Monetary Policy in an Era of High Financial Market Volatility: on the Challenges Facing Emerging Markets

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Inflation targeting in EMs

Prior to the “Great Recession" EMs started to adopt inflation targeting policies, but real exchange rates remained an important determinant of monetary policy.

The crisis casts doubts on inflation targeting policies:

- Inflation targeting helps anchoring inflation expectations.
- But what level to target? 5%?
- Set a higher inflation target to avoid hitting the zero bound in a deep recession.

EMs adopted broader stabilization objectives

Approach taken in many EMs:

- controlled financial openness (1),
- managed exchange rate volatility (2),
- active monetary policy (3).

Accumulation of foreign reserves helps to self-insure against (1), delays appreciation of exchange rate (2), while keeping (3) as an option.

Why should countries adopt broader stabilisation objectives?

Paper does not spell out the economic rationale in all detail, but gets straight to the point: self-insurance helps you weather a storm if no-one will be able/willing to help you in the storm.

And the smoother adjustment in many EMs during the global financial crisis seems to show that EM policymakers did the right thing:

- Although in general limited use was made of foreign reserves, reserves were used to fund deleveraging in countries with higher external debt exposure.
- Once the worst was over, countries allowed exchange rates to depreciate which stimulated exports.
- Policies control the financial inflows from developed countries which are flushed with liquidity, but limited investment opportunities.

Too good to be true?

Most developed countries envy the quick rebound in the EMs, particularly in Asia. However:

- Growth did not turn negative, but growth rates dropped significantly and in many cases have stayed below pre-crisis levels.
- It took big policy efforts to prevent further decline in economic growth. In particular, PRC unleashed massive stimulus packages over the last few years from which countries with close trade ties to PRC benefited.
- The global financial crisis was about the financial sector in the developed countries. EMs mostly indirectly affected through demand channels (but then many economies are export-oriented).
- How should we have expected the developing countries to fare in the crisis? Many changes occurred since the last big EM crisis.

Things went all right, but it is time to get to the root of the problem

Abandoned by international investors and left to the harsh forces of the IMF in earlier crises, many EMs have embarked on a path of self-insurance.

But when is the time to solve the underlying cause?

An incomplete to-do list

- Bonds issued in EM currencies are not viewed as close enough substitutes to bonds issued in foreign currencies. National central banks cannot fully act as lenders of last resort. What can be done to resolve this problem?
  - Continue the path of the Asian Bond Market Initiative to develop liquid financial markets that trade in regional currencies.
  - Deeper financial markets would also enhance the effectiveness of the monetary transmission channel in EMs.
- Why put so much money aside, if there is still so much work to do? Or would spending only cause inflationary pressures?
- Enhance regional financial safety nets – what is the roadmap for AMRO and the CMIM?

Conclusion

I agree with the author that EMs have performed reasonably well throughout the global financial crisis.

There is no time though for EMs to rest on their laurels. To expand and secure prosperity financial markets cannot lag too far behind the rapid developments in the real economy.

EMs have the great opportunity of doing it better than Europe and the US.