VI Transitioning to Full-Fledged Inflation Targeting

This section addresses how the role of the exchange rate can be designed to facilitate the transition to inflation targeting for emerging economies. Many emerging economies with other anchors are transitioning or aiming to transition to an inflation-targeting framework (Stone, 2003; Roger and Stone, 2005). They operate with a flexible exchange rate and some sort of inflation objective, although the central bank is not held formally accountable and the priority of policy objectives can be unclear. The policy framework is relatively ad hoc in many respects, with the exchange rate playing an important yet poorly defined role. Compared with inflation-targeting economies, these economies' policy frameworks are less amenable to modeling and pose a qualitatively different set of policy challenges. This section addresses how these countries can improve policy effectiveness and, ultimately, transition to inflation targeting.[42]

The available information suggests that emerging economies with other anchors manage their exchange rates more actively than inflation-targeting economies. In addition, their exchange rate regime arrangements are somewhat more rigid, they have much higher reserve volatility, and they have more volatile nominal exchange rates than inflation-targeting emerging economies (see Tables 2.1 and 2.2). They also have relatively stable real effective exchange rates, indicating that pass-through is high and monetary policy credibility is relatively low. In some cases, this could also indicate real exchange rate targeting.

These economies' relatively high levels of exchange rate management and volatility suggest they may be more vulnerable to exchange rate shocks. Indeed, as noted in Section III, the emerging economies with other anchors that have flexible exchange rates are typically less financially developed and more dollarized and their monetary policy credibility indicators are generally weaker. Their less systematic approach to policy can result in shifting monetary policy objectives that can also contribute to exchange rate volatility.

The monetary operations of emerging economies with other anchors tend to be based on foreign exchange intervention and are more ad hoc and less market based than those of inflation-targeting advanced or emerging economies (see Table 2.1). Their announced intervention objectives are oriented toward stabilizing markets, smoothing exchange rate fluctuations, and enhancing competitiveness. The intervention framework is less transparent, and the link between intervention activities and policy objectives is usually not explicit. Intervention is often unsterilized, which may be the result of a lack of sterilization instruments and undeveloped money markets rather than an explicit policy choice. Sterilization may also be limited by the costs to the central bank or to the government of issuing liquidity-absorbing instruments.

Policy is generally less transparent in emerging economies with other anchors than in countries with full-fledged inflation targeting (see Table 3.3; Roger and Stone, 2005). The multiplicity of objectives and uncertainty regarding the linkage between policy objectives and policy instruments make it more difficult for policymakers to explain their policy actions, especially when their objectives shift over time. The relative lack of transparency may also reflect the unwillingness of central banks to state their intervention objectives in the context of dollarization and balance sheet mismatches. One problem arising from the lack of transparency is that, in the event of a failed policy action, it may be impossible to distinguish whether the failure was due to unforeseen events or a lack of commitment.

The more ad hoc nature of policy implementation by emerging economies with other anchors can also limit policy effectiveness. A large operational role for the exchange rate, induced by market deficiencies and less formal central bank internal institutional arrangements, can keep the central bank focused on the short-term stability of the foreign exchange market at the expense of the long-term stability of the macroeconomy. The credibility of the central bank's commitment to price stability

[42]This section does not deal with all the policies that constitute the foundation for moving to full-fledged inflation targeting, which include political support for the inflation target, a strong fiscal position, institutional independence of the central bank, flexible prices and wages, a sound financial system, and reasonably well developed monetary policy implementation tools (Roger and Stone, 2005; Carare and others, 2002). Of course, most of these ingredients are important for any successful monetary policy framework, especially for economies for which it is not feasible to adopt full-fledged inflation targeting. Duttagupta, Fernandez, and Karacadag (2004) and Ötker-Robe and Vávra (2007) comprehensively examine moving from a fixed to a floating exchange rate.

can be weakened, along with the short-term effectiveness of its operations. Unsterilized intervention is inherently inconsistent and thus complicates the attainment of policy objectives and policy communication.

