



BANCO CENTRAL DE RESERVA DEL PERÚ

***XIX FLAR Annual Economic Studies Conference
"Inflation, Monetary and Fiscal Policy in Emerging Markets"***

Comments on "Monetary Policy Transmission in Emerging Markets: Proverbial Concerns, Novel Evidence"

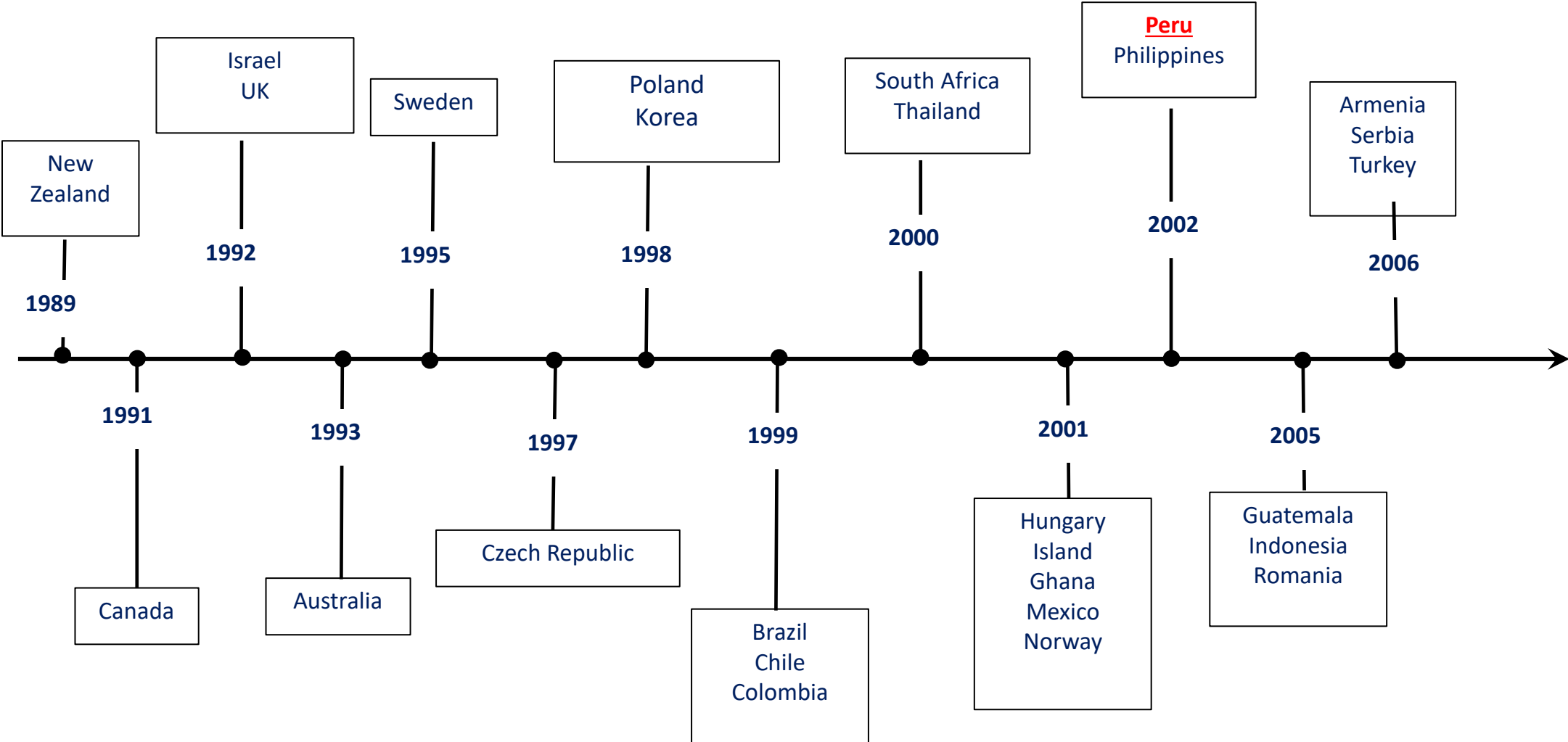
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Introduction

- Assessing the transmission channels of monetary policy (MP) is crucial for Central Banks (CBs).
- MP effects are extensively studied in Advanced Economies (AEs) but less thoroughly in Emerging Markets (EMs).
- The paper by Ariadne Checo, Francesco Grigoli, and Damiano Sandri (BIS) enhances our understanding of MP transmission in EMs compared to AEs.

