# Challenges in Implementing Inflation Targets in Emerging Markets Economies

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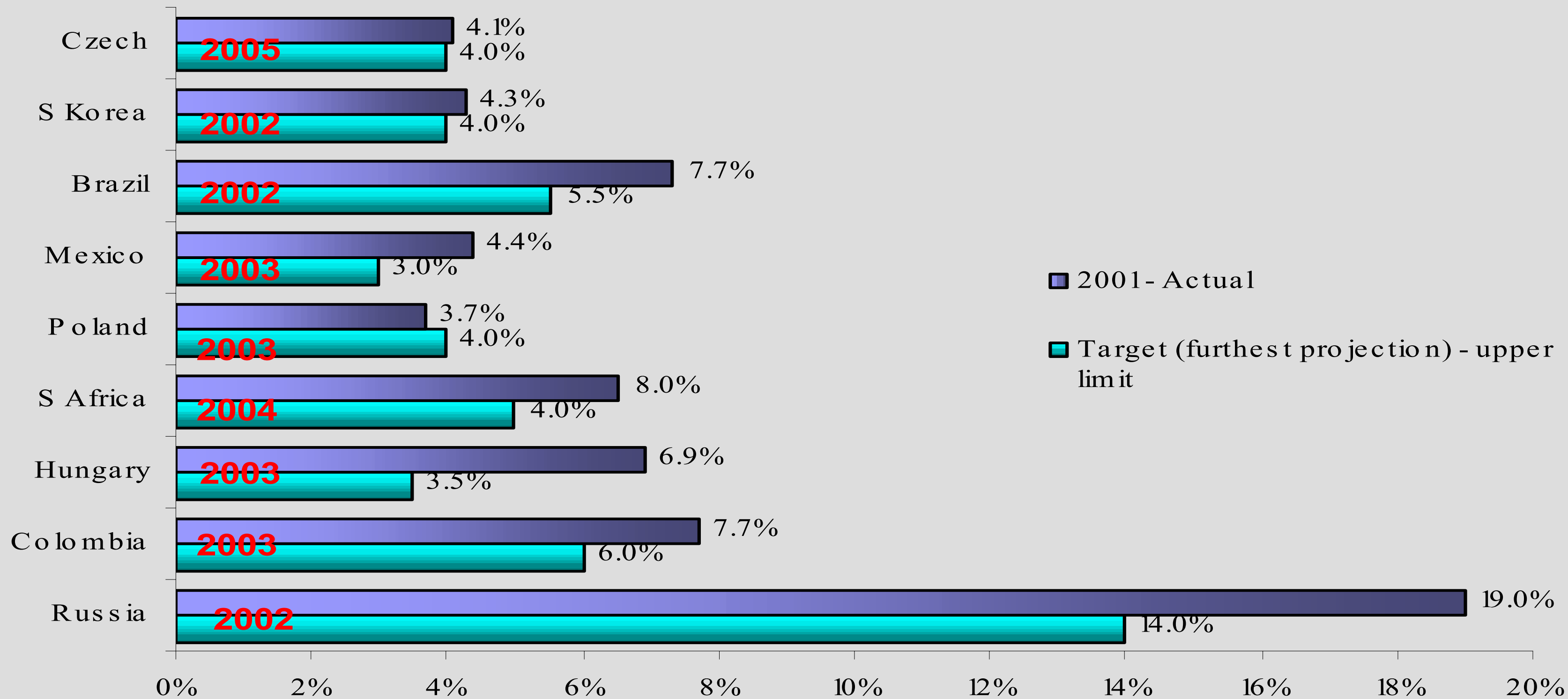
# 5 Key Questions on Inflation Targeting

- Why lower inflation?
- Why use inflation targeting?
- How does inflation targeting work? What would be ideal conditions for their implementation?
- How does EM reality deviate from these “ideal” conditions?
- Impact of inflation targeting on financial markets?

# Why Lower Inflation?
# Inflation convergence is a prerequisite for integration with the global world economy.

## The Inflation Targets Challenge in EM:




Turkey

Current: 68.5%; Targets: 35% (02), 20% (03), 12% (04)

# Why Use Inflation Targeting?

- Other monetary policy regimes gave no satisfactory results, such as:

  -fixed money growth rules

  -fixed exchange rates

  -crawling pegs

  -monetary conditions index rules
- Since their inception in the late 1980's to date, no single country that adopted inflation targeting abandoned this regime.

