Monetary policy graduation in emerging markets

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Emerging countries have typically pursued procyclical macroeconomic policies
Motivation

- Emerging countries have typically pursued procyclical macroeconomic policies

- Such policies amplify the business cycle (the “when it rains, it pours” phenomenon)
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A significant number of emerging countries have graduated when it comes to fiscal policy.
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Do we also observe graduation in monetary policy?
Fiscal policy mostly procyclical in emerging countries
Fiscal graduation: Before and after 2000

CHI

CHI
What about monetary policy? (1960-2009)

(Federal Reserve Bank of Chicago)
Who has graduated? (Before and after 2000)
Who has graduated? (II)

Recent graduate
- Chile
- Mexico

Established graduate
- UK
- Colombia
- USA

38% of dev. countries

Still in school
- Uruguay

Back to school

Corr(cycle, cycle RGDP) 1960-1999

Corr(cycle, cycle RGDP) 2000-2009
What is behind graduation?

- Prototypical emerging country before 2000:

During crises, steep depreciation of currency → need to defend the currency → higher interest rates. We call this "fear of free falling" (FFF). We argue that FFF is a critical factor behind procyclical monetary policy. In terms of a "Taylor rule":

\[ i_t = \alpha (y_t - y_f) + \beta (\pi_t - \bar{\pi}) + \gamma (\epsilon_t - \bar{\epsilon}) \]

In a recession (crisis): lower output calls for lower \( i \); rapidly depreciating currency calls for higher \( i \). We measure FFF by the correlation between cyclical components of \( i \) and exchange rate depreciation.
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- We measure FFF by the correlation between cyclical components of $i$ and exchange rate depreciation
The higher is FFF, the more procyclical is monetary policy

Corr(cycle i, cycle RGDP) = 0.24 - 0.53*** x Fear of free falling
R² = 0.25
FFF is negatively related to quality of institutions
Over time, FFF diminishes and countercyclicality of monetary policy increases.
Regressions confirm the importance of FFF

Panel regressions. Dependent variable is the cyclical component of central bank interest rate

<table>
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<th>All countries</th>
<th>Industrial</th>
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<td>0.47***</td>
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<td>5.92***</td>
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<td>Δ% exchange rate cycle</td>
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<td></td>
<td>[1.7]</td>
<td>[1.8]</td>
<td>[3.1]</td>
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<tr>
<td>RGDP cycle * Fear of free falling</td>
<td>-3.05***</td>
<td>-2.12</td>
<td>-2.30**</td>
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<td></td>
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Conclusions

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- Critical step in ensuring macroeconomic stability during crises/recessions.