EMs transitioned from pegged exchange rate regimes to an Inflation Targeting (IT) framework later than other economies.



Challenges in Identifying MP Transmission Channels in EMs

- IT adoption in EMs initially raised concerns due to the lack of pre-conditions typically present in AEs.

Table 7. Preconditions and Current Conditions in Inflation Targeting and Nontargeting Emerging Market and Industrial Countries

<i>Item</i>	<i>Targeters</i>				<i>Nontargeters</i>	
	<i>Emerging markets</i>		<i>Industrial countries</i>		<i>Emerging markets</i>	
	<i>Pre-adoption</i>	<i>Current</i>	<i>Pre-adoption</i>	<i>Current</i>	<i>Pre-adoption of current regime</i>	<i>Current</i>
Technical infrastructure	0.29	0.97	0.74	0.98	0.51	0.62
Financial system health	0.41	0.48	0.53	0.60	0.40	0.49
Institutional independence	0.59	0.72	0.56	0.78	0.49	0.64
Economic structure	0.36	0.46	0.47	0.55	0.55	0.44

Source: Batini and Laxton, 2007, "Under what conditions can inflation targeting be adopted? The experience of emerging markets"

- These concerns have since dissipated, shifting the focus to how MP transmission channels have evolved in EMs.

Paper Overview

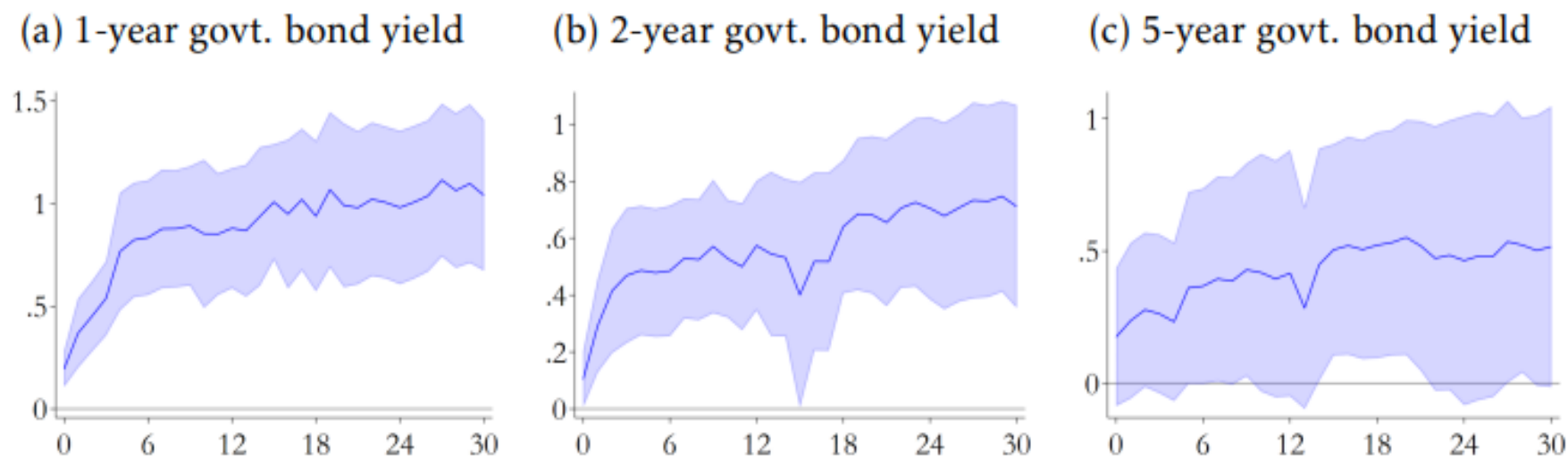
- Identifying MP shocks in EMs is challenging due to the heterogeneity across countries regarding communication styles and data limitations.
- The paper uses Bloomberg analysts' forecasts to identify MP shocks and explores their impact at both macroeconomic and firm levels across 18 EMs.

