FOCUS · Emerging monetary policy and domestic macroeconomic conditions

A recurring theme in the debate regarding emerging monetary policy is the dependence of emerging central banks on their US peer. This has become even more important in the current context of US monetary policy normalisation. Emerging countries have become increasingly integrated within the world economy. Consequently, the monetary policy implemented by their central banks has also become more sensitive to the Fed's.[1] But emerging monetary policy also largely depends on each country's domestic macroeconomic conditions, particularly now that their exchange rates tend to be more flexible. In this article we look at the macroeconomic conditions of the main emerging economies and the implications in terms of the right monetary policy for their central banks.

One tool often used to assess whether a country's monetary policy is appropriate for its economic conditions is the Taylor rule, named after the US economist who developed it in the 1990s. Essentially, this rule estimates the level at which a central bank should set its interest rate given the country's macroeconomic conditions.

The Taylor rule estimate[2] for five of the main emerging central banks highlights several aspects of the trend in emerging monetary policy over the last ten years. First, in the period from the end of 2008, just after the crisis, up to the end of 2010, the benchmark rates set by the central banks and the rate provided by the Taylor rule were notably similar. As from 2010, however, these benchmark rates fell below the Taylor rule estimate. This suggests the emerging central banks implemented a more accommodative monetary policy than warranted by their domestic macroeconomic conditions. Since the end of 2016 there has also been a relatively large gap between the benchmark rates and the level recommended by the Taylor rule but this time in the opposite direction, suggesting emerging monetary policy is becoming more restrictive than necessary (see the chart).

One of the main reasons for these differences since the financial crisis between the monetary policies implemented in emerging countries and those recommended by the Taylor rule is actually the monetary policy implemented in the US. For instance, between 2010 and 2016 the incredibly accommodative measures taken by the Fed forced emerging central banks to adopt a more accommodative stance than warranted by the macroeconomic conditions in their respective countries. If they had not brought their monetary policy at least partly in line with the financial conditions encouraged by the Fed's stance, their currencies would have appreciated, eroding exports and pushing down inflation. Conversely, since the Fed started to normalise its monetary policy, emerging central banks have taken a more restrictive stance than warranted by their countries' macroeconomic conditions to stop their currencies from depreciating further.

The monetary policy adopted by the main emerging central banks is expected to be somewhat more accommodative in the future. In any case, the continued normalisation of monetary conditions in the US means that emerging central banks will have maintain a slightly more restrictive stance than desired.

Emerging monetary policy according to the Taylor rule *

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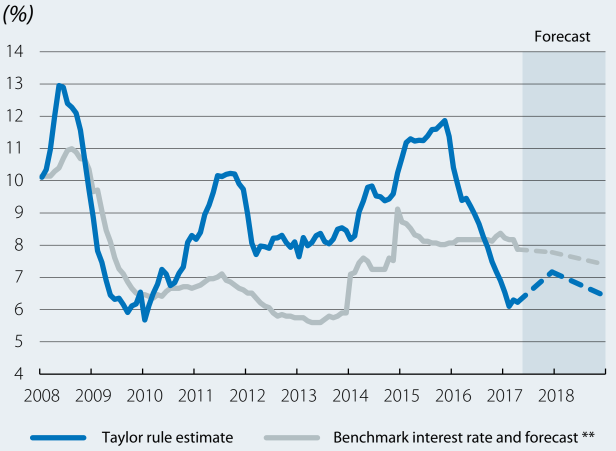

Notes: ** Simple average of the five emerging central banks chosen (Brazil, China, Mexico, Russia and Turkey). ** CaixaBank Research forecast for benchmark rates.*
Source: *CaixaBank Research, based on data from Bloomberg and Thomson Reuters Datastream.*

1. For more details, see the Focus «Which emerging central banks will have to follow in the Fed's footsteps?» in MR05/2017.
2. The specific model used is the following: $i = r^* + \pi + 0.5\,(\pi - \pi^*) + 0.5\,c\,(u - u^*)$, where i is the nominal benchmark interest rate, r^* the equilibrium real interest rate, π the inflation rate, π^* the inflation target, c is a coefficient to be estimated, u the current rate of unemployment and u^* the full-employment level (non-accelerating inflation rate of unemployment or NAIRU).