# How to Implement Inflation Targeting?

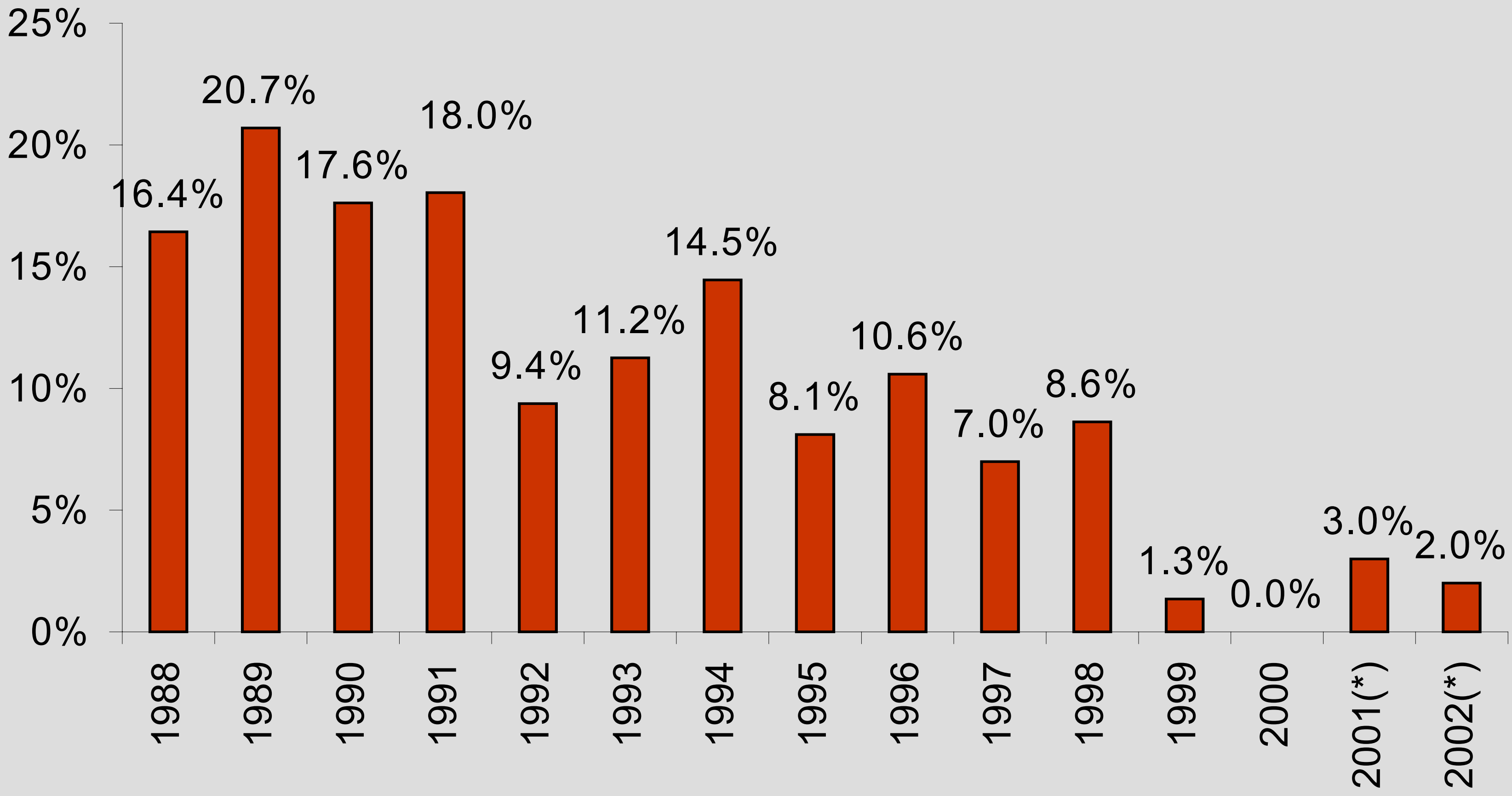
- Policy must be forward looking.  The central bank sets rates so as to ensure that monetary conditions support the achievement of the inflation target.  If inflation is expected to deviate from target, policy adjustments will be required.
- To be effective, policy must be clear, transparent, and have credibility. Multi-year targets are better than single-year ones.
- The ideal setting:  targets are set by the government and implemented by an instrument-independent central bank, fiscal policy and wage policy are compatible with the target, and a floating exchange-rate regime is in place.

# EM Realities Pose Some Difficulties for Inflation Targeting

- **Many EM have a history of high and chronic inflation. This has resulted in some inflation inertia in economic institutions and individuals' expectations. Together, these create some lack of credibility at the initial stages of targeting.**
- **One example: strong passthrough from exchange rates to prices.**
- **Fiscal policy often does not internalize the inflation targets.**
- **Wages are not always consistent with the target.**

Implications: need a 'conservative' central bank and there is likely to be an overburdening of monetary policy. When possible, fx market intervention should be avoided, as in many cases it has proven to be counterproductive.