Comment I: MP Transmission Channels

Finding:

MP in EMs has strong effects on local-currency government bonds yields.

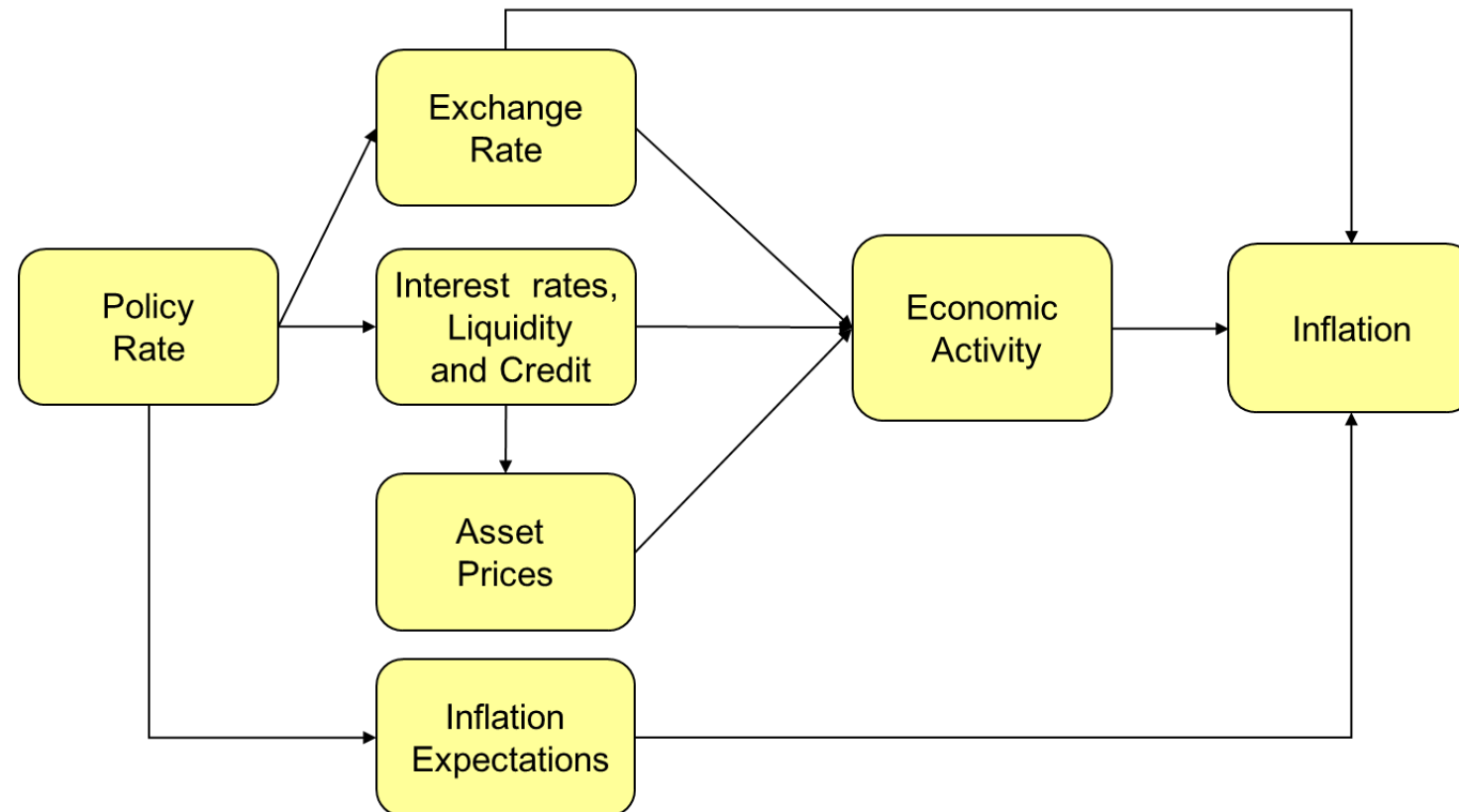
Figure 3: Financial market responses to a 1pp monetary policy shock
(Percent)