Over the longer term, emerging economies with other anchors should aim to transition to a single nominal anchor, which in most cases will be an inflation target. A single, firm nominal anchor better concentrates inflation expectations and, over time, establishes and entrenches policy credibility. Money anchors are used by only a very few emerging economies; the main candidate anchors are the exchange rate and a full-fledged inflation target. In recent years, a great deal of experience has been gained about how to transition to full-fledged inflation targeting (Roger and Stone, 2005; Schaechter, Stone, and Zelmer, 2000). More emerging economies with other anchors have switched to a full-fledged inflation-targeting regime than to other regimes (Stone and Bhundia, 2004).

In sum, the main challenge for an emerging economy with another anchor is to develop a more systematic approach to monetary and exchange rate policy. This involves developing a more open and market-friendly approach focused on a single operating target, fostering financial and external stability, developing the institutional setting, and, if feasible, transitioning to a single nominal anchor. These changes lead to consistency between objectives over time and, ultimately, to more policy credibility.

The Policy Role of the Exchange Rate

The open-economy inflation-targeting and exchange-rate-based inflation-targeting approaches can be sensible transition options for emerging economies with other anchors.[43] Moving to a single operating target imposes a unifying discipline on the operating framework. At the same time, the exchange rate plays an important role in the policy framework owing to these economies' structure and vulnerability to shocks. The simulation results of Section IV show that, for a financially vulnerable emerging economy, either the open-economy or exchange-rate-based inflation-targeting approach can generate better inflation and output volatility performance than the plain vanilla approach (which has no explicit role for the exchange rate) or a policy reaction function dominated by the exchange rate.

The degree of domestic money market development helps shape the choice between an open-economy inflation-targeting approach and an exchange-rate-based inflation-targeting approach. The former may be preferable in countries with developed money markets because this approach employs an interest rate operating target implemented with domestic monetary instruments (usually repos). In countries with undeveloped domestic money markets, an exchange-rate-based inflation-targeting approach may make most sense because foreign exchange operations are the most viable policy instruments.

Reducing the weight of the exchange rate in the reaction function over time effects the transition toward inflation targeting. For the open-economy inflation-targeting approach, this means reducing the importance of the exchange rate and output and raising the weight of the inflation target in interest rate policy. Shifting to exchange-rate-based inflation targeting entails shifting from the lagged exchange rate and output to the inflation rate in the exchange rate reaction function.[44]

Central Bank Policymaking

Developing an integrated and systematic policy role for the exchange rate facilitates the transition to inflation targeting. In some emerging economies with other anchors, policy objectives shift over time, and foreign exchange and domestic operations are not integrated. Thus, an important challenge for the central banks in these economies is to move toward decision-making frameworks that embody a consistent approach to adjusting policy in response to economic developments and changing prospects. This requires establishing a process for integrating economic and financial analysis into policymaking. In general, a macroeconomic model plays a key role. Effective use of the model requires establishing effective two-way communication between the senior managers of the central bank and the economists involved in forecasting and policy analysis.[45]

Transparency

The circumstances for emerging economies with other anchors are less favorable for transparency, especially with respect to the exchange rate. This reflects the

[43]Pursuing inflation targeting within an exchange rate band is a less attractive option than other approaches. Fundamentally, this is because the inflation-targeting objective can come into conflict with and be subordinated to the exchange rate objective. This can lead to sharp reversals in policy stance and can significantly complicate policy communication, which is highly important in a forward-looking policy framework. As a consequence, it may be difficult to build credibility and anchor expectations, which may provoke speculative behavior in financial markets, challenging the sustainability of the dual objectives. The experiences in Chile, Hungary, and Israel suggest that the central bank may eventually come under pressure from the markets to choose between the primacy of the inflation or the exchange rate objective (Leiderman and Bufman, 2000).

[44]This transition is similar to changing from a backward-looking exchange rate crawl regime, under which the crawl is based on past inflation, to a forward-looking crawl based on expected inflation.

