Floating with an anchor

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The latest exchange-rate fad in emerging economies is for flexible currencies, but fixed inflation targets. Will it last?

ESPECIALLY in emerging markets, exchange-rate regimes are the hemlines of macroeconomics—ideas about what looks best change all the time, at the whim of fashion. In recent decades, the shifts have followed a pattern, veering between floating currencies on the one hand, and fixed exchange rates on the other, taking in a slew of pegs, bands and crawls in between. In the financial crises of 1997-98, the middle ground was weakened: pegged exchange rates crashed from Bangkok to Brasilia. Since, the extremes have been in vogue.

In Latin America, dollarisation has hogged the headlines. Argentina, which already has a currency board, flirted with the idea of adopting the dollar last year. Central America’s small states are studying the option (already adopted by Panama). In a recent, desperate, decision, Ecuador also decided to abandon its currency, the sucre, in favour of the dollar.

But the hullabaloo about dollarisation has distracted attention from a quieter trend in the opposite direction. Over the past year, Brazil, Chile and Colombia have all abandoned their exchange-rate targets and bands, and moved to fully floating currencies. Mexico’s peso has floated since 1995. And each of these countries—along with other emerging economies including Poland, South Africa and the Czech Republic—sets monetary policy through a more-or-less formal process of inflation targeting. The goal is to keep the flexibility of a floating currency, allied to a rigorous monetary framework to conquer inflation.

Inflation-targeting is a strategy for conducting monetary policy pioneered in the early 1990s by Canada, Sweden, New Zealand and Britain. It requires the central bank to announce publicly a numerical target for inflation in the medium term. The bank, which must at least be operationally independent, is then responsible for achieving these targets and must provide regular public information about its strategy and decisions.

Among emerging markets, Brazil has the most technically sophisticated inflation-targeting
framework, according to a recent study by Frederic Mishkin, an economist at Columbia University in New York*. Brazil publishes a fancy quarterly inflation report that offers probabilities of different inflation paths (available at www.bcb.gov.br, the central bank’s website). For 2000, the country’s inflation target is 6%, falling to 4% in 2001 (with an allowable range of plus or minus two percentage points around the target). Chile’s strategy has fewer bells and whistles. But it has the longest history of publicly announced inflation targets. In 1990, it began publishing them for the following year. It is only in recent years, however, that the inflation rate became the main goal of monetary policy. Mexico, too, announces inflation targets, but has a less formal approach than Brazil.

So far, the strategy of combining floating currencies with an explicit inflation target has proved remarkably successful in the countries that have pursued it. Floating currencies have not led, as many feared, to extreme exchange-rate volatility. Though there have been bouts of jitters—notably in Brazil in the summer of 1999—the newly flexible currencies of Latin America have actually been quite stable.

**Floating not sinking**

Moreover, countries do seem to have succeeded in hitting their inflation targets, at least so far. Despite an initial big fall in its currency, the real, after Brazil abandoned its exchange-rate peg, inflation in 1999 was within its target range at just under 9%. After gradually reducing inflation throughout the 1990s, Chile ended the decade with prices rising at the remarkably low annual rate of 2.3%. Mexico still has a higher rate of inflation (close to 11% in 1999) but there, too, the trend is downward. Given this record, it is hardly surprising that other emerging economies are keen on similar arrangements.

That may make sense. Floating rates are less vulnerable to sudden speculative crises. And the openness, accountability and anti-inflation focus that targets can instil in emerging-economy governments are surely to be welcomed. But, like earlier trends, this one is no panacea.

First, emerging economies have specific problems that make inflation-targeting difficult. Many, for instance, still have relatively high rates of inflation (say, 20% or more). At these levels it is difficult to predict future inflation rates with any accuracy, so setting targets might actually damage the central bank’s credibility. Exchange-rate flexibility (which is a prerequisite for inflation-targeting) can also bring problems. In Latin America, in particular, many countries have a big share of assets and liabilities denominated in dollars. This means that big exchange-rate movements can have a devastating impact on a country’s balance sheet. That is one reason why even in floating-rate regimes, governments pay attention to the value of their currencies.

Moreover, inflation-targeting has barely been tested. Brazil’s striking recent success at combating inflation may not last: it has yet to solve its deep-seated fiscal problems. Economic studies suggest that there are several circumstances in which big currency depreciations may have little inflationary effect: when economies are in recession; when the exchange-rate was initially overvalued; and when the inflation rate before the depreciation was low. All of these conditions obtained in Brazil in 1999. Now two no longer hold, and the risks of higher inflation have risen. With such a short record of success, the central bank’s credibility is still fragile.

Also, the fashion for floating rates and inflation targets took hold just as the environment for emerging economies began to improve. Brazil, Chile and Mexico have all seen their economic prospects brighten during the past year as commodity prices rose, rich-country economic growth strengthened and private capital flows to emerging markets resumed. That has meant that inflation targeting, especially in Brazil, has been politically easy, since it has meant gradually falling interest rates.

Less clear is how the system will cope with a financial shock caused, say, by a sharp slowdown in the United States. When hard times come, central banks may be able to raise interest rates,
prevent excessive currency volatility and stick to their inflation targets. But there is a real risk that emerging-market currencies will plummet, inflation overshoot, central banks lose credibility and confidence erode. And if that happens, expect yet another exchange-rate fad.

* “Inflation targeting in emerging market countries.” To appear in “AEA papers and proceedings”, May 2000