# Israel: High Inflation Preceded Gradual Inflation Convergence Under IT



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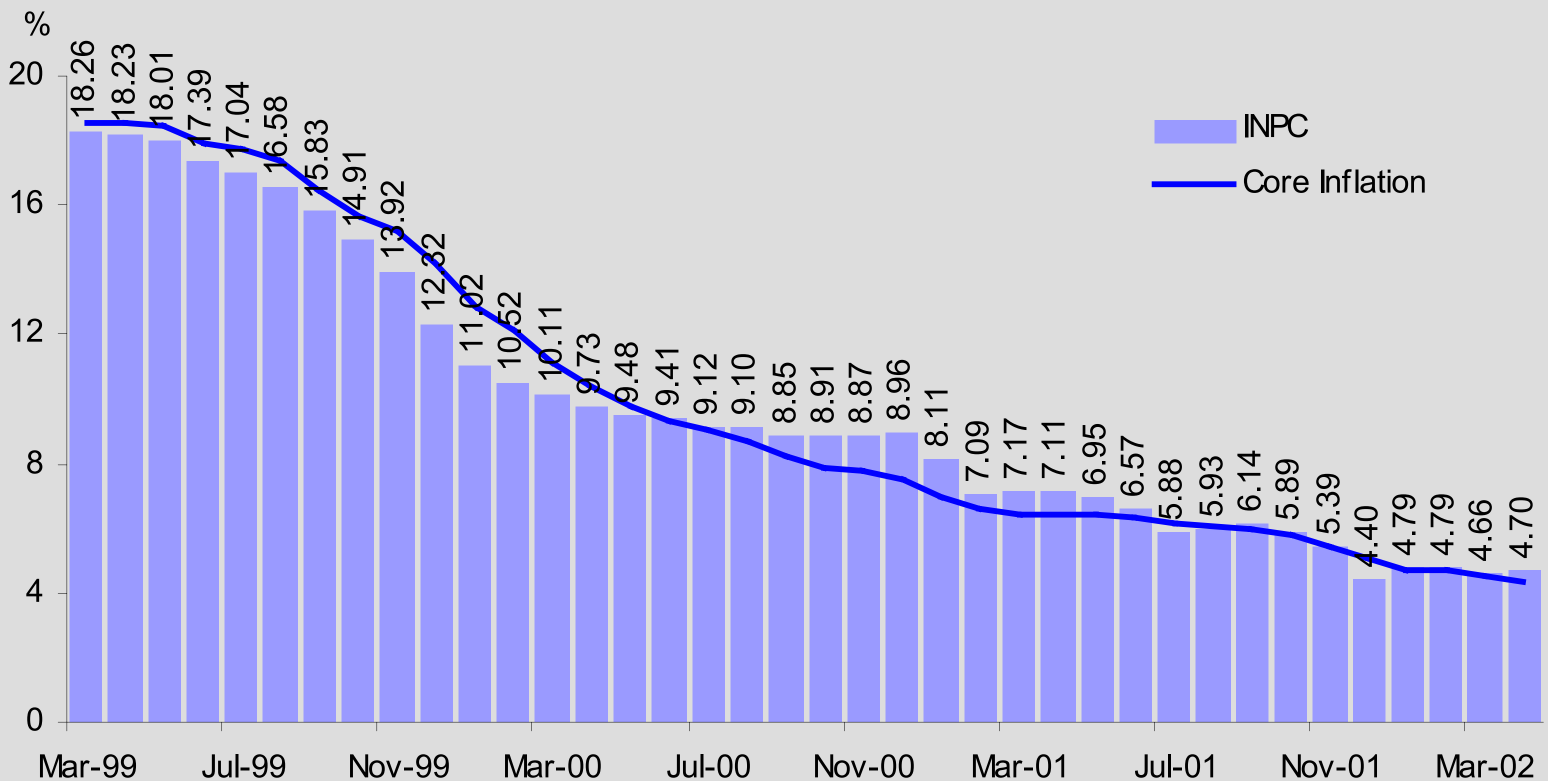
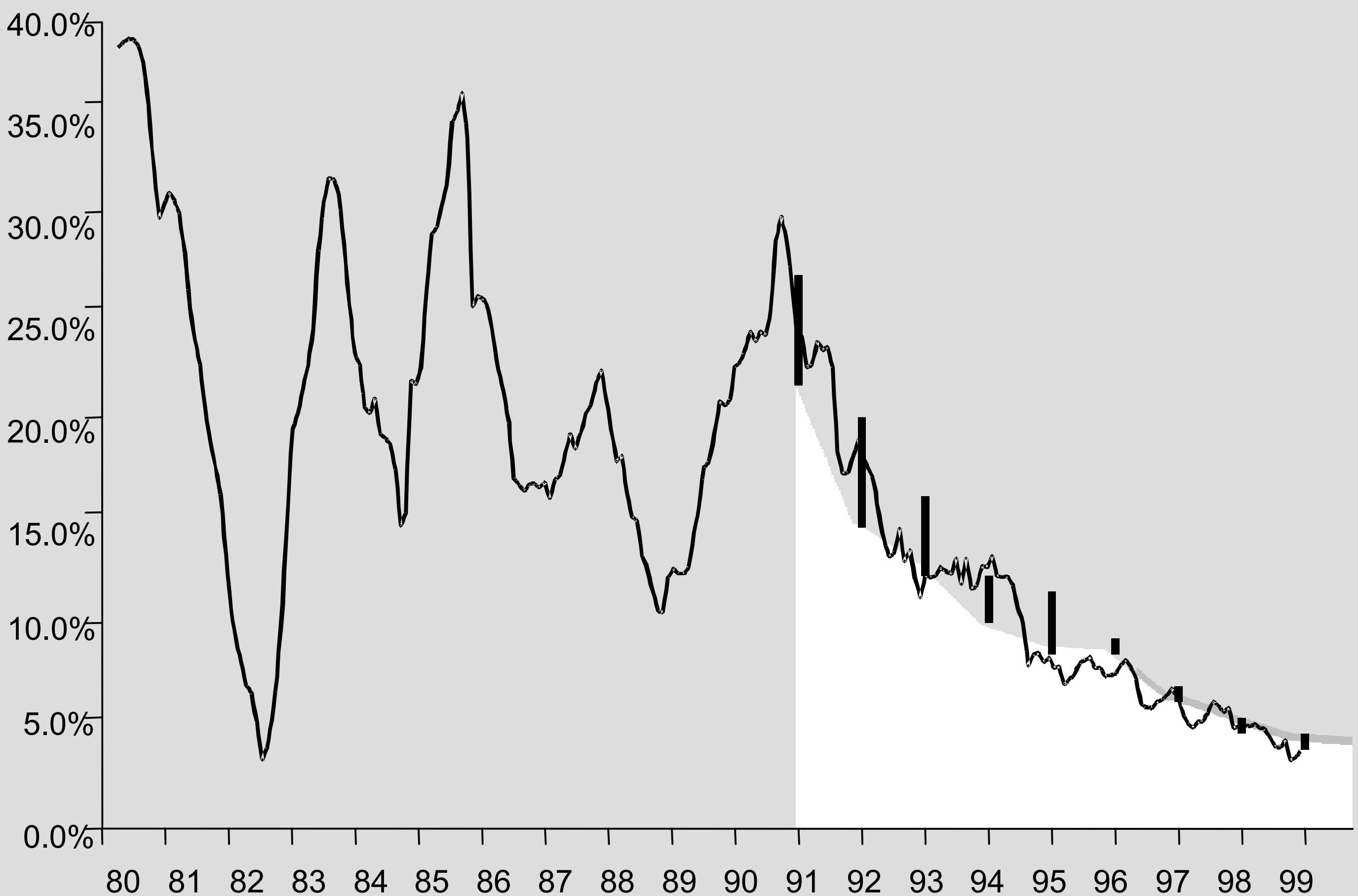
# Mexico's Disinflation



