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MONETARY POLICY RESPONSE TO EXCHANGE RATE VOLATILITY IN LARGE EMERGING MARKET ECONOMIES

Abstract:

Financial stabilisation through monetary policy reforms has constituted a major debate in attempts to restructure the financial systems in large emerging market economies (LEMEs). This is due to the institutional setbacks caused by price variability on the exchange rate as a result of poor policy framework, underdeveloped financial system, and institutional imbalances. To mitigate the problem of price variability or inflation rise that affects financial and economic stability since the era of financial liberalisation that increased the degree of capital flows, LEMEs adopt inflation targeting (IT) regime guided by the Taylor monetary policy rule.

Despite the positive impacts of the policy rule in the advanced economies, an argument has been presented on the practicability of the Taylor policy rule in LEMEs considering the underdeveloped financial system that incapacitates the economies' ability to institute effective monetary policy. Furthermore, there is the view that the policy rule did not adequately capture all the relevant factors needed for effective monetary policy formulation in LEMEs. This study, therefore, investigates whether the Taylor policy rule in LEMEs is credible in maintaining price stability in the economies and determines whether exchange rates play a role in the conduct of policy interest rate setting in LEMEs using different price variability instruments-CPI and PPI inflation. The countries studied and the period covered in accordance with their IT adoption date are Brazil-1999Q1, India-2016Q2, KoreaQ1-1998, Mexico-1999Q1, Russia-2014Q1, South AfricaQ1-2000, and Turkey-2005Q1 and the end year for all countries in 2019Q4. The variables considered were interest rates, inflation gap for CPI, inflation gap for PPI, output gap, and real effective exchange rate.

Although the OLS estimator was used for the estimation, but the conditions of OLS were violated leading to the application of the GMM estimator. The results from the GMM estimation reveal a strict inflation targeting for all countries with PPI inflation than with CPI inflation while a very insignificant number of the economies follow the Taylor rule, and none complies with the Taylor principle. The implication of the results is that Taylor's rule does not match the economic structure of LEMEs therefore, adopting unconventional monetary policy should be considered.

Keywords:

Monetary policy, Interest Rate Rule, Inflation Targeting, emerging Markets

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