

Evaluating Emerging Markets' Monetary Policy

Non-technical Summary

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Inflation targeting has become one of the most influential innovations in modern macroeconomic policy. Today, most major central banks publicly commit to keeping inflation near an explicit target—often around 2 percent—and adjust interest rates to achieve it. The power of this framework does not lie only in what central banks actually do, but in what people *believe* they will do: if households, firms, and financial markets believe the central bank will act decisively to contain inflation, their expectations adjust accordingly, making inflation itself easier to control. *Credibility*, in other words, is the cornerstone of effective monetary policy nowadays.

This logic has worked reasonably well in advanced economies. But its success in emerging markets is far less certain. Since the early 2000s, many emerging-market central banks have adopted formal inflation targets. Yet these countries face constraints that richer economies largely do not. They are more exposed to external shocks, more dependent on exports and capital flows, more vulnerable to exchange rate instability, and often more subject to political pressure. Currency depreciation can quickly become both an economic and political crisis. In such environments, it is not obvious that inflation targets meaningfully discipline monetary policy when difficult trade-offs arise—especially given the historical legacy of fiscal dominance and seigniorage (printing money to finance spending).

When inflation rises but the currency comes under pressure, should the central bank raise interest rates to defend price stability, or hold back to support economic growth and financial stability? When unemployment rises sharply, does the commitment to inflation control survive? These are not abstract questions—they are the everyday dilemmas policymakers face in emerging economies.

This paper proposes a new way of answering this important question: are central banks in emerging markets actually behaving as if they are committed to inflation targeting? Rather than relying on official statements, press releases, or legal mandates, the approach focuses on behavior—what interest rate decisions reveal about policymakers' true priorities.

The method rests on a simple idea from calculus: in a single-variable optimization problem, the optimal choice satisfies a first-order condition: the slope evaluated at the optimal value equals to zero. But this condition also implies that if a small change in the choice variable could move the slope closer to zero, then the current choice cannot be

optimal. The direction and magnitude of that change indicate how the current choice should be adjusted to improve outcomes.

Applied to monetary policy, this means that if policymakers are choosing interest rates optimally given their objectives, small changes in interest rates should not improve outcomes. If a small adjustment would clearly improve performance—lowering inflation without much cost to growth, for example—then current policy cannot be fully consistent with the stated goals. Observed policy decisions therefore contain information about both policy errors and underlying priorities.

This logic can be used in two complementary ways. First, assuming central banks act optimally given their own policy objectives, we can work backward from the observed interest rate to infer the implicit weights they place on output, inflation, and the exchange rate over time (i.e., “revealed preference”). Second, we can impose some benchmark objectives—such as an inflation-target benchmark or an equal-weight benchmark—and ask whether policy rates should have been higher, lower, or unchanged under those standards.

Applied across twelve emerging economies over several decades, the results paint a cautiously optimistic picture. In many countries, monetary policy behavior has gradually shifted toward placing greater and more stable emphasis on inflation stabilization since the early 2000s. This pattern is especially visible in countries with painful histories of high inflation, such as Mexico (Figure 1). Over time, their policy decisions increasingly resemble those of central banks that take inflation targets seriously. This helps explain why inflation in many emerging markets has become less persistent than in earlier decades.

Crucially, credibility does not appear to require rigidity. Figure 2 illustrates this with Chile. During extreme stress—such as the global financial crisis and the COVID-19 pandemic—the central bank temporarily shifts toward supporting economic activity, as shown by a sharp rise in the implied weight on output stabilization. Yet this shift is short-lived. Once the crisis subsides, policy behavior reverts toward inflation-focused priorities. This pattern suggests flexible implementation rather than a breakdown of credibility.

The framework also yields concrete prescriptions. Figure 3 shows that for South Korea: all benchmarks suggest that interest rates should have been lowered more aggressively during the 2008 Global Financial Crisis. At the same time, the benchmarks disagree during the 1997 Asian Financial Crisis: an inflation-target benchmark suggests easing, while an equal-weight benchmark suggests tightening. This divergence highlights the genuine trade-offs policymakers often face in extreme situations and helps explain why policy can appear conflicted during crises.

Not all cases are equally encouraging. Turkey stands out as a sharp contrast. Figure 4 shows that under virtually all benchmarks, policy rates have been systematically too low in recent years, especially following intensified political interference since the early 2020s. The consequences—surging inflation and collapsing credibility—are clearly visible in the data. This case underscores a broader lesson: inflation targeting on paper is not sufficient. Credibility ultimately depends on institutional independence and political commitment.

