Monetary regime transition in the emerging world

By Andrés Velasco
January 7, 2013 – *Project Syndicate*

Is inflation targeting – the rule that most of the world's major central banks (though not the United States Federal Reserve) use to set interest rates – in its death throes? Many analysts seem to think so.

Mark Carney, currently Governor of the Bank of Canada, has not even taken over his new job at the helm of the Bank of England, yet he has already announced that he might change the BoE's policy anchor. In Japan, the Liberal Democrats won December's general election after having promised a more expansionary monetary policy. And in the US, the Fed has announced that it will keep interest rates low until unemployment reaches 6.5%.

None of this is as new as it seems. Among rich countries, inflation targeting has been on its way out since the 2008-2009 financial crisis. The large-scale asset purchases carried out by the European Central Bank, for example, have little to do with any definition of inflation targeting.

But inflation targeting has also been losing its hold on policymakers in emerging-market economies. Starting in the 1990's, central banks in Brazil, Chile, Mexico, Colombia, Peru, South Africa, South Korea, Indonesia, Thailand, and Turkey adopted varieties of the scheme. But things changed with the global financial crisis. In joint research with Roberto Chang and Luis Felipe Céspedes, we show that all inflation-targeting central banks in Latin America have used a range of non-conventional policy tools, including currency-market interventions and changes in reserve requirements. Again, this is a far cry from the textbook version of inflation targeting.

What comes next? In the developed world, the leading contender to replace inflation targeting is nominal-GDP targeting. This seems to be what Carney has in store for Britain. Under the proposed new system, if the BoE would like to keep inflation around, say, 2%, and expects the trend rate of GDP growth to be 3%, it should announce a target for nominal GDP growth of 5%.

This new regime might help rich-country central banks to keep their economies suitably stimulated. But, from the point of view of emerging countries, changing the monetary-policy regime in this way makes little sense. Central banks in Asia and Latin America have had three problems with inflation targeting from the outset, but moving to nominal-GDP targeting solves none of them.

The first problem concerns capital inflows and exchange-rate appreciation. When rich-country central banks cut interest rates, capital moves south and east. Some inflows are always welcome. But when the flow becomes a flood, the currency strengthens sharply. Commodity exports typically continue to grow, but industrial and non-traditional exports suffer.

Increasing interest rates only attracts more capital, while cutting rates can cause the economy, already stimulated by the foreign inflows, to overheat. Faced with this dilemma, many emerging-market countries have turned to exchange-rate intervention, and then to raising banks' reserve requirements, in order to make foreign borrowing less attractive.

This is a problem that concerns the composition of output (traditional versus non-traditional exports), not just its level. Moving to nominal-GDP targeting would not make a difference.

The second problem is shared by rich and middle-income countries' central banks: how to ensure that monetary policy addresses the need to maintain financial stability. Inflation

targeting concerns itself with the prices of goods and services, not the prices of financial assets. If "irrational exuberance" set in and a bubble developed in real-estate or equities markets, well, so be it, the standard theory maintains.

After the devastation wrought by the boom-and-bust cycle of recent years, not many economists are comfortable with the "so be it" attitude anymore. Nor are many emerging-market countries' central banks, which are adopting changes in reserve requirements and loan-to-value ratios, among other measures, to prick asset-price bubbles in their early stages.

Advocates of nominal-GDP targeting claim that these prudential measures could be added to create an extended version of their preferred regime. Perhaps, but they could be added to the standard inflation-targeting regime as well. Moving from one system to the other helps little in this regard.

The final problem concerns central banks' role as lenders of last resort in a crisis. This job is especially important – and difficult – in emerging markets, because a significant share of debt, both public and private, is typically in foreign currency. As a result, lending in crisis situations implies using international reserves and providing foreign-currency liquidity. This, too, is alien to the standard target-inflation-and-float-the-currency regime. But it would be just as alien to a system in which the central bank targeted nominal GDP and the currency floated.

These considerations suggest that the way out does not lie in moving from one simple, one-size-fits-all rule to another. Emerging markets need a monetary-policy regime that takes explicit account of capital-flow volatility, asset-price misalignments (including the exchange rate, which is the price of foreign currency), and the resulting financial instability.

The feedback from these factors to interest rates probably should not be the same in tranquil and turbulent times. A comprehensive regime should encompass two rules – one for crisis situations and one for "the rest of the time" – plus explicit guidelines for moving from one to the other and back.

We are far away from being able to formulate and apply such a rule. But at least the debate has now begun. The floor is open.

Andrés Velasco, a former finance minister of Chile, is a visiting professor at Columbia University's School of International and Public Affairs. He has consulted for the International Monetary Fund, the World Bank, and the Inter-American Development Bank, as well as for several Latin American governments.