Policy International Centre for Inclusive Growth

The International Policy Centre for Inclusive Growth is jointly supported by the Poverty Practice, Bureau for Development Policy, UNDP and the Government of Brazil.

One pager No. 141

April, 2012

Intersections between Exchange Rate and Inflation Policies in IMF Recommendations

by Raquel Almeida Ramos,
International Policy Centre for Inclusive Growth (IPC-IG)

Several developing countries have adopted a free floating exchange rate regime in recent years, especially after the late-1990s currency crisis. This regime is being advocated based on the argument that it would smooth domestic and international shocks and allow monetary policy independence. Within this framework, central banks would be able to make use of monetary policy with the sole goal of fighting inflation, which, in turn, would be enough to stabilise output. Regardless of the simplicity of this policy combination, it might not be effective in *every* country. Some important country-specific circumstances must be considered when analysing the possible implications and potential complications of such a policy framework.

One important issue is the impact that exchange rate volatility can have on an economy, and, among other aspects, on inflation. This is even more relevant to developing countries, where exchange rate volatility tends to be higher, contributing to a higher exchange rate pass-through to inflation. The higher exchange rate volatility in developing countries, in turn, stems from their greater vulnerability to external shocks and the lower liquidity of their currencies in international markets. As a result of these two characteristics, the impact of the exchange rate on inflation is greater in developing countries.

A second important issue is the limitation of controlling inflation through monetary policies. A first restriction is the weak transmission mechanism of monetary policy in some developing countries—meaning that the effectiveness of the policy might be only partial. Another limitation is the output cost implied in the policy, which, depending on the country's economic situation and prospects, might not always be optimal.

Given this specific context of developing countries—of significant shocks from the exchange rate to inflation and the limitations related to monetary policy—controlling exchange rate volatility is very important in the fight against inflation. Indeed, policymakers would be opting for a more interventionist approach to curb inflation—the fear of floating would in fact be a fear of inflation. Moreover, that does not require abandoning monetary policy independence, as such control is effected through direct interventions in the exchange rate markets. An illustration of this rethinking of the intersection between exchange rate and inflation was its recognition inside the International Monetary Fund (IMF). Blanchard (2011) stated that developing countries' central bankers were right to care about the exchange rate and affirmed the need to fight inflation through different instruments.

Regardless of the importance of these issues in developing countries' policymaking and the apparent receptiveness of IMF headquarters, the IMF's recent policy recommendations remained focused on pushing for full exchange rate flexibility and were highly focused on the use of monetary policy as the sole instrument for fighting inflation. This was done even in cases when the analysis showed that this policy combination would clearly create policy challenges or had recently created problems (Roy and Ramos, 2011).

The case of Paraguay is a good example. As the country report presents, Paraguay has a sizeable exchange rate pass-through and a weak monetary transmission mechanism, which makes exchange rate intervention a very important instrument to fight inflation. Moreover, controlling exchange rate variability would also be important to preserve stability, due to the high dollarisation of the country's financial sector. Nevertheless, the IMF considers that these interventions are a confusing signal about its commitment to low inflation and recommends the authorities to avoid them.

Moldova also has a still underdeveloped transmission mechanism, and recent inflation drivers had been mainly cost-push. In this case, limiting exchange rate volatility seems to be an appropriate option. Nevertheless, the IMF recommends exchange rate intervention to be limited, aiming at smoothing erratic movements only.

In the case of Egypt, the IMF mentions that exchange rate changes are important for building inflation expectations. Nevertheless, it advises the country's authorities to allow greater exchange rate variability along with the country's transition towards a fully-fledged inflation targeting regime. However, given the exchange rate's impact on inflation, such a policy would increase—rather than decrease—inflation variability and, therefore, also inflation. Moreover, limiting exchange rate variability in the context of the inflation targeting (IT) regime should not be discouraged, as it can coexist with monetary policy independence. The country authorities have shown concerns over this policy advice; they defended their more interventionist approach and underscored the importance of protecting the economy from excessive volatility.

In the case of Vietnam, the IMF advised the country to move towards a more flexible exchange rate regime at the same time that, in a contradictory manner, it mentioned the importance of exchange rate stability in attracting foreign direct investment (FDI) and in building the country's favourable economic outlook.

In conclusion, the IMF resists recommending policies aimed at averting excessive exchange rate volatility, despite their important role in helping to control inflation and in promoting economic stability. Developing countries, on the other hand, have been assuming a different position: they are implementing more interventionist policies and stating their concerns over the IMF's advice. The lack of a constructive debate with regards to these policies is worrying, given the importance of the exchange rate and of inflation, and given that the IMF has a primary role in securing a stable international monetary system.

References:

Blanchard, O. (2011). 'Monetary Policy', *Monetary Policy in the Wake of the Crisis*. Washington DC, IMF.

Roy, R., and Ramos, R. (2012). 'An analysis of IMF policy recommendations'. *IPC-IG Working Paper 86*. Brasília, International Policy Centre for Inclusive Growth.

International Policy Centre for Inclusive Growth (IPC - IG)
Poverty Practice, Bureau for Development Policy, UNDP
Esplanada dos Ministérios, Bloco O, 7º andar
70052-900 Brasilia, DF - Brazil

E-mail: ipc@ipc-undp.org ▪ URL: www.ipc-undp.org
Telephone: +55 61 2105 5000

The views expressed in this page are the authors' and not necessarily those of the United Nations Development Programme or the Government of Brazil.

Click and comment