Evaluating Emerging Markets' Monetary Policy

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[Preliminary results; please do not cite or circulate; draft available upon request]

Abstract:

Are emerging markets' central banks credibly upholding their inflation targets? This paper builds on Barnichon and Mesters (2023) "optimal policy perturbation" (OPP) statistic to evaluate monetary policy effectiveness across emerging markets. A central challenge is that emerging markets' central banks tend to balance three policy objectives: sustained output growth, moderate inflation rates, and most distinctively, exchange rate stability—owing to the "fear of floating"—which partially weakens their promise adherence to Federal Reserve's "dual mandate" policy goal. Combining empirical impulse responses from a Bayesian VAR and professional forecast data from the Economist Intelligence Unit as real-time proxies for central banks' information sets, I introduce a numerical algorithm that computes optimal weights to minimize deviations of the OPP statistic from zero, where zero indicating policy is consistent with market expectations and hence no systematic policy error. The preliminary results show that (1) there are noticeable deviations from optimal monetary policy around the 1997 Asian Financial Crisis, 2008 Global Financial Crisis, and the Covid-19 pandemic and (2) most inflation-targeting regimes have grown increasingly credible and effective at anchoring expectations, thereby explaining the marked decline and increased transience of inflation rates since the turn of the millennium.

Figure 1. Brazil: Optimal perturbation statistics (OPP) over time

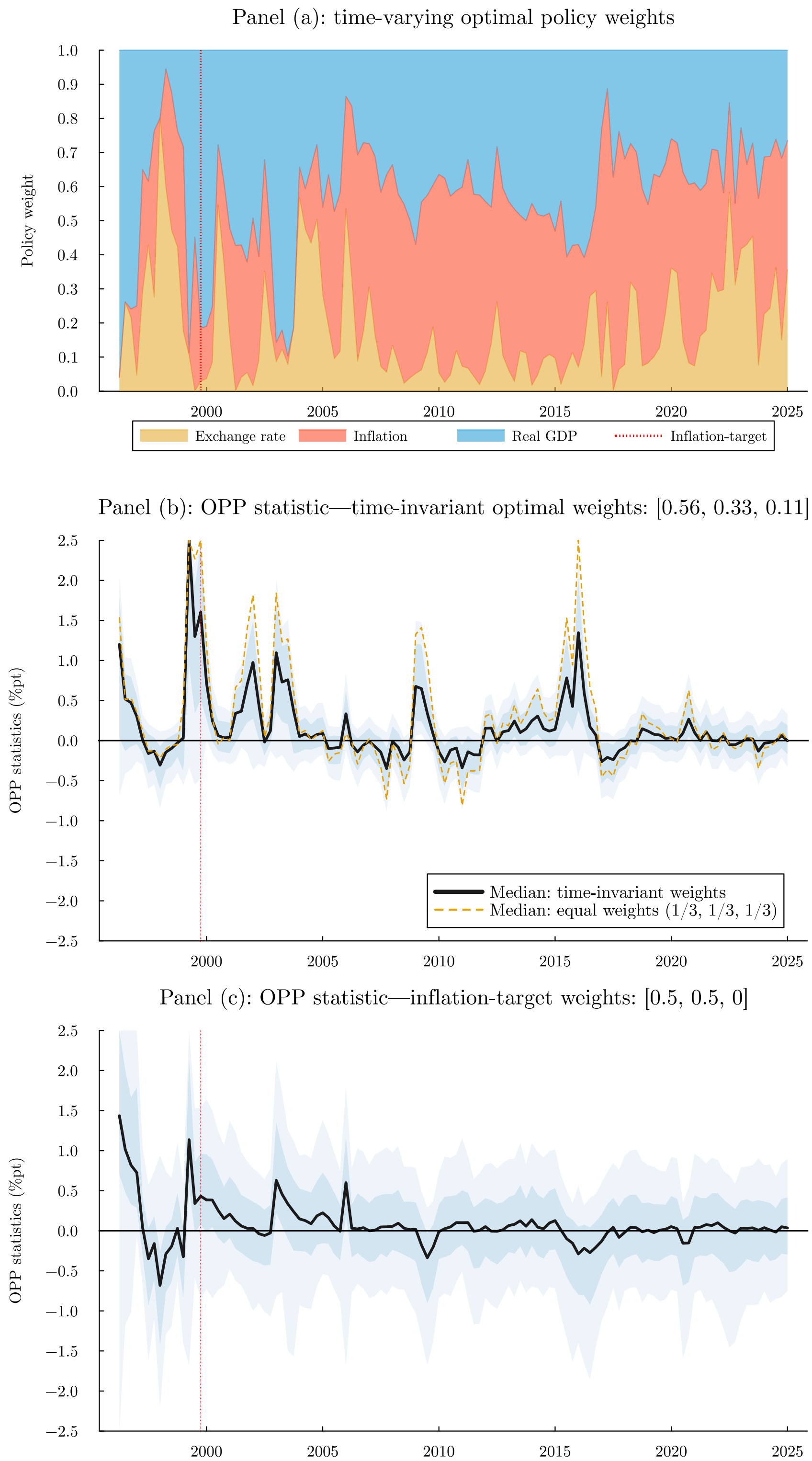


