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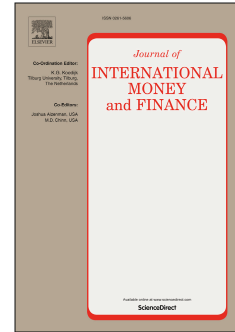

Two Targets, Two Instruments: Monetary and Exchange Rate Policies in Emerging Market Economies

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Two Targets, Two Instruments:

Monetary and Exchange Rate Policies in Emerging Market Economies

Atish R. Ghosh, Jonathan D. Ostry, and Marcos Chamon[1]

February, 2015

Abstract

This paper examines the case for using two instruments—the policy interest rate and sterilized foreign exchange market intervention—in emerging market countries seeking to stabilize inflation and output while attenuating disequilibrium currency movements. We estimate policy reaction functions for central banks, documenting that indeed both instruments tend to be deployed. We show that whether discretionary monetary policy or inflation targeting is preferable depends on the volatility of shocks relative to the central bank's time inconsistency problem. The use of FX intervention as a second instrument improves welfare under both regimes, but more so under inflation targeting. Overall, a regime of (two-way) sterilized intervention-cum-inflation targeting can result in better outcomes in the presence of imperfect capital mobility/asset substitutability—yielding similar gains to a discretionary policy but without jeopardizing the inflation target.

JEL Classification Numbers: F21, F32.

Keywords: emerging markets; monetary and exchange rate policies; inflation targeting; sterilized intervention; capital flows.

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