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Monetary aggregate targeting and exchange rate targeting under financial repression in developing countries

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Under financial repression central banks use direct instruments of monetary policy (such as controls on interest rates, credit ceilings, and directed lending) to regulate the price, quantity, or composition of credit to generate the resources that governments cannot obtain through conventional taxation. Giovanini and De Melo (1993) estimated that during the period 1984-87, for instance, governments of developing countries extracted about 2% of GDP in revenue from financial repression. Also, the Mexican government extracted about 6% of GDP (about 40% of total conventional tax revenue) from controls on financial markets. The evidence suggests that financial repression has created severe inefficiencies in credit allocation and the financial intermediation process. Moreover, direct instruments tend to lose their effectiveness because agents find ways to circumvent them. As a result, many countries have in the past few years liberalized their financial systems and adopted indirect instruments of monetary management.

Indirect instruments of monetary policy are market based and operate through interest rates. Their main purpose is to affect overall monetary and credit conditions through changes in the supply and demand for liquidity.

The use of indirect instruments allows policymakers to exercise greater flexibility in implementing monetary policy. Almost all industrial countries rely on this type of instruments to control the behavior of monetary aggregates. They are also becoming

more widely used in developing countries. In Brazil, the monetary authorities use both outright purchases and sales of treasury bills in the secondary market, as well as repurchase agreements through informal auctions, as instruments of monetary control. In the Philippines, reverse repurchase agreements are used to absorb excess liquid reserves; their maturities range from one week to a month. The process of financial liberalization has been accompanied by increased reliance on the use of indirect instruments of monetary policy, as open-market operations. In sub-Saharan Africa, progress in that area has been notable during the early 1990s. The transition from a regime of direct instruments may create a variety of problems. The volume of central bank transactions may be large relative to the total volume of transactions in the secondary market. Sales of governments securities by the central bank to reduce liquidity may lead to a rise in interest rates on these securities. And a conflict between monetary management objectives and debt management objectives when monetary policy relies on primary market sales or government securities.

But, the efforts aimed at understanding and quantifying the transmission process of monetary policy in developing countries has been related to the transition to flexible exchange rates and the adoption of inflation targeting as monetary policy. The decision to target inflation was related to the recognition that inflation entails severe social and economic costs and the use of monetary policy to achieve other goals may conflict with price stability

Price stability as a medium by focusing directly in the final objective itself, the inflation rate of the price level, and by adopting a pegged nominal exchange rate or a monetary target as an intermediate goal.

Monetary targeting presumes the existence of a stable relationship between one or more monetary aggregates and the general level of prices. Then, the monetary policy can be directed at a particular rate of growth in the monetary aggregate compatible with

low inflation. Monetary targeting requires adequate knowledge of the parameters characterizing the demand for money. In an economy undergoing rapid financial liberalization these parameters may be highly unstable. So, money ceases to be a good predictor of future inflation, and the relation between the intermediate target and the final objective becomes unstable. Similarly in disinflation, the demand for money may be subject to large and unpredictable shifts; the information content of money for future inflation will be very low. Both arguments suggest that relying on monetary aggregates can be potentially risky.

In the developing world many countries have viewed pegging their nominal exchange rate to a stable low-inflation foreign currency to achieve domestic price stability with two dimensions. First, higher domestic relative to foreign inflation results in a real exchange rate appreciation, the demand for domestic goods would fall and induce a cyclical downswing that would put downward pressure on domestic prices. Second, to the extent that wage, and price-setting decisions anticipate the consequences of wage and price increases been too high, they would make higher domestic inflation less likely to occur in the first place.

In a world of high capital mobility and unstable capital movements, conventional pegged exchange rates have proved fragile. Simply pegging the exchange rate pegs can be sustainable only when they are credible, and credibility is to a large extent determined by domestic macroeconomic policies. An inflation targeting may operate better than an exchange rate targeting framework. To the extent that the domestic currency has been attacked because the central bank had an implicit or explicit exchange rate objective. The adoption of inflation targeting may lead to a more stable currency if it signals a clear commitment to macroeconomic stability and a freely floating exchange rate.

A key characteristic of inflation targeting regimes compared to other approaches to controlling inflation is that the adjustment of policy instrument relies on a systematic

assessment future inflation, as opposed to an arbitrary forecast. There is an important operational difference between an inflation targeting regime and monetary and exchange rate targeting. Changes in monetary policy instruments affect the money supply and the exchange rate faster than inflation itself; this leads to the existence of a control lag and a reaction function that relates the policy instrument to an inflation forecast. The credibility of an inflation targeting regimen depends on the credibility of a promise to reach the inflation target in the future. This depends on whether the public believes that the central bank will stick resolutely to the objective of price stability. Credibility and reputation of the monetary authorities may play a crucial role in dampening inflation expectation under inflation targeting. Because performance can only be observed ex post, the need for transparency and accountability more acute under inflation targeting to help the public assess the stance of monetary policy and determine whether deviations from target are due to unpredictable shocks rather than policy mistakes.