[45]See Laxton and Scott (2000), and Nelson (2008).

need to maintain flexibility in light of economic vulnerabilities and uncertainties, less developed markets, and lower policy credibility. However, moving toward more transparent policy implementation can increase the effectiveness of policy and build awareness of the challenges posed by multiple objectives, thus garnering support for a single nominal anchor. One way to enhance transparency is for the central bank to make explicit its foreign exchange and domestic operations, for example, by announcing a schedule of auctions and clarifying the terms. Regular communication between the central bank and banks also helps improve the understanding of policy. Monetary policy reports help make thinking about policy formulation and implementation more systematic and also educate the public and the markets about the benefits of moving to inflation targeting.

Financial Market Development

In many emerging economies with other anchors, foreign exchange interventions play a more important role than domestic operations. Although the foreign exchange markets of many such economies are thin and underdeveloped compared to those of their inflation-targeting counterparts, they are more developed than the domestic markets. When central banks use foreign exchange operations as the main instrument, the markets may assume that exchange rate management is a priority even when this is not the case.

Financial market development improves policy implementation and can reduce policy conflicts. Market development is typically less costly and more practical than other structural reforms (fiscal, labor market) that bear on monetary and exchange rate policy, and the payoff can be especially high for emerging economies with other anchors, given their generally low level of market development.

Foreign exchange market development often requires changing the central bank's role from market-controlling to market-supporting (Ferhani and others, 2009). Such a reduction of the role of the central bank often requires shifting the handling of official foreign exchange receipts from the central bank to the market, discontinuing foreign exchange market practices that are not based on market-oriented techniques (Serbia), moving toward more market-supporting trading mechanisms, shifting market-making from the central bank to commercial banks, and developing a market-supportive framework for the central bank's own foreign exchange operations. In Israel, the multilateral trading session managed by the central bank was gradually replaced by an interbank system to allow more exchange rate flexibility in the transition to a crawling band.

However, emerging economies with other anchors often face a chicken-and-egg dilemma over market development versus exchange rate policy flexibility (Ötker-Robe and Vávra, 2007; Ferhani and others, 2009). Foreign exchange market development is inhibited by a lack of movement in the exchange rate, but moving toward a more flexible exchange rate regime is constrained by a thin market. In Azerbaijan, the strong focus on exchange rate stability, coupled with the lack of foreign exchange market development, seems to have triggered an ad hoc intervention style. On the other hand, active management of the exchange rate challenges the further development of the foreign exchange market because it creates a disincentive for developing risk-management instruments. This dilemma can be addressed by use of specific measures to promote development of risk-management instruments and by financial regulation and supervision that is designed to account for foreign exchange risk.

Market players should begin to find it in their interest to drive development as the central bank reduces its role and the exchange rate becomes more flexible. This can involve industry agreements on trading rules and formation of dealer associations. The technical infrastructure should be developed so as to facilitate continuous postings of bid and offer prices and ensure the transparency of the price-formation process. Electronic trading platforms increase operational efficiency and improve market transparency. A domestic security market yield curve is necessary for the introduction of forward instruments.

Money market development reduces the need to use foreign exchange intervention for reasons unrelated to monetary policy and facilitates sterilization. Roger and Stone (2005) and Ferhani and others (2009) identify a sequence of reforms that support the introduction of money market operations but which must be tailored to each country's particular circumstances.

Financial and External Stability Policies

For emerging economies with other anchors, enhancing financial stability can come into conflict with other policy objectives. Enoch and Ötker-Robe (2007) provide an overview of macroeconomic, supervisory, and prudential policies to address the risks arising from rapid credit growth and balance sheet currency mismatches. Kazakhstan introduced supervisory measures to reduce credit growth partly to mitigate conflicting monetary and exchange rate objectives. Several countries have successfully reduced dollarization (Kokenyne and Veyrune, 2008), primarily through macroeconomic stabilization.

The model simulations in Section IV suggest that structural policies that improve financial and external stability can allow for a smaller role for the exchange rate. Policies to reduce balance sheet exposure to currency changes, develop the financial sector, and build overall credibility can, according to the model results, markedly reduce the variability of the exchange rate and the current account.