Figure 2. Chile: Optimal perturbation statistics (OPP) over time

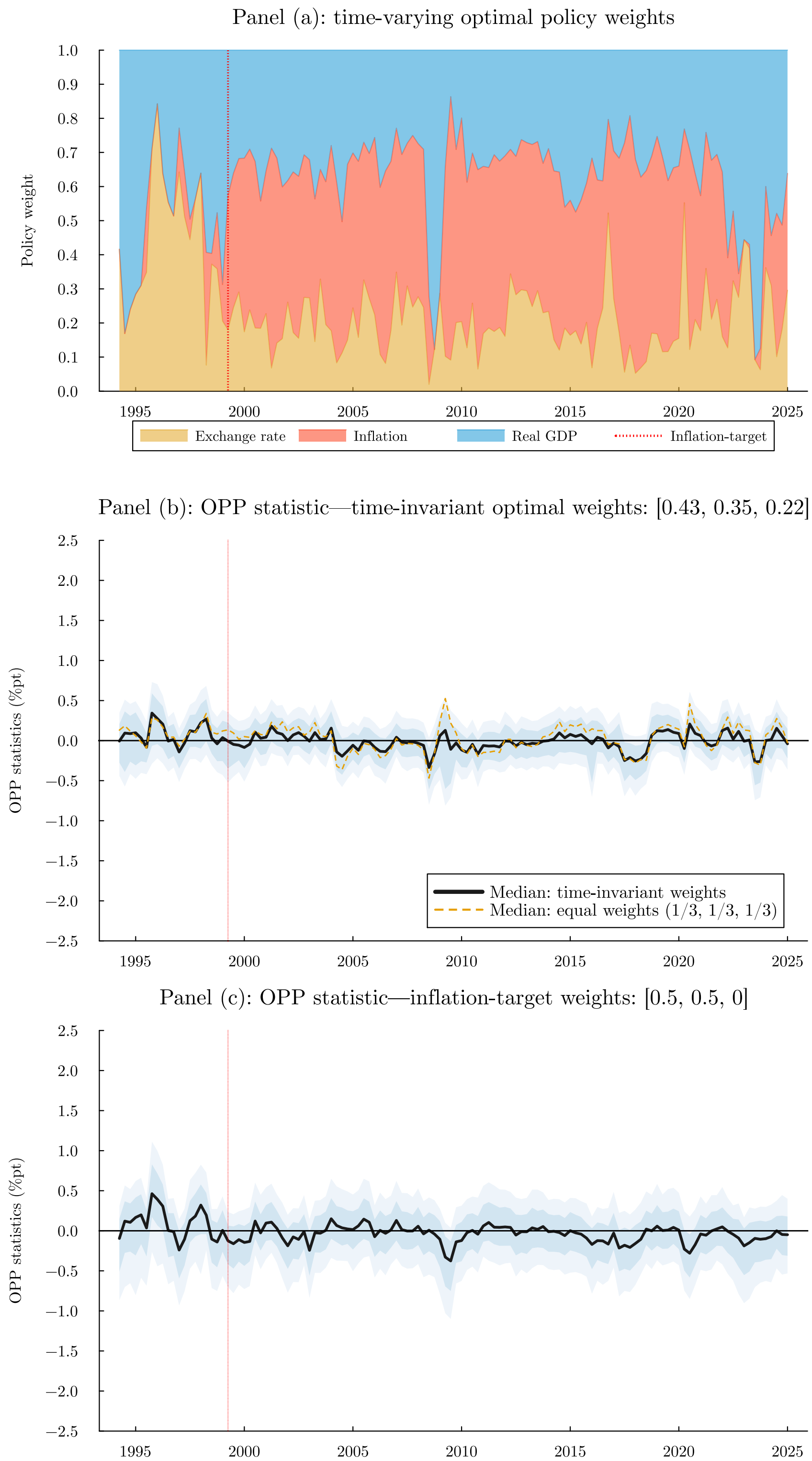


Figure 3. Colombia: Optimal perturbation statistics (OPP) over time

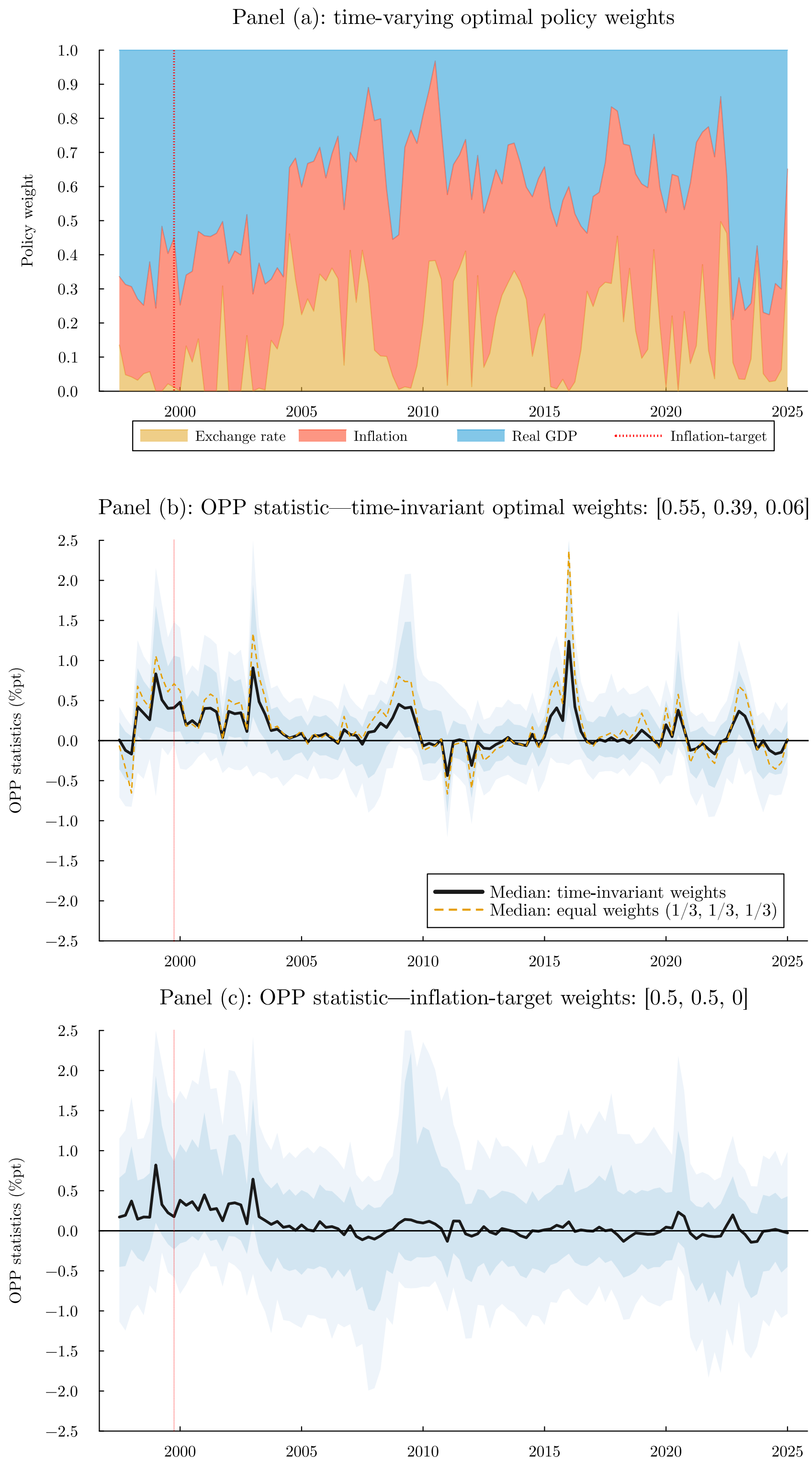


Figure 4. Indonesia: Optimal perturbation statistics (OPP) over time

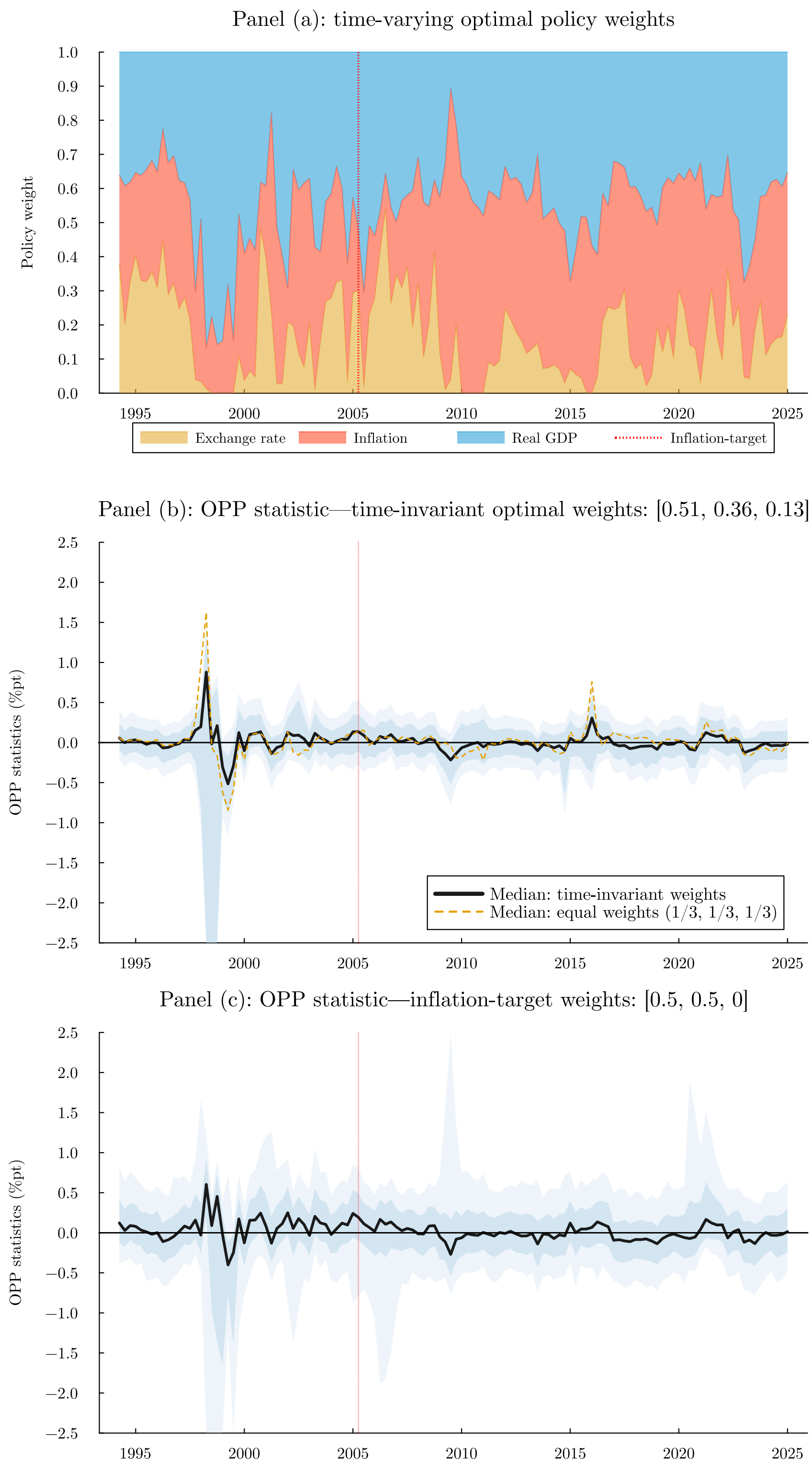


Figure 5. Israel: Optimal perturbation statistics (OPP) over time

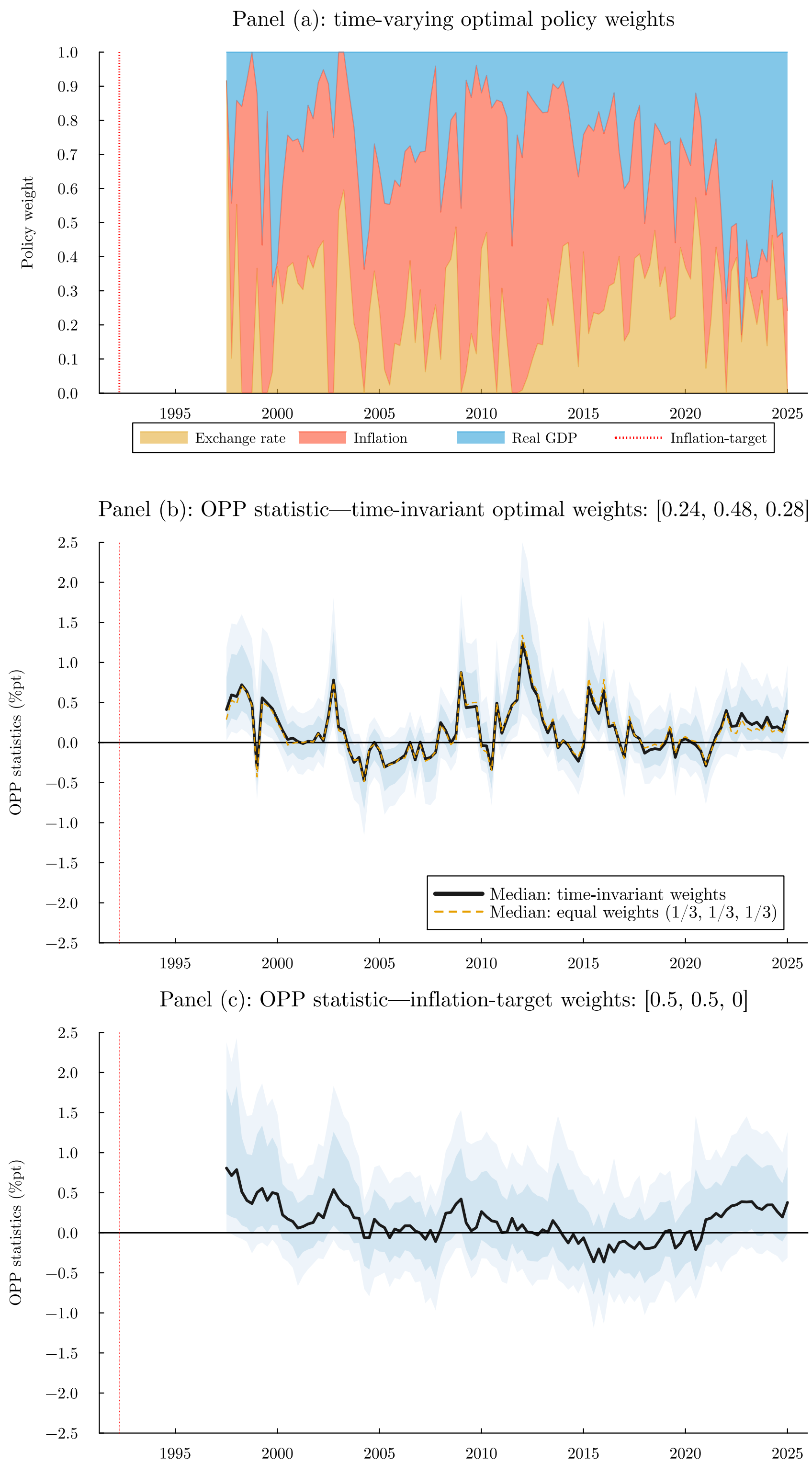


