Implicit Asymmetric Exchange Rate Intervention under Inflation Targeting Regimes

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Abstract

In the last decades, many developing countries abandoned their existing policy regimes and adopted inflation targeting (IT) by which they aimed to control inflation through the use of policy interest rates. During the period before the crisis, most of these countries experienced large appreciations in their currencies. Given that appreciation helps central banks to curb inflationary pressures, we ask whether central banks in developing countries have a different policy stance with respect to depreciation and appreciation. We specifically claim that during the period under investigation (2002-2008), central banks in developing countries which implement IT have tolerated appreciation but fought against depreciation in order to hit their inflation targets. In order to support our claim, we analyze two components of central bank's response to exchange rate movements. First, we analyze central banks' interest rate decisions by estimating a non-linear monetary policy reaction function using a panel threshold model. Evidence suggests that whereas central banks respond to depreciation pressures, they remain inactive to appreciation. Secondly, we construct a probit model in order to investigate the determinants of foreign exchange intervention of central banks. We find that depreciation has an explanatory power for sale interventions whereas appreciation does not explain purchase interventions. Hence, we conclude that central banks' policy stance in IT developing countries with respect to exchange rate movements is asymmetric favoring appreciation. In this sense, IT seems to contribute to the ignorance of dangers regarding to financial flows leading to appreciation of currencies in developing countries.

Key words: Inflation Targeting, Central Banking, Developing Countries, Exchange Rates

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