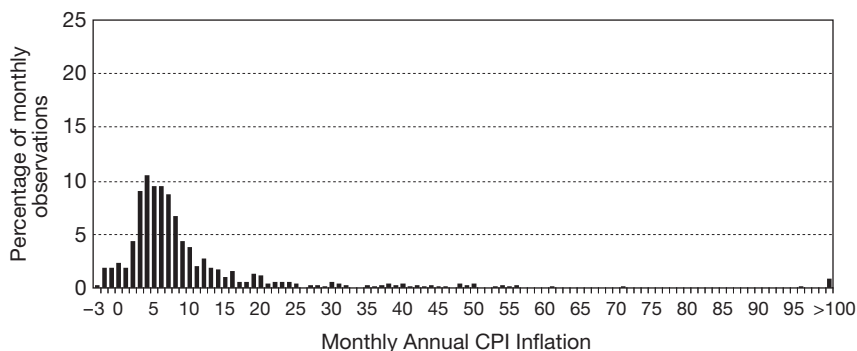
The main disadvantage of a commitment is the possibility of costly reneging due to insufficient support for fiscal and structural policies. In addition, commitment to a single anchor reduces the policy options and could thus backfire in a particularly fluid environment. Indeed, the credibility needed to realize these benefits rests largely on factors beyond the control of the central bank. The apparently shorter period between announcing and adopting a CBA (versus an FFIT) raises the possibility that the benefits of announcing an imminent CBA are less than for precommitting to an FFIT.

*5. When is credibility sufficient to allow the announcement of a commitment to a single-anchor monetary regime?*

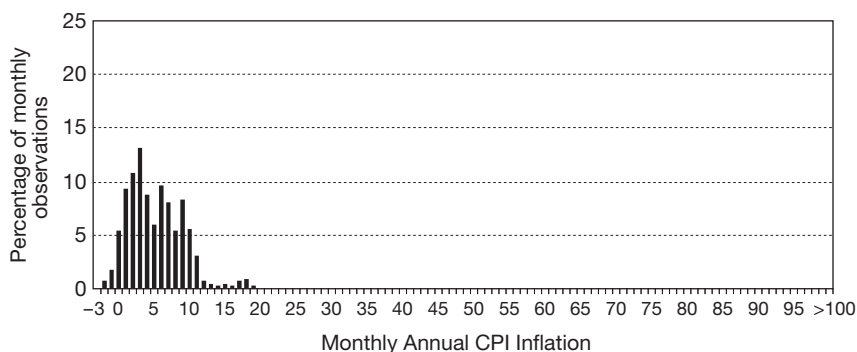
Timing the exit from ITL to a single-anchor monetary regime poses a difficult challenge. The low level of policy credibility and lack of an explicit single objective for ITL countries indicates that ITL can be viewed as a transitional monetary regime. Clearly, a regime founded on a single nominal anchor is preferable to ITL. However, adopting a single-anchor regime before structural reforms are fully entrenched could be highly costly to credibility if the new anchor is subsequently abandoned.

The issuance of long-term, local-currency government debt would provide a market-based benchmark of monetary policy credibility. Further, debt ratings close to those enjoyed by single nominal anchor countries would be a useful timing benchmark. The S&P long-term domestic-currency government debt ratings of the 11 emerging market FFIT countries at the time of their adoption of this regime ranged from BBB to A.

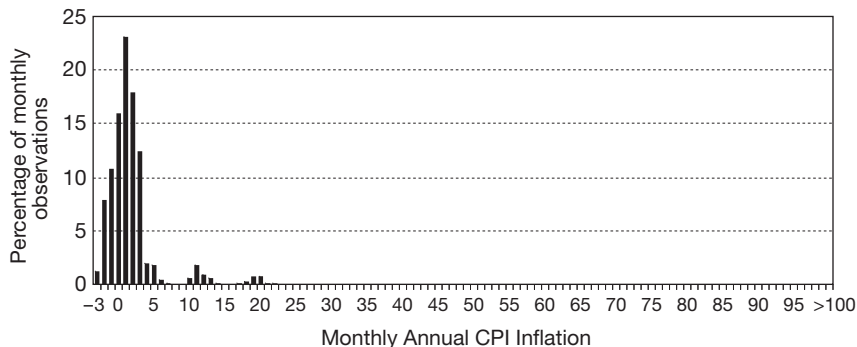
**Figure 7.1a. ITL Countries: Year over Year Monthly  
CPI Inflation Density, January 1999–May 2002**