Figure 6. South Korea: Optimal perturbation statistics (OPP) over time

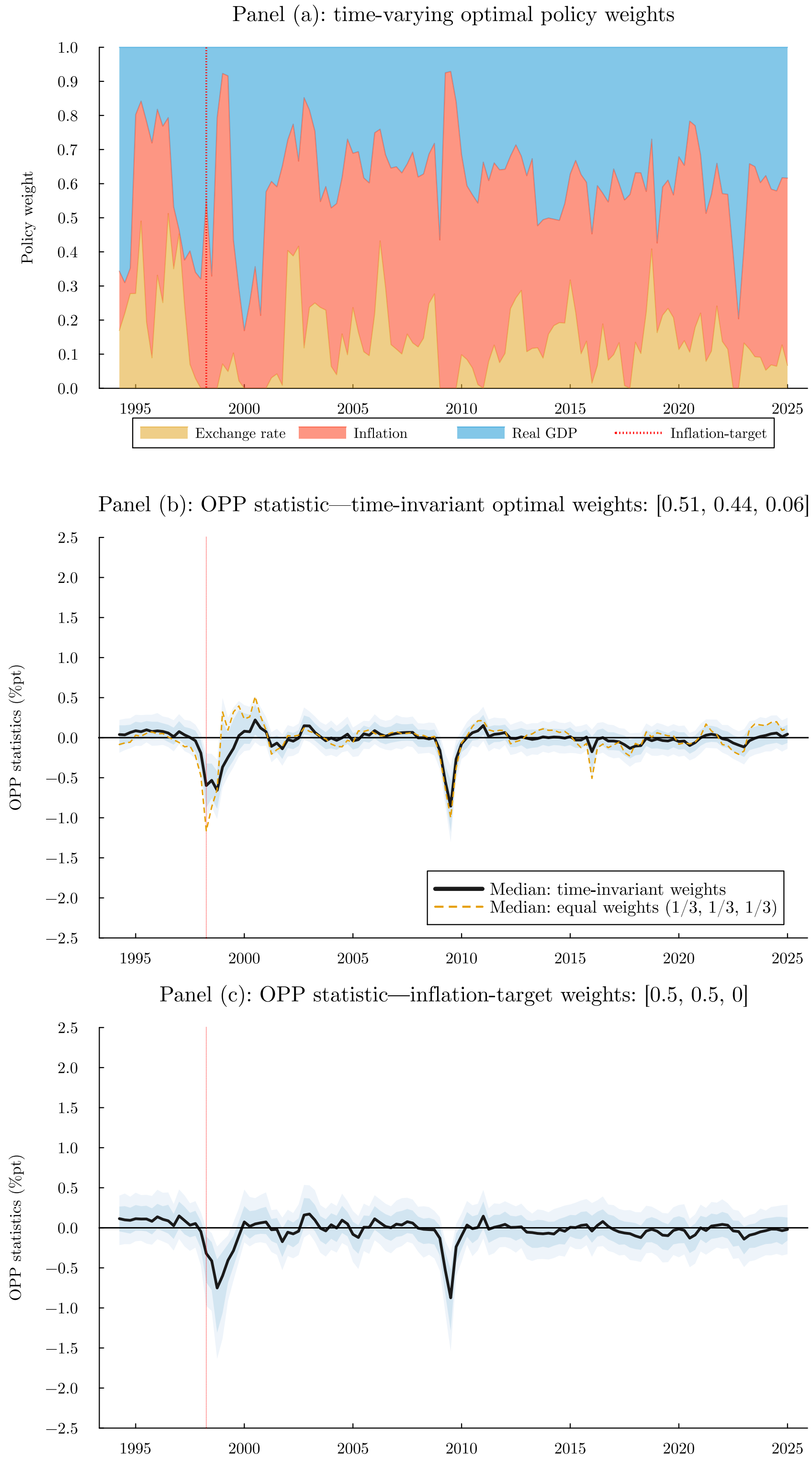


Figure 7. Mexico: Optimal perturbation statistics (OPP) over time

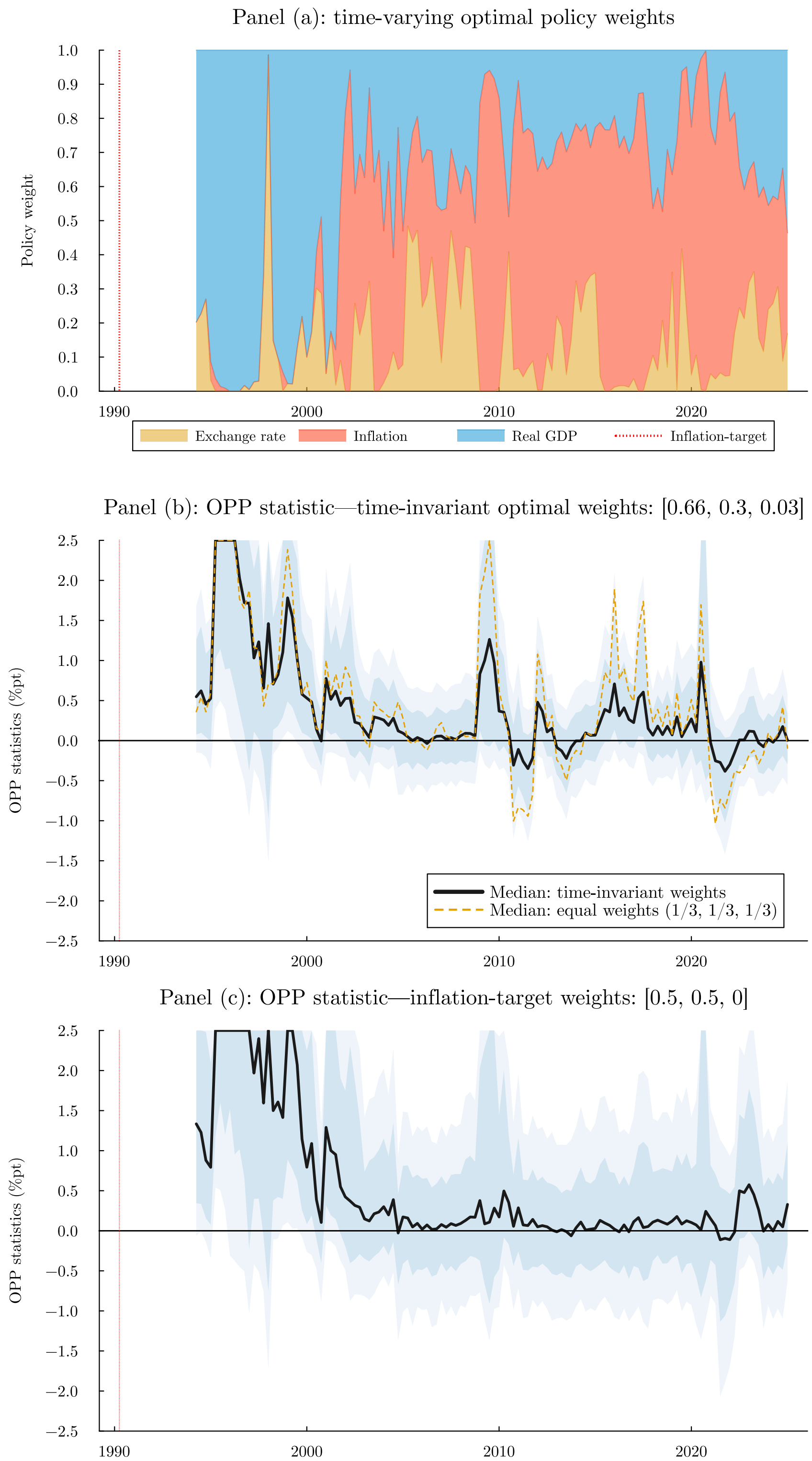


Figure 8. Peru: Optimal perturbation statistics (OPP) over time

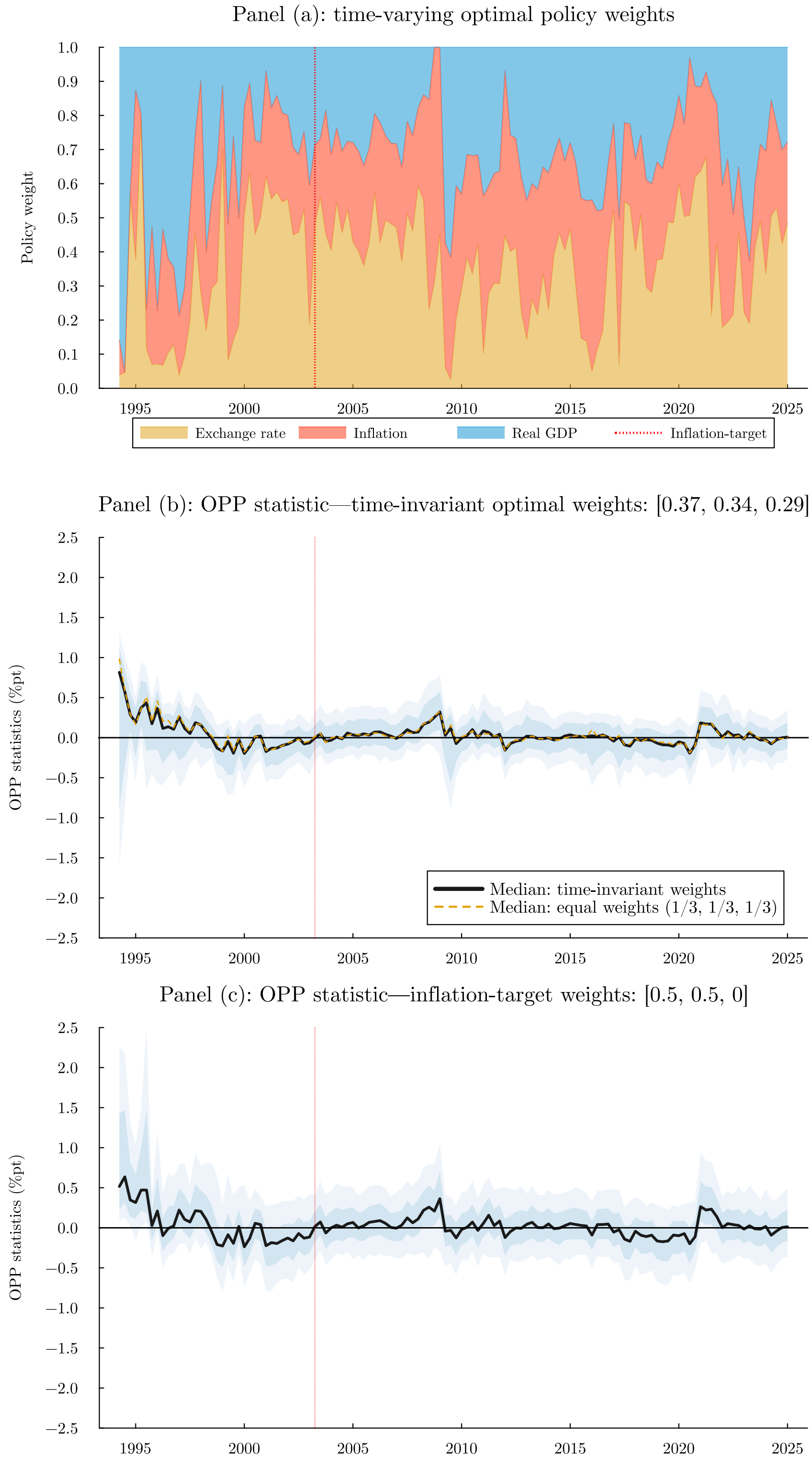
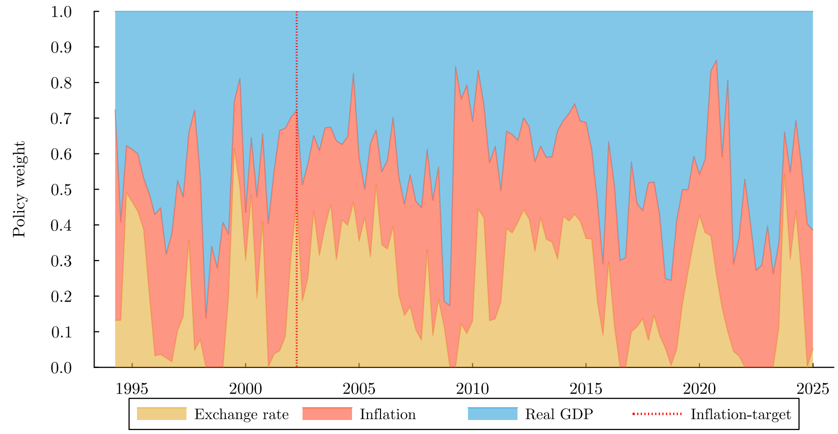
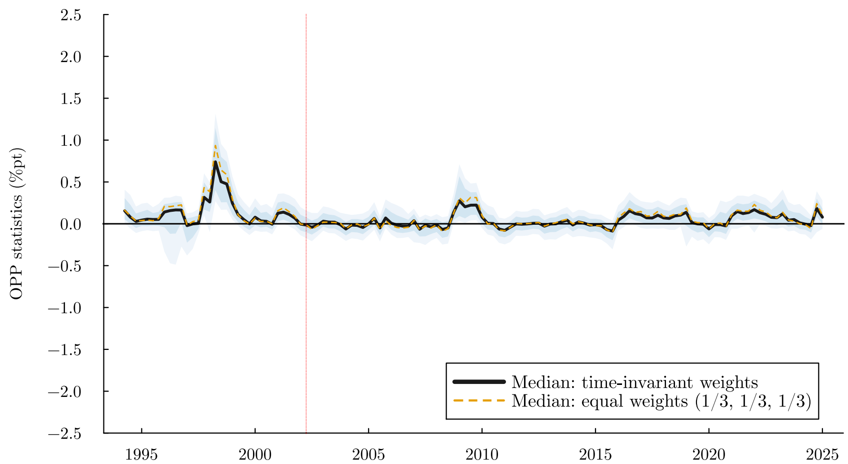


