CAN INFLATION INFLATION TARGETING WORK IN EMERGING MARKET COUNTRIES?

by

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OUTLINE

- **Why EM Economies Differ from Advanced Economies**
- **Developing Strong Fiscal and Financial Institutions**
- **Developing Strong Monetary Institutions**
- **Two Case Studies of Inflation Targeting: The Chilean and Brazilian Examples**
- **Dealing with Exchange Rate Movements**
- **How Can the IMF Help?**
- **Concluding Remarks**

WHY EM ECONOMIES DIFFER FROM ADVANCED ECONOMIES

- **Weak fiscal institutions**
- **Weak financial institutions (prudential supervision)**
- **Weak monetary institutions**
- **Currency substitutions and liability dollarization**
- **Vulnerability to sudden stops (of capital inflows) and terms of trade shocks**

DEVELOPING STRONG FISCAL AND FINANCIAL INSTITUTIONS

- **Fiscal imbalances Can Blow up π-Targeting**

  - Unpleasant monetarist arithmetic/fiscal theory of price level

  - Deficits lead to Asset Confiscation and Crisis (Argentina)

- **Fiscal Reforms Needed for π-Targeting to Work**

DEVELOPING STRONG FISCAL AND FINANCIAL INSTITUTIONS

- **Banking Problems Lead to Twin (FX and financial) Crises**

  - Will blowout π-target

- **Need Financial Institutional Reform**

  1. Prudential Supervision
  2. Limit Safety Net
  3. Avoid Currency Mismatch for Economy as a Whole
  4. Increase Openness

DEVELOPING STRONG MONETARY INSTITUTIONS

- **Public/institutional commitment to Price Stability and Central Bank Instrument Independence**

    - For both Law not Enough (Argentina vs Canada)

- **Flexibility Advantage of π-Targeting Also a Weakness**

    - Shocks Greater in EM Countries

    - Requires Even More Transparency and Good Communication Skills of CB

CASE STUDIES: CHILE

- **$\pi \downarrow$ from 20%+ to 2%**
- **Growth 6% 1991-2002**
- **Success based on Sound Institutions**

    1. Surplus avg under 1% GDP 1991-2002
    2. Excellent Prudential Supervision
    3. 1989 gave Independence to Central Bank
    4. 1991-2000 eased into full-fledged π-Targeting
    5. Capital controls minor contribution

- **However, some Fear of Floating and Sudden Stop in 1998**

CASE STUDY: BRAZIL

• **Full-fledged π-targeting announced June 1999**

- Not preceded by fiscal and monetary reforms
- worked until 2002 election, but then big depreciation shock
- π overshoot in 2002 illustrates problems from weak fiscal and monetary institutions

• **High Transparency of CB and π-Targeting Worked**

- Adjusted target upwards and explained that doing otherwise would entail too much output loss
- π fell to within adjusted target range, *i* fell, growth resumed
- Needed help from fiscal reforms (primary surplus ↑ and passage of pension reform)

DEALING WITH EXCHANGE RATE MOVEMENTS

- **EM Countries Need Pay Special Attention to Exchange Rate**

  - Can go too far, Run risk of moving to exchange rate anchor and policy mistakes

    E.g., Chile and Hungary

  - Passthrough is Regime Dependent
    May Improve over Time

DEALING WITH EXCHANGE RATE MOVEMENTS

- **How to Deal with Exchange Rate**

  - Smooth as is done with interest rates:
  - Determined by Market over longer horizon
  - Avoid FX Intervention

HOW CAN THE IMF HELP?

- **IMF needs to focus more on basic fiscal, financial and monetary institutions rather than FX regime**

- **IMF needs to downgrade Financial Programming Framework**

    - Net Domestic Assets makes little sense under π Targets

HOW CAN THE IMF HELP?

- **IMF monitoring can be more forward looking**

  1. Monetary Policy Institutions
     - Central Bank Independence
     - Central Bank Mandate
  2. Assessment of CB Procedures
     - Forecasting
     - Explanation of Actions

       Similar to issue for Supervision of Risk Management

CONCLUDING REMARKS

- **π-Targeting can be effective tool for EM Countries**

  - Not a panacea
  - Requires even more attention to institutional development
  - IMF can help by providing incentives