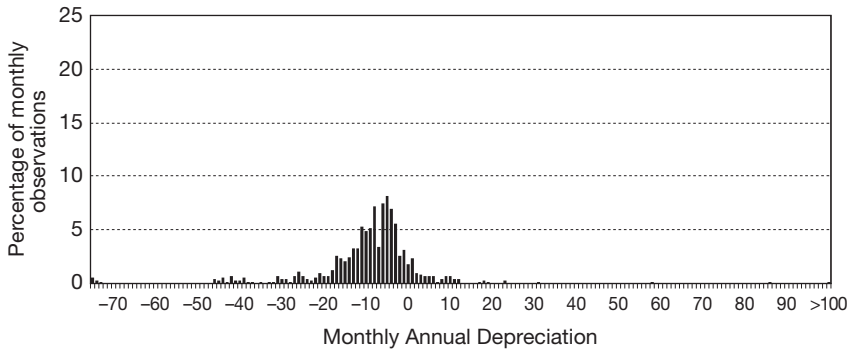
**Figure 7.1b. FFIT Countries: Year over Year Monthly  
CPI Inflation Density, January 1999–May 2002**



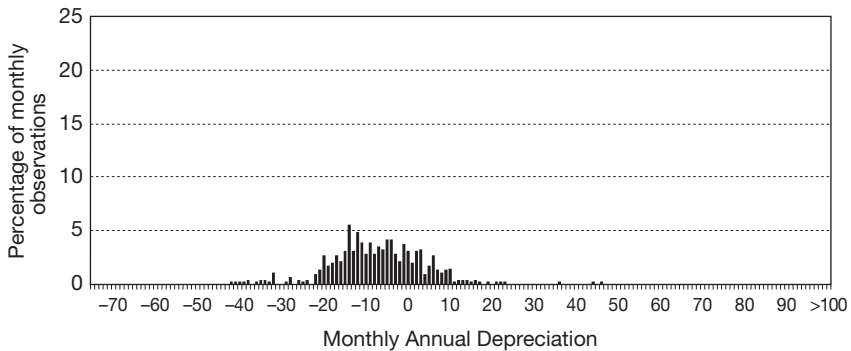
**Figure 7.1c. FXR Countries: Year over Year Monthly  
CPI Inflation Density, January 1999–May 2002**



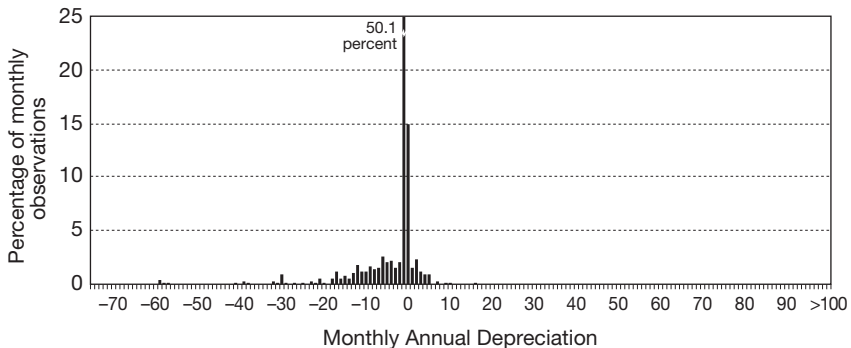
**Figure 7.2a. ITL Countries: Year over Year Monthly Exchange Rate Change Density, January 1999–May 2002**



**Figure 7.2b. FFIT Countries: Year over Year Monthly Exchange Rate Change Density, January 1999–May 2002**



**Figure 7.2c. FXR Countries: Year over Year Monthly Exchange Rate Change Density, January 1999–May 2002**



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