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Targets and Instruments

Many decades ago, Mr. Tinbergen formulated a powerful economic policy insight: there must be one instrument per target. This insight still informs much of the debate on how to conduct monetary policy particularly now that central banks around the world aim to achieve not only low and stable inflation, but also broader financial and exchange rate stability. Given these additional objectives, what supplementary instruments could central banks use? A recent IMF Staff Discussion Note discusses this in detail (available at: http://www.imf.org/external/pubs/ft/sdn/2012/sdn1201.pdf).

The impossible trinity is an example of Tinbergen's insight: if a country has relatively free capital mobility, it cannot target both a fixed exchange rate and have an independent monetary policy. The basis for this idea is that central banks have only one instrument, namely the policy rate, and it needs to decide whether to use this to fix the exchange rate or to achieve low and stable inflation. Indeed, it is often claimed that inflation targeting (IT), to be successful, needs to include a high degree of exchange rate flexibility, with the policy rate geared to stabilizing inflation and the exchange rate allowed to fluctuate freely.

The early adopters of IT were very much of this view. Their logic was simply that, as long as inflation targets coexist with other objectives of monetary policy, tension between the different policy goals would be unavoidable. Allowing free floating was considered by many to be a litmus test of a country's commitment to a credible IT regime for low and stable inflation.

There are reasons to question the logic of this position. The crisis has taught us that policymakers need to deliver more than stable consumer prices if they are to achieve sustained and stable growth, and that the instruments at their disposal include more than just the policy interest rate. In the context of the emerging markets, it has long been recognized—and to a degree reinforced by the crisis—that significant balance-sheet mismatches imply that it is rarely optimal to ignore possibly large deviations of the exchange rate from its medium-run equilibrium, even in an IT context. On the contrary, reacting to such changes can deliver better economic outcomes under IT than benign neglect of the exchange rate. Thus, there are potentially two policy targets: inflation and the exchange rate.

While emerging market countries are certainly much more integrated in global financial markets than a couple of decades ago, their proneness to experience sudden stops suggests that this integration is far from perfect. Given also their smaller stocks of outstanding local-currency denominated assets than most advanced economies, emerging market economies have greater scope for sterilized intervention. This opens up the fortuitous possibility that policymakers may be operating in a two-target, two-instrument world.

For this to work, two central assumptions need to be met: first, large movements in the real exchange rate away from medium-run equilibrium have to be costly for the economy. This could occur, for example, because policymakers may worry about sharp depreciations because of the foreign currency exposure of unhedged domestic borrowers, or they may worry about appreciation pressures stemming from large, and at times volatile, capital inflows that reduce competitiveness and could raise unemployment. Even though policymakers should not try to target persistent undervaluation, they may wish to limit exchange rate volatility and large and abrupt movements away from equilibrium in either direction. In other words, there may be a "comfort zone" beyond which the authorities would not want to see the exchange rate move.

A second assumption that needs to be met is that sterilized intervention has to be effective to influence the exchange rate. Why would this not be the case? Assume the exchange rate is strengthening and appreciating away from its equilibrium value. The central bank buys foreign currency and sells local currency to limit the appreciation. This is the intervention part. It then sterilizes by, for example, selling government bonds or central bank bills, or by using the Special Deposit Accounts as is done in the Philippines, to take the additional local currency out of the market again to prevent inflationary pressures. Now, one could argue that this has no impact on the exchange rate: at the end of the day, all that has changed is that the central bank holds more dollars and less government bonds (or more in SDAs), while the opposite is true for the private sector and nothing has changed in the aggregate. There will be an effect, however, if markets are not indifferent between the kind of assets they are holding. If there is imperfect capital mobility/asset substitutability, central banks indeed have two instruments (the policy interest rate and foreign exchange (FX) intervention).

The global financial crisis has reminded emerging markets, if they needed reminding, that capital flows can be highly volatile and that crises need not be home grown. Given that many Emerging Market Economies' (EMEs) central banks have established their price-stability credentials only recently (and often after histories of high inflation), IT frameworks are generally thought to be useful for guiding policy and maintaining credibility. Although such frameworks typically go hand-in-hand with free floating in advanced economies, there is no logically necessary reason for them to do so in EMEs. If EME central banks worry about currency movements away from medium run levels (which they typically do), then an IT-cum-sterilized-FX-intervention regime may provide the best of both worlds: the discipline of IT with the exchange rate responsiveness of a managed float and the use of macroprudential tools to prevent specific asset-price bubbles. The academic community is now catching up with what EME central banks have implicitly recognized long ago, namely that it is optimal to use a variety of instruments and targets to achieve low and stable inflation, prevent excessive volatility in the exchange rate, and maintain broad financial stability.

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