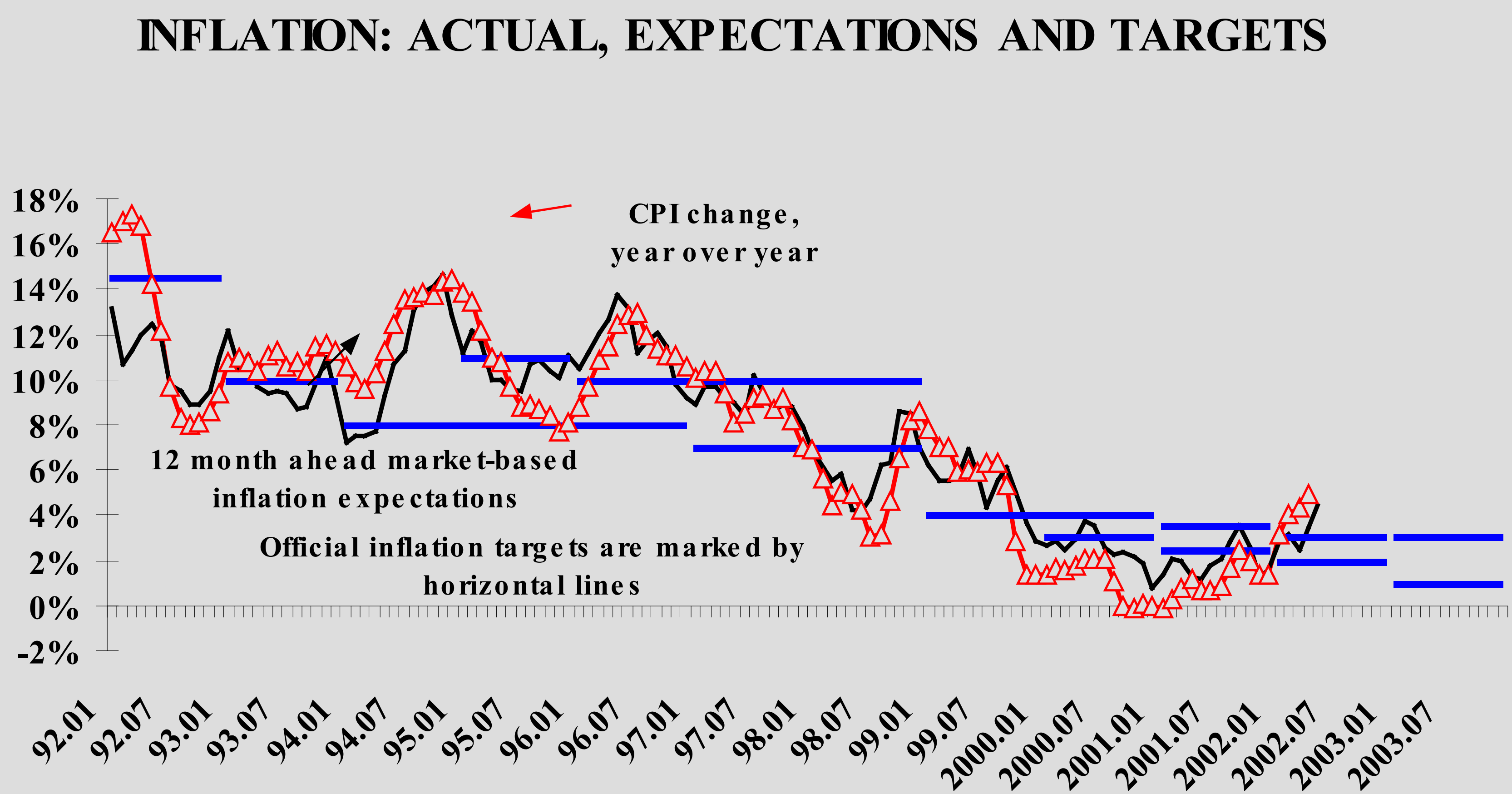
# Inflation and Inflation Targets in Chile [a]