Source: The paper

Comment I: MP Transmission Channels

- Long-term rates are relatively new or non-existent in EMs and are significantly affected by international conditions.
- EM financial markets are smaller, riskier, and less liquid.
- For this reason, short-term rates are likely more relevant than long-term rates in EMs.
- Managing inflation expectations may be more important for EM CBs.

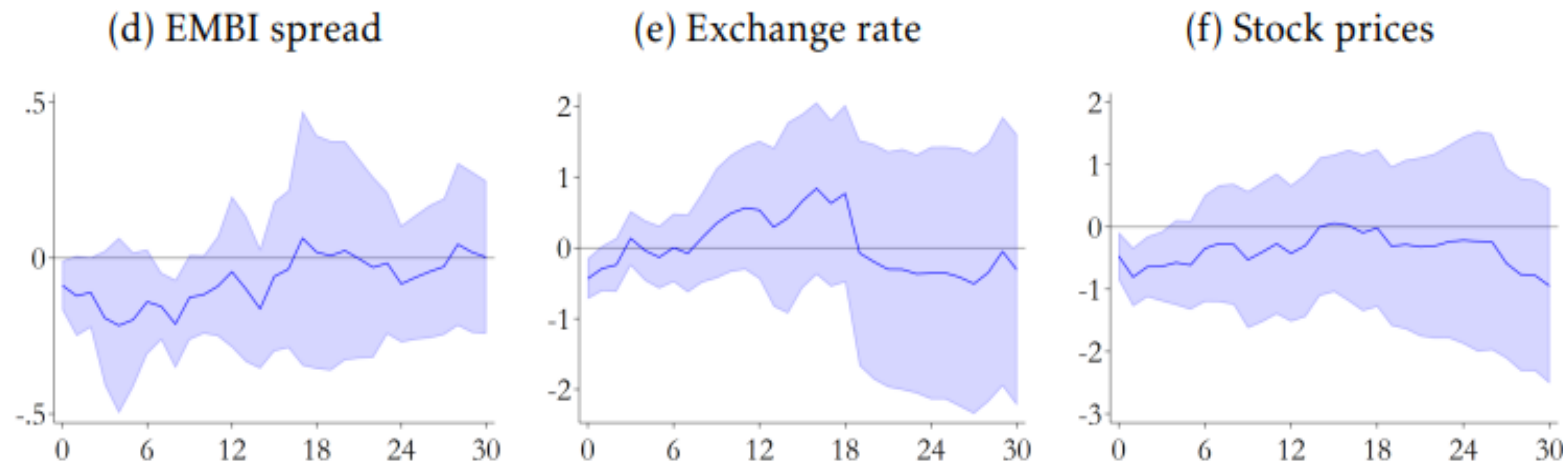


Comment II: MP Effects on Financial Variables

Finding:

MP tightening in EMs appreciates exchange rates and reduces stock prices, but these effects are short-lived.

