

Monetary Policy in Developing Countries

This is a very incomplete summary of the Monetary Policy Workshop in London, October 22, 2011. The material builds on contributions from participants in the open discussion and in the presentations (for the latter, see in particular the material presented by Paolo Pesenti and Chris Adam).

Modelling Monetary Policy in Developing Countries

The design of appropriate monetary policy builds on two critical ingredients: 1) a representation of the economy, characterizing technology, market structure and behaviour of different actors (households, firms governments); and 2) a normative dimension, which relies on a welfare function that summarizes the social costs and benefits from different policy actions.

A natural question is whether the current framework and methodological approach used for the analysis of monetary policy in developed countries (i.e., New Keynesian DSGE models) can be exported to the analysis of policy in developing countries. A consensual view emerged that there are important new dimensions that need to be taken into account in the evaluation of monetary policy in developing economies. There was a healthy discussion on whether one needs to “start from scratch or whether part of the existing framework can be employed in the analysis of monetary policy in LIC”. Towards the end, agreement was reached on what are some of the ingredients or considerations that have to be part of the framework needed to study monetary policy in LIC (some might think of this as ‘starting from scratch,’ or fundamental deviations from canonical New Keynesian DSGE).

1) High Volatility

DSGE techniques typically focus on small perturbations from non-stochastic steady state in (log-) linearized versions of the model. But LICs are subject to high volatility related to both supply and demand shocks. There may be important theoretical non-linearities. Large movements in spreads and risk premia.

2) Nature of Shocks and growth effects

A common practice in macroeconomic analysis of developed countries is to isolate the cyclical component of fluctuations. However, in LIC the trend is far from stable and can be hardly separated from the cycle. The current crisis in East Africa is a case in point: a seasonal drought has killed a sizable part of the cattle (a key asset in this economies), which will have repercussions for growth in years to come.

An important issue is whether monetary policy should factor in that countries are still far below their longer-term steady states.

Supply shocks are at least as important as demand shock (the key shock in NK models to which monetary policy optimally reacts).

3) Non-homotheticities: subsistence level

Many households in LIC live at or near subsistence levels. Contractionary monetary policies are then particularly problematic in these economies and have to be thoroughly thought-through. Redistributive measures may have to be taken along with monetary contractions.

Inequality is an important dimension in the conduct of monetary policy in LIC, both because it is much higher than in developed economies, and because a large fraction of the population is at subsistence levels.

4) International dimension

Critically, economic models for LIC should feature the international dimension, with the inherent exposure to terms-of-trade shocks, financial flows, changes in interest rates, etc. The choice of the exchange rate regime is still a critical issues on which developing countries need guidance. In studying exchange rate issues the balance-sheet effect should receive as much emphasis as the competitiveness effect. Finally, most LIC have quite closed capital accounts and hence they operate under conditions of near financial autarky---in big contrast with the literature and assumptions in the international business cycle literature.

5) The sectoral composition of the economy

Many LIC are highly concentrated in agriculture, an inherently highly volatile sector, with little scope for prices to adjust to supply shocks.

6) Credit-constrained consumers and firms.

Financial constraints are very important and can play a key role in the transmission mechanism.

7) Objective function

For many of the reasons highlighted above, we should be open to the possibility that the optimal relative weight on output stabilization (relative to inflation) is higher in poor countries.

Other research question

8) Limit to central bank independence/Fiscal dominance

Broadly speaking, central banks enjoy less independence in poorer countries. This raises both normative questions (should central banks be independent in developing countries?) and positive ones, as the lack of independence may be a factor in explaining macroeconomic outcomes in some of these countries. A closely related issue is the issue of fiscal dominance. The political economy of decision making and the interaction between the bank and the fiscal authority and other interest groups deserve special attention.

9) Banks and the transmission of policy.

Due to undeveloped financial markets monetary policy is mostly transmitted through the banking sector, and it is important to keep this into account in analysing monetary policy. Perhaps most importantly, in these often financially repressed economies it is not uncommon for central banks to operate through “unconventional” tools (e.g. interest rate caps on banks). Hence, a rethinking of the transmission channel is needed in the presence of such tools is needed. Such rethinking should also take into account the often monopolistic structure of banking system/ government-owned banks.

10) Policy tool and role of monetary aggregates

Related to the point above, it is often not clear whether it makes sense to think of policy as targeting a specific interest rate. Is there a role for monetary aggregates? A

possible positive answer to this question may be constructed around the observation that data is very poor (see next point). Monetary aggregates may be easier to measure.

11) Data

Data on LIC are of much lower quality. Limits on data quality and quantity are perhaps the greatest limitation for researchers. Improve the data collection and dissemination process is then highest priority in this area. It was reported that the IMF is engaged in a large-scale effort to improve the supply of high-frequency macroeconomic data in LICs.

12) Growth and monetary policy

Can monetary policy be part of a growth strategy? Can it play a role in the provision of credit? There were many divided views on this issue, with the ones against pointing to classic results on long-run monetary neutrality and in favour stressing the role of exchange-rate policy for exploiting potential increasing returns to scale.

13) Mobile banking

This is an exciting new development. The implications it might have for monetary policy are not well understood. This seems to be an “up for grabs” question that deserves urgent attention.

14) Forecasting

It was reported that major “asks” from policy makers in LICs include (i) empirical tools for inflation forecasting and (ii) empirical models of the monetary transmission mechanism.