Source: Landerretche, Morande, and Schmidt-Hebbel (1998).

(a) Target is set in September for the following calendar year

# Israel…..



INFLATION: ACTUAL, EXPECTATIONS AND TARGETS
CPI change, year over year
12 month ahead market-based inflation expectations
Official inflation targets are marked by horizontal lines
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
-2%
92.01
92.07
93.01
93.07
94.01
94.07
95.01
95.07
96.01
96.07
97.01
97.07
98.01
98.07
99.01
99.07
2000.01
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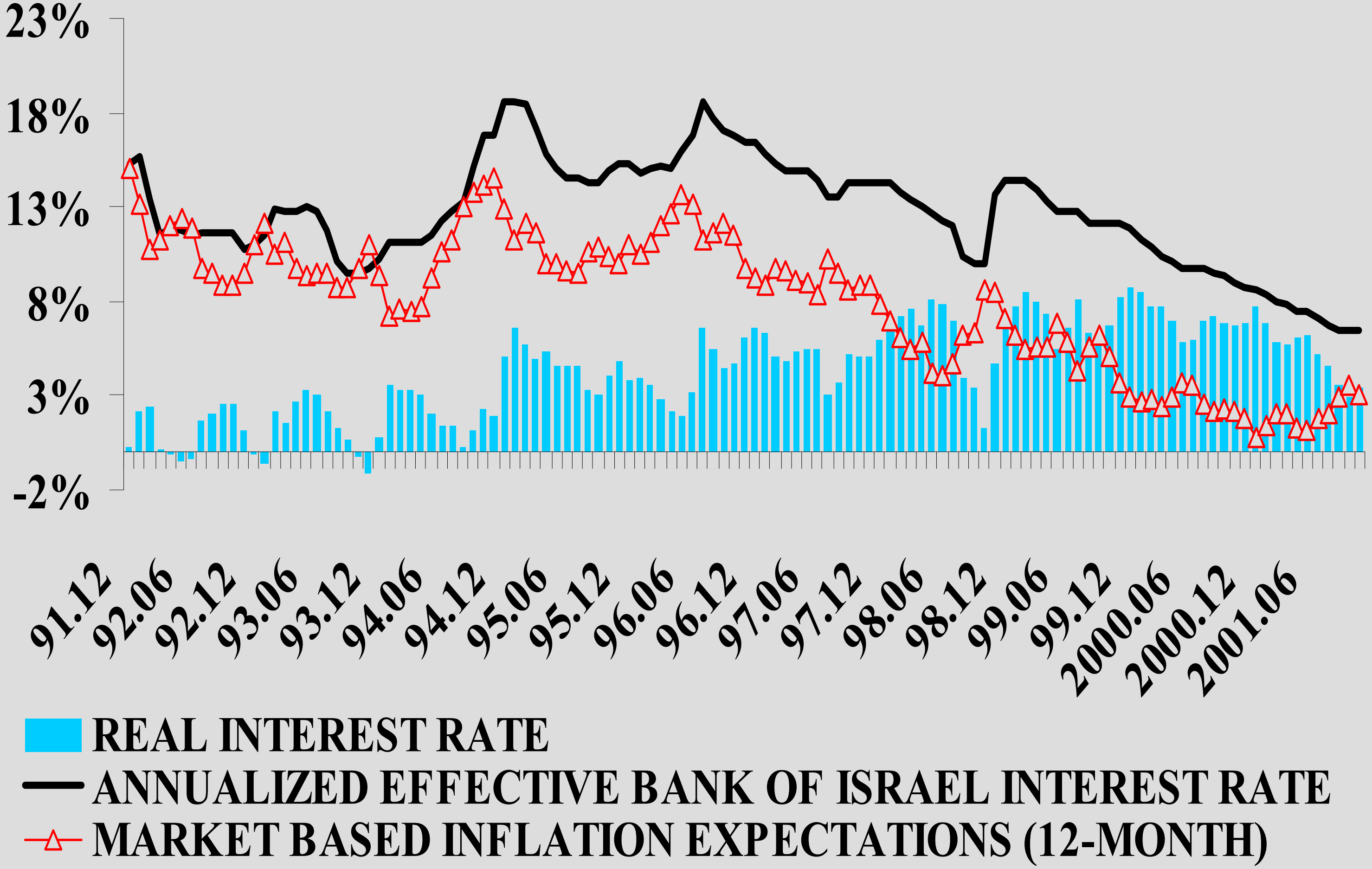
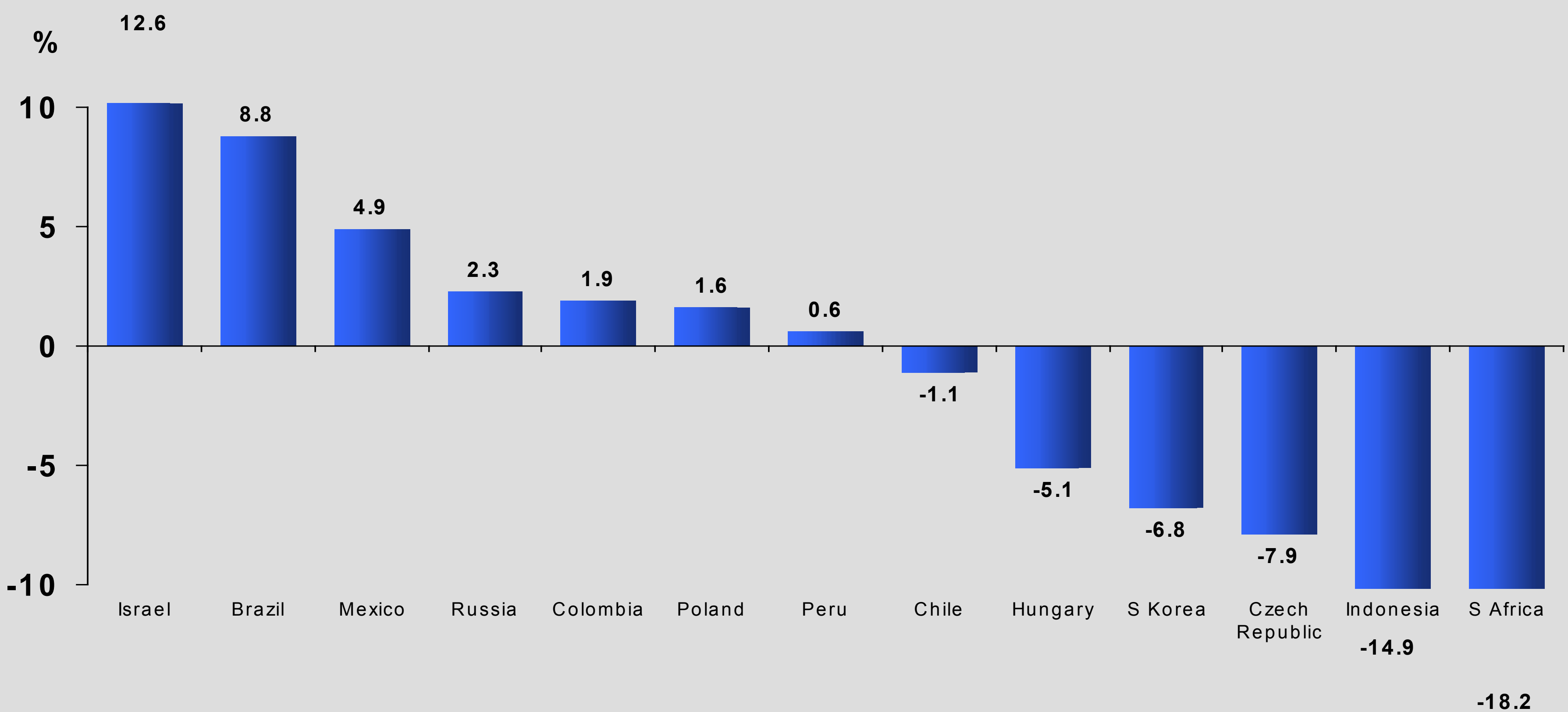
# Monetary Policy Reaction to Expected-Inflation Scares: The Case of Israel