Figure 3: Financial market responses to a 1pp monetary policy shock
(Percent)



Comments:

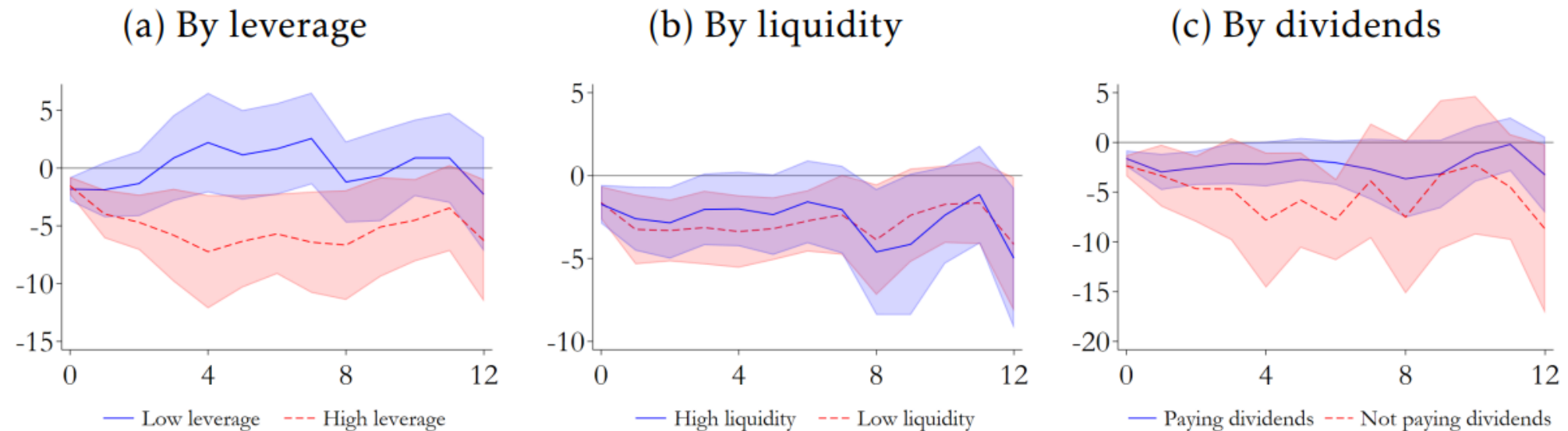
- This finding highlights the importance of external shocks. EM exchange rates are significantly affected by external conditions.
- The reduction in stock prices seems not robust.
- EM stock markets are small, implying a low relevance for the wealth channel.

Comment III: Firm Heterogeneity

Finding:

Firms with weak financial conditions are more exposed to MP.

Figure 7: Heterogeneous responses of fixed capital across firms
(Percent)



Comments:

- This finding suggests greater potential for policies that reduce credit market volatility.
- FX intervention and macroprudential policies are well-suited for EMs.

Comment IV: Definition of MP shock

Interest rate determination:

$$i = f(\theta, \mathbb{E}, \tau) + \epsilon^{mp}$$

Diagram illustrating the components of the interest rate determination function $f(\theta, \mathbb{E}, \tau)$:

- θ : CB preferences
- \mathbb{E} : Expectations
- τ : Economic drivers - output gap

In the paper:

$$FE_{a,c,t} = i_{c,t} - f_{a,c,t}$$

Diagram illustrating the components of the forecast error term $f_{a,c,t}$:

- $f_{a,c,t}$: Analysts' forecast

“Private sector expectations of future policy rate derive from the combination of a forecast of the economy and the central bank reaction function. There is no reason to assume that the private sector has the same view of the future path of the economy as the central bank.”

- Mervyn King, “Inflation targets: Practice ahead of theory”

Comment IV: Definition of MP shock

How to understand ϵ^{mp} ?

According to Christiano, Eichenbaum, and Evans, 1998:

- Exogenous shock in CB preferences.
- Strategic considerations to guide private agents' expectations.
- CB adjustments due to measurement errors.

