Exchange rate regimes, monetary policy and inflation targeting

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Policy issues

• Do some exchange rate regimes deliver better economic outcomes?
  – And is it the same for advanced and emerging market countries?

• How are exchange rate regimes linked to global imbalances?
Policy issues

• How do inflation targeting countries with floating exchange rates think about the exchange rate?

• What are the lessons for policy makers?
Exchange rate regimes and economic performance; conventional wisdom

- Mussa (1986); real exchange rates were more variable under floating regimes
- Baxter and Stockman (1998); little evidence of systematic differences in the behaviour of other macroeconomic aggregates or international trade flows under alternative exchange rate systems.
- Ghosh, Gulde and Wolf (2002); inflation was lower and growth higher in countries with fixed ER
Exchange rate regimes; how much choice do policy makers have?

- Bi-polar view: countries’ effective choice is between hard pegs (such as monetary unions or currency boards) or free floats (usually with inflation targeting).
- Discredited theory and empirically not true
All Countries: Exchange Rate Regimes, 1991 and 1999

- **Hard Peg**: 25 (16%) in 1991, 45 (24%) in 1999
- **Intermediate**: 98 (62%) in 1991, 63 (34%) in 1999
- **Float**: 77 (42%) in 1991, 36 (23%) in 1999

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Developing and Emerging Market Countries: Exchange Rate Regimes, 1991 and 1999

<table>
<thead>
<tr>
<th>Regime</th>
<th>1991</th>
<th>1999</th>
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<tbody>
<tr>
<td>Hard Peg</td>
<td>3 (5%)</td>
<td>14 (25%)</td>
</tr>
<tr>
<td>Intermediate</td>
<td>15 (27%)</td>
<td>36 (65%)</td>
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<tr>
<td>Float</td>
<td>16 (29%)</td>
<td>26 (47%)</td>
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Conventional wisdom has been challenged

- Little correlation between reported regimes and what happens in practice;
- Flexible currencies exhibited fear of floating (Calvo and Reinhart 2002)
- Fixed rates moved o/a devaluations or dual/parallel markets
- Correlation only held 50% of time (Reinhart Rogoff 2004)
- Only 20% of de jure free floats actually floated
- About half of “managed floats” had de facto pegs, bands or anchor currency
- 45% of unofficial pegs “floated”
Why “floaters” might not move much

– Stable macroeconomic position
– Desire for ER stability but with flexibility to respond to shocks
– Avoid speculative attacks

• Fear of floating
  – Concern about pass-through
  – Financial vulnerabilities/currency mismatch
  – Competitiveness
  – Nominal anchor for inflation expectations
De facto exchange rate studies

- De Facto classifications;
  - Gulge, Ghosht, Wolf
  - IMF
  - Levy-Yeyati and Sturzenegger

- New results on relationship between exchange rate regime and growth, inflation
  - Reinhart and Rogoff (2004)
    - “no support for the popular bipolar view”
    - Intermediate regimes alive and well
Figure 4. De Jure Regime Distribution, 1973–99
(in percent of annual observations)

Source: Rogoff et. al. (2004)
Figure 3. Natural Classification Regime Distribution, 1940–2001
(in percent of annual observations)

Source: Rogoff et al. (2004)
Exchange rate regimes and global imbalances

• Hybrid international monetary system; some systemically important countries float while others fix or manage exchange rates

• Could lead to asymmetric shocks if imbalances unwind
Exchange rate regimes and global imbalances

• Are imbalances result of decentralised savings/investment decisions?
• Or do national economic policies contribute?
  – US current account deficit; partly funded by build up of FX reserves in Asian central banks
• Oil prices have added to imbalances
Bank of England survey

- Research workshop at CCBS. Experts from 28 countries plus IMF, BIS
- Survey of 94 central banks
- 3 month research project; which monetary frameworks have delivered best inflation results?

“Monetary Policy Frameworks in a global context” Mahadeva and Sterne, ed (2000)
Use of Explicit Targets in the 1990s

Number of Countries with particular combination of explicit targets

- Exchange Rate
- Exchange Rate and Money
- Exchange Rate, Money & Inflation
- Money
- Money & Inflation
- Inflation

Use of Explicit Targets in the 1990s
Implications for policy

• Low inflation (below 3.8%) associated with stable inflation

• Traditionally, stable inflation achieved in Germany, US, Japan and countries that pegged to these currencies. Later, under inflation targeting regimes.

• BoE survey did not find examples of developing countries achieving low stable inflation except thro fixed ER.
Recently low inflation achieved by emerging markets with floating ER and inflation targeting

in emerging markets, “IT appears to have been associated with lower inflation, lower inflation expectations and lower inflation volatility relative to countries that have not adopted it”

IMF WEO Aug 2005
Inflation targeting

• Institutional commitment to price stability as main goal of monetary policy
• Public announcement of quantitative target for inflation over specified horizon
• Official interest rate is main policy instrument
• Floating exchange rate
Inflation Targeters; Start Dates and Initial Inflation

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Exchange rates and inflation targeting

• Some EM central banks initially adopted IT in conjunction with ER target (eg Hungary, Chile, Israel)

• Problem of 1 instrument and 2 targets usually resolved either by trade off, or use of sterilised intervention in FX market as second instrument. (Though strong doubts about effectiveness when there are open capital markets)
Exchange rates and inflation targeting

- Problem in clarity
- Policy conflicts undermine credibility of targets; benefits of anchoring inflation expectations are not realised
  - …Most countries gradually abandoned ER targets.
Inflation targeting and floating exchange rates

• Inflation targeters do not ignore exchange rate;
• ER channel important **transmission mechanism** for monetary policy
  – directly (traded goods prices, and therefore CPI)
  – indirectly (via wealth and income, and aggregate demand)
  – indirectly (via balance sheets and credit channels)
Forecasting exchange rates

- No shortage of models: Dornbusch (1976); Equilibrium approach; New Open Economy macroeconomic (NOEM) models; microstructural approach
- But they don’t fit the data. And forecasting performance is poor; Mees and Rogoff (1983) found they were no better than a random walk
Forecasting exchange rates

- Key part of inflation targeting framework is inflation forecast
- Exchange rate assumption/forecast is important input
- The exchange rate is hard to predict:

“I have no idea where exchange rates will go in the future and I have no intention of ever starting to forecast exchange rates. That’s a mug’s game”

(Mervyn King)
Exchange rates and inflation forecast

• Unconditional forecast; interest rate path and exchange rate path are endogenous

• Conditional forecast; uses technical assumptions for exchange rates (also interest rates)

• Both have advantages and disadvantages
Alternative exchange rate projections
Lessons for central banks

- Empirical studies on exchange rate regime and economic performance not conclusive.
- Strong monetary framework (eg inflation targeting) more important than exchange rate regime per se
- Need to minimise risk of disruptive market adjustments to global financial imbalances
- Good communication important
Exchange rates regimes and monetary policy

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