Taken together, the evidence supports a cautiously optimistic conclusion. Since the early 2000s, many emerging-market central banks have increasingly behaved in ways consistent with sustained commitment to inflation stabilization. Temporary departures during crises are common, but in most cases policy priorities subsequently revert toward inflation discipline. Inflation targeting has gradually gained substance and credibility in many countries, even while remaining fragile where institutions are weak. The overall trajectory is more optimistic than skeptical: over time, many emerging-market central banks appear to have learned to behave in ways that make their promises increasingly believable.

Figure 1: Inflation weight rises Sharply after inflation-target adoption in Mexico

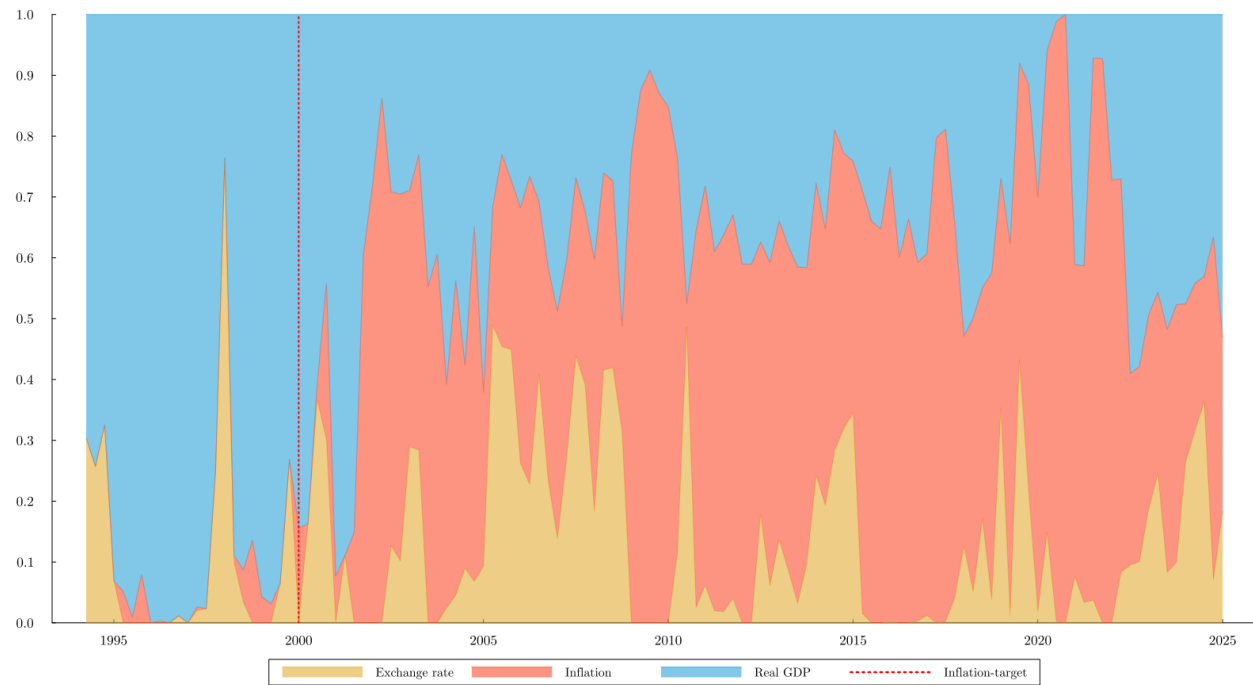


Figure 2: Temporary shift toward output stabilization during crisis in Chile

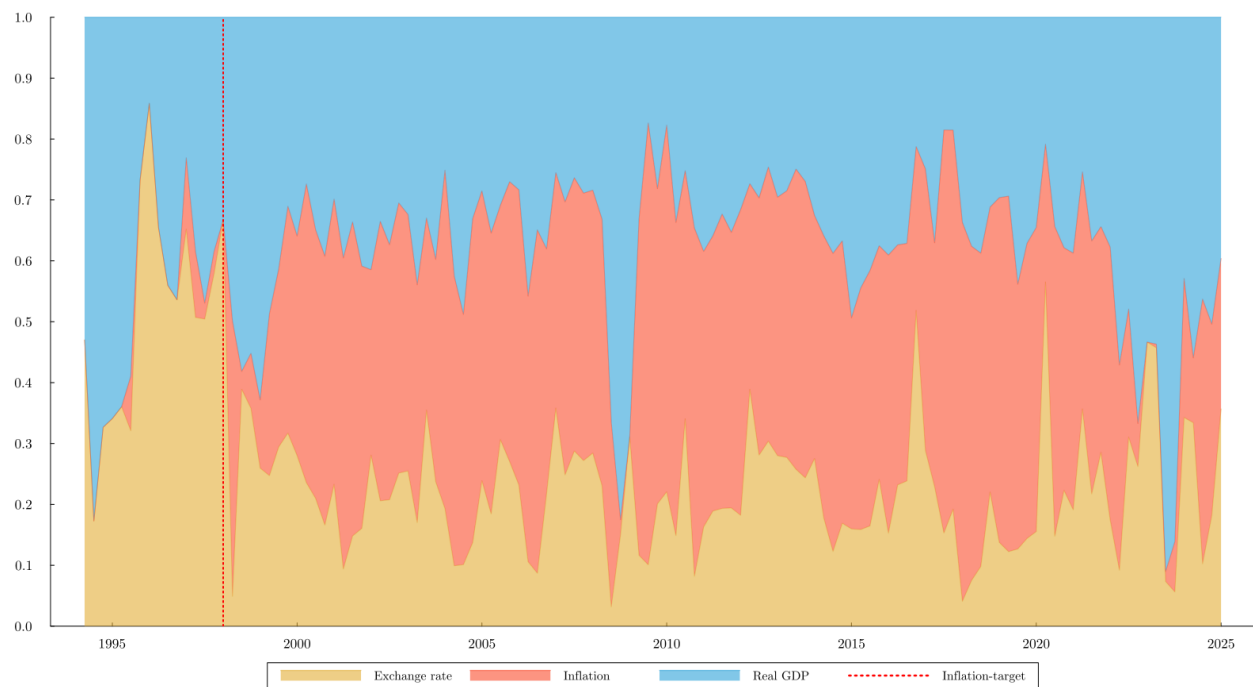


Figure 3: More aggressive monetary easing during financial crises in South Korea

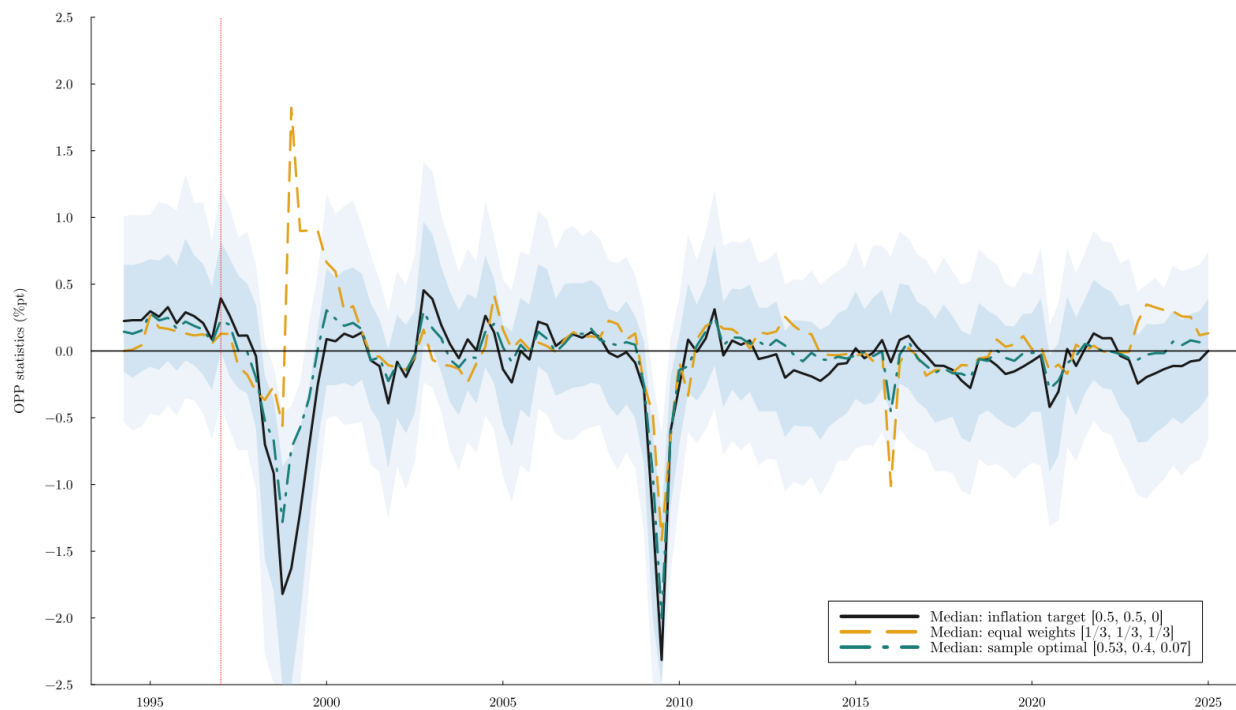


Figure 4: Persistent positive OPP deviations in Turkey