Figure 9. Philippines: Optimal perturbation statistics (OPP) over time

Panel (a): time-varying optimal policy weights



Panel (b): OPP statistic—time-invariant optimal weights: [0.37, 0.36, 0.27]



Panel (c): OPP statistic—inflation-target weights: [0.5, 0.5, 0]

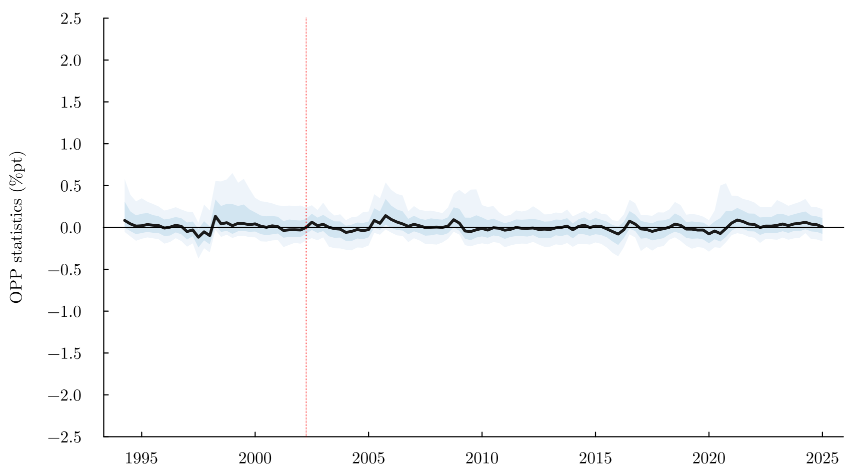


