

The Role of the Exchange Rate in Inflation-Targeting Emerging Economies

**Mark Stone, Scott Roger, Seiichi Shimizu, Anna Nordstrom,
Turgut Kişinbay, and Jorge Restrepo**

Contents

Preface	vii
I Executive Summary	1
Summary of Key Findings	1
II Introduction	3
III Why the Exchange Rate Plays a Large Role in Emerging Economies	7
Pass-Through from the Exchange Rate to Inflation	7
Output Stability	7
Financial and External Stability	8
Underdeveloped Financial Markets	9
Credibility	10
Other Exchange Rate Policy Channels	11
IV Different Roles for the Exchange Rate and the Policy Trade-Offs	12
A Taxonomy of Inflation-Targeting Approaches	12
Evaluation of Alternative Inflation-Targeting Approaches	15
V Foreign Exchange Market Intervention in Inflation-Targeting Policy Implementation	25
Plain Vanilla Inflation Targeting	26
Open-Economy Inflation Targeting	28
Inflation Targeting with Exchange Rate Bands	29
Exchange-Rate-Based Inflation Targeting	30
VI Transitioning to Full-Fledged Inflation Targeting	31
The Policy Role of the Exchange Rate	32
Central Bank Policymaking	32
Transparency	32
Financial Market Development	33
Financial and External Stability Policies	33
VII Implications of Recent Global Shocks	34
Inflation Pressure and Capital Inflows	34
The Global Financial and Economic Crisis	37
Implications	38
VIII Conclusions	39
Why Are Emerging Economies Particularly Concerned about the Exchange Rate?	39

	How Should the Exchange Rate Be Taken into Account in an Inflation-Targeting Framework?	39
	What Is the Appropriate Role of Foreign Exchange Market Intervention in Inflation-Targeting Policy Implementation?	39
	What Key Issues Warrant Further Work?	40
IX	Case Studies in the Role of the Exchange Rate in Inflation-Targeting Emerging Economies	41
	Guatemala	41
	Hungary	43
	Iceland	45
	Kazakhstan	48
	Peru	50
	Philippines	52
	Singapore	54
	South Africa	56
X	Foreign Exchange Intervention Practices: Selected Cases	59
	Azerbaijan	59
	Brazil	61
	Chile	62
	Colombia	63
	New Zealand	65
	Romania	67
	Serbia	68
	Sweden	69
	Turkey	71
	Appendix I	73
	Appendix II. The Small Open-Economy Model	82
	References	90