According to Bauer and Swanson, 2023

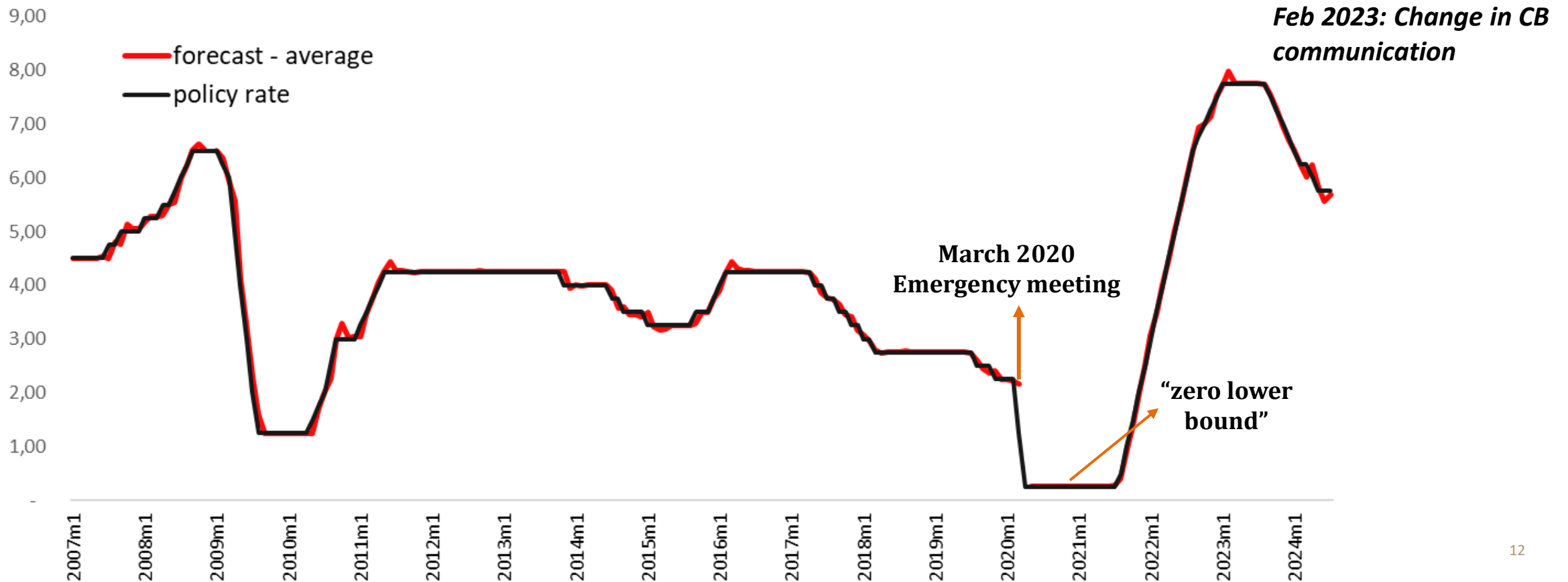
- Agents' imperfect information about CB response function.

Q: How does the paper interpret an MP shock?

Comment V: FE as MP Shock

1. *CBs use communication to reduce analysts' FE.*
2. *How does the paper handle emergency meetings?*