Figure 10. Thailand: Optimal perturbation statistics (OPP) over time

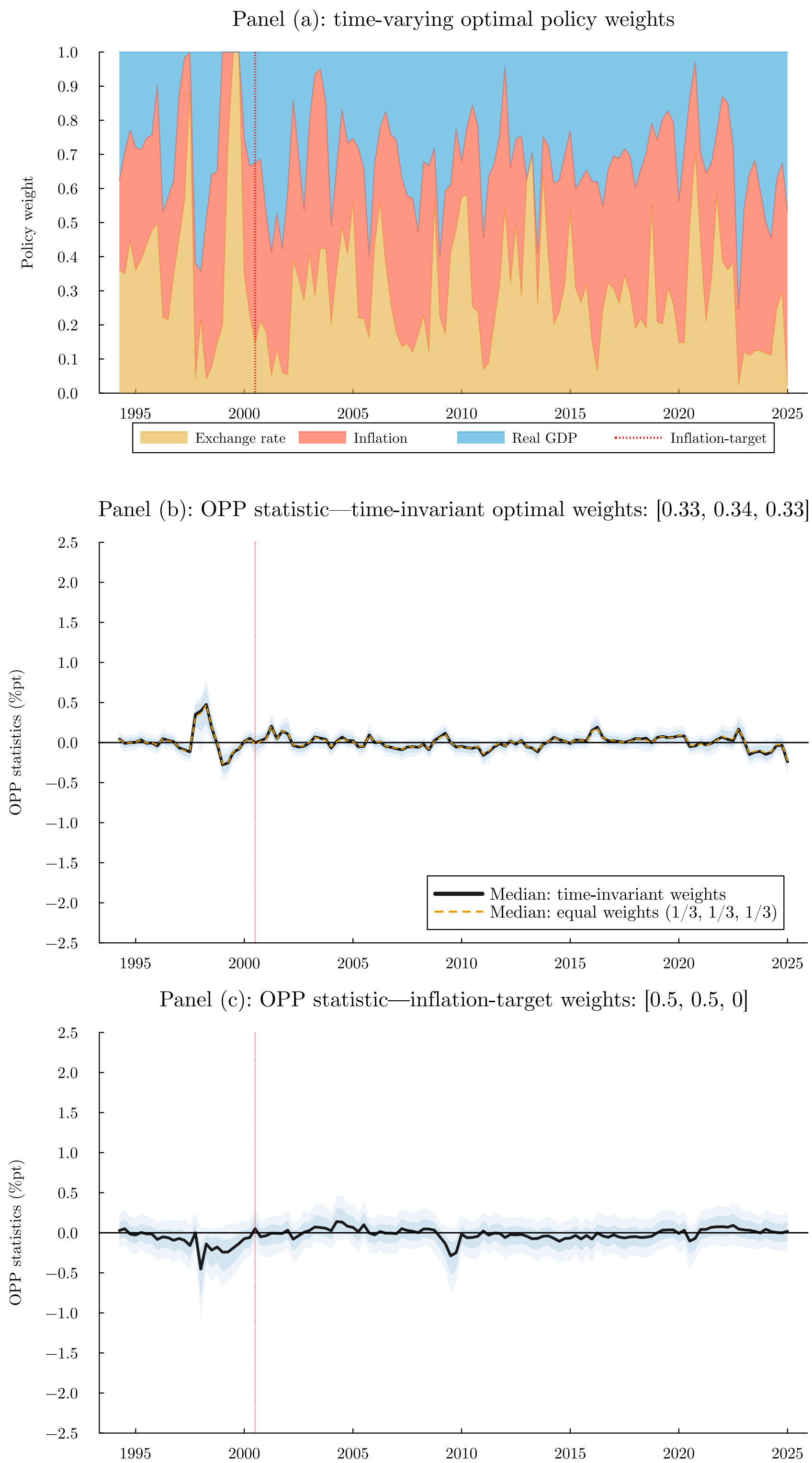


Figure 11. Turkey: Optimal perturbation statistics (OPP) over time

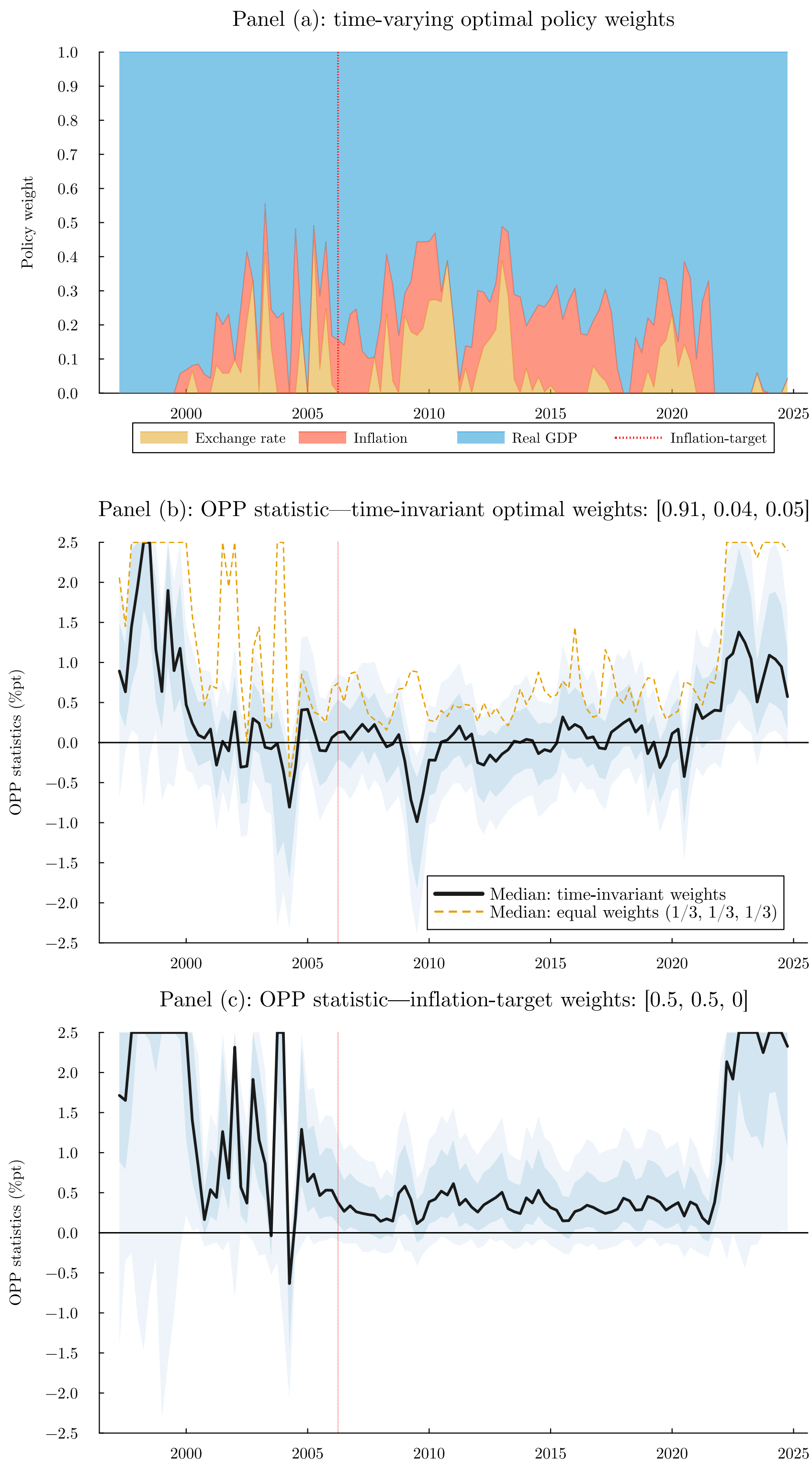


Figure 12. South Africa: Optimal perturbation statistics (OPP) over time