Monetary Policy and Fiscal-led Inflation in Emerging Markets

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