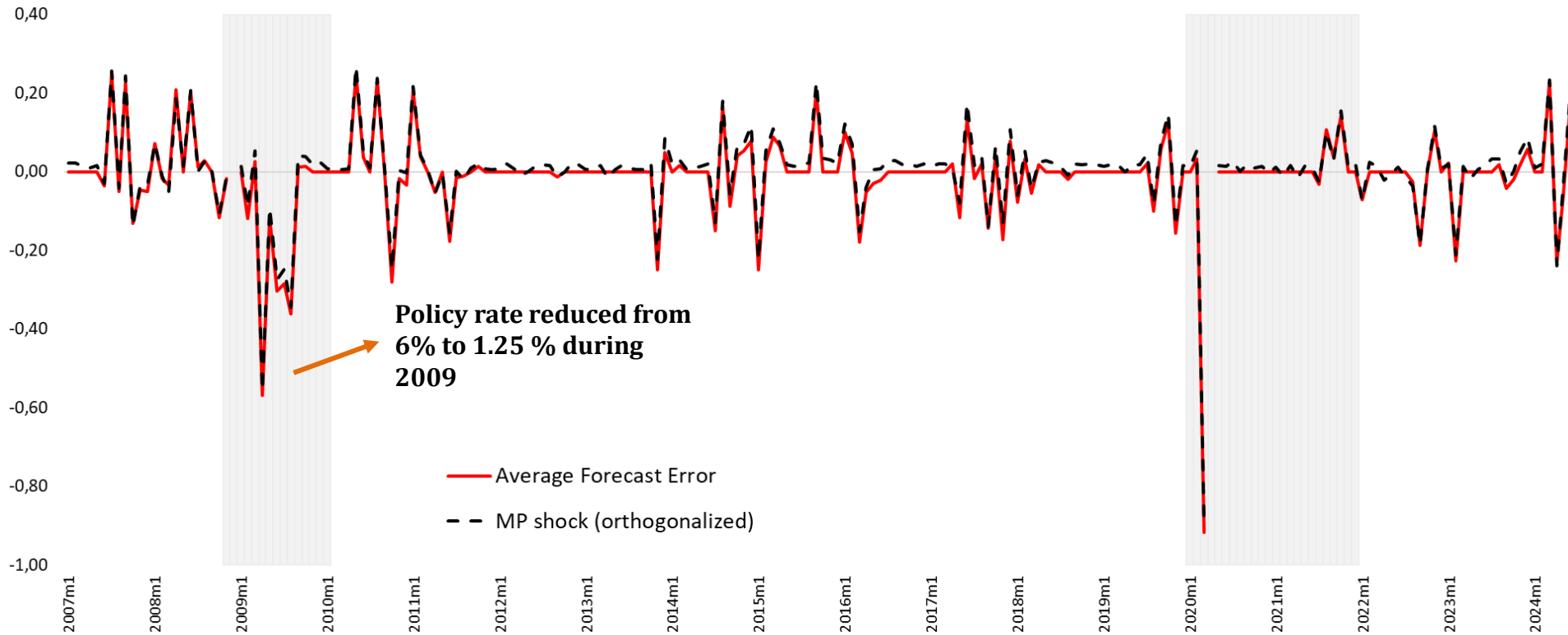
Figure: Bloomberg analysts' forecast - Peru



Comment V: FE as MP Shock

The paper orthogonalizes $FE_{a,c,t}$ with respect to economic variables.

Figure: Analysts' forecast error and MP shock- Peru



Comment:

Shock sizes are small for crisis periods. Do they accurately reflect the CB's position?

Comment VI: Anticipated versus Unanticipated

“Most variation in monetary policy instruments is accounted for by responses of policy to the state of the economy, not by random disturbances of the economy”

- Sims (1998)

“If policy is completely characterized as a feedback rule on the economy, so that there are no exogenous policy shocks, then the VAR methodology would conclude that monetary policy does not matter. Yet while monetary is not causing output movements in this example, it does not follow that policy is unimportant; the response of the economy to nonpolicy shocks may depend importantly on the way monetary policy endogenously adjusts”

- Walsh (2010)