# Currencies as Shock Absorbers

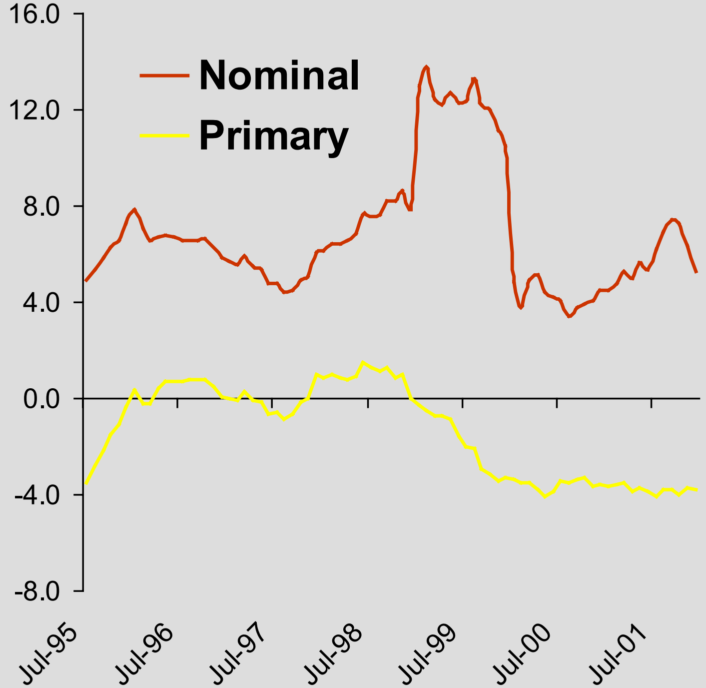
2002, YTD Depreciation



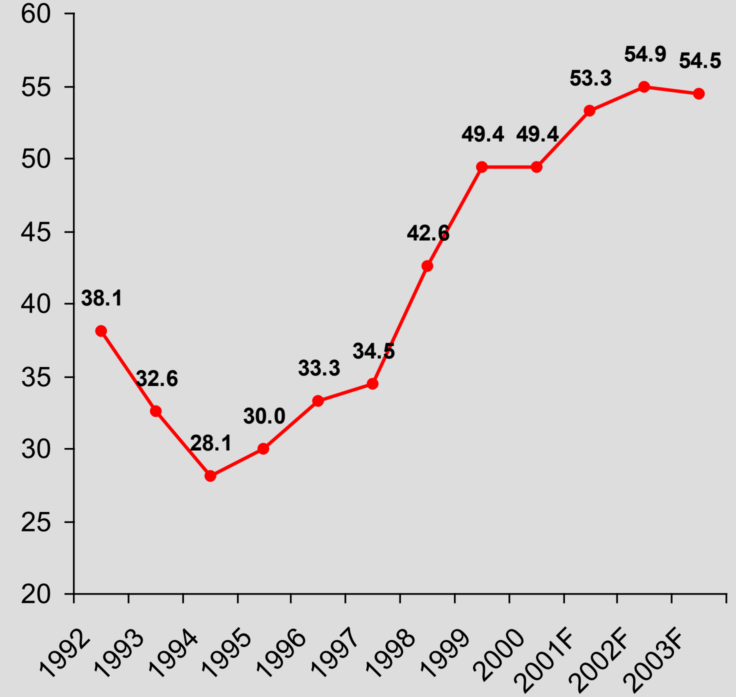

**Venezuela: 43.6%**

# Fiscal Discipline is Crucial: The Case of Brazil

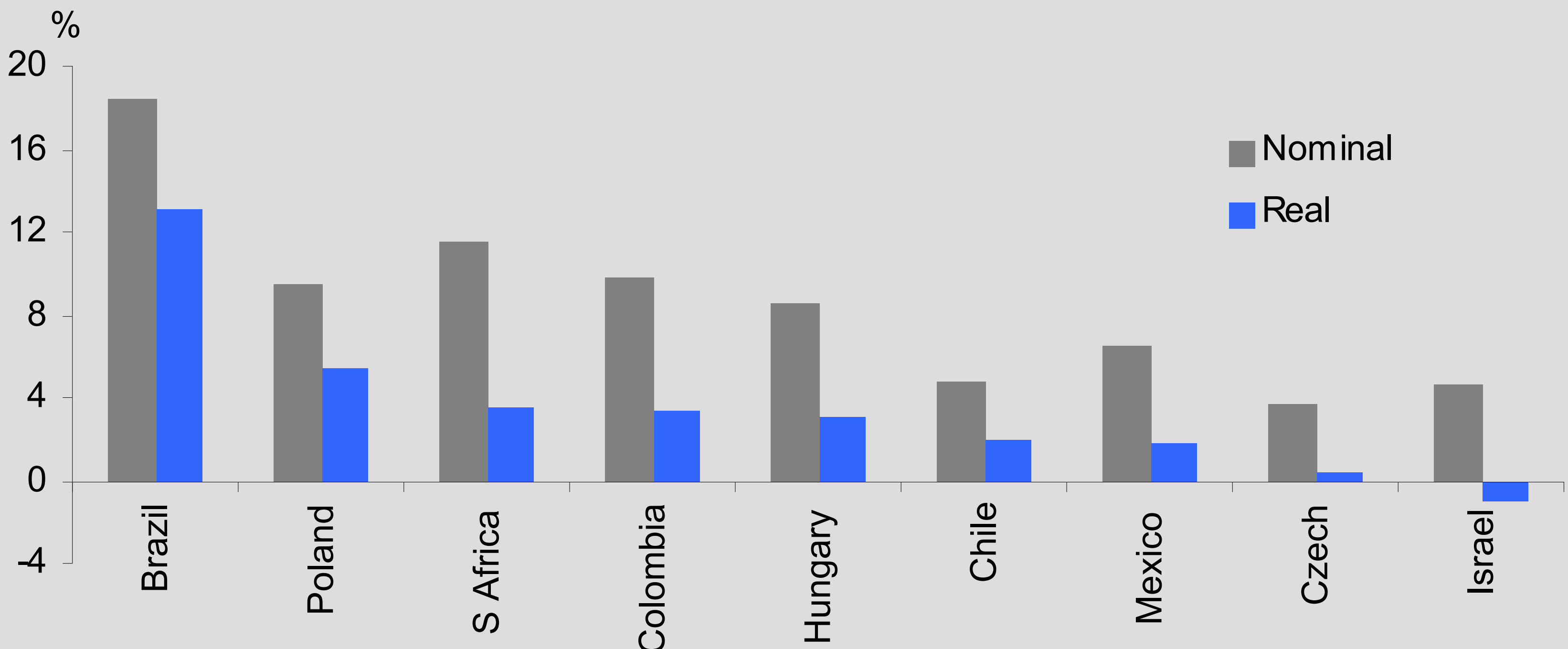
## PSBR (% GDP)




## Net public debt (% of GDP)



# The Bottom Line:
# Current Nominal and Real Interest Rates




* latest avaialbe data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# Impact on Financial Markets

- Focus on inflation forecasts. There are 3 types: from econometric models, from private sector surveys, and from market-based inflation expectations.
- Focus on the central bank reaction function. Central-bank watching as a learning process. The need for transparency, clarity, and good communication with the public. Policy will be seen as forward looking.
- The hope is for smaller medium-term inflation uncertainty while adjusting to currency volatility at the same time.