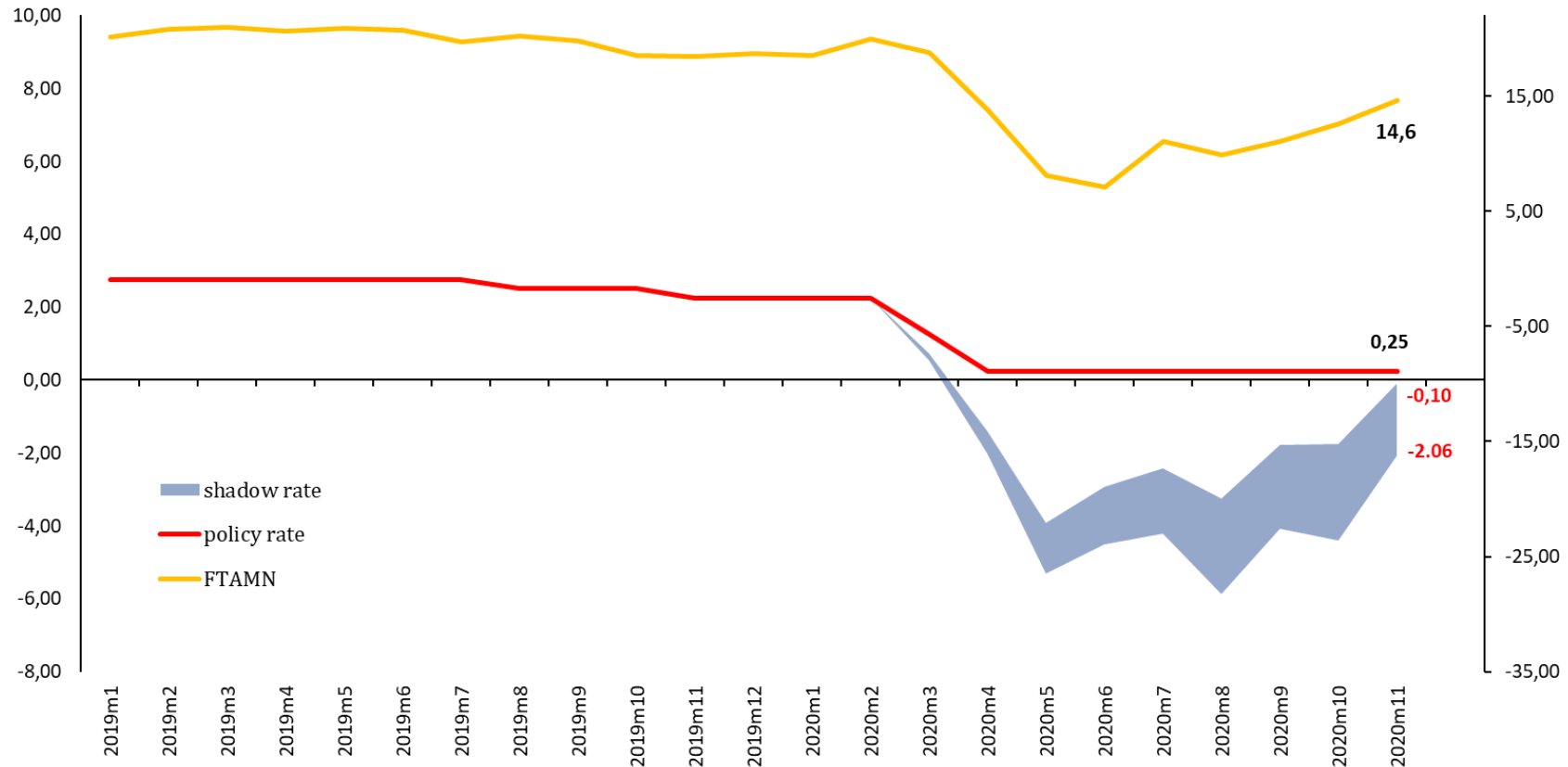
Comment:

What is the role of anticipated versus unanticipated MP responses?

Comment VII: FE and ZLB

Comment: During 2020-2021, analysts' forecast errors were close to zero, but the CB's position was quite expansive (low policy rate and Central Bank Balance Sheet expansion). **Q:** *How do MP shocks work near the ZLB?*

Figure: Policy rate, Loan rates (FTAMN), and shadow rate – Peru (percent)



Concluding Remarks

- The paper comprehensively characterizes MP transmission channels.
- The findings align with the development level of EM financial markets, highlighting the lower relevance of the wealth effect, as well as the macroeconomic vulnerabilities from the relationship between external capital flows and local financial conditions.
- Future research on MP transmission channels may explore other tools beyond the policy rate, such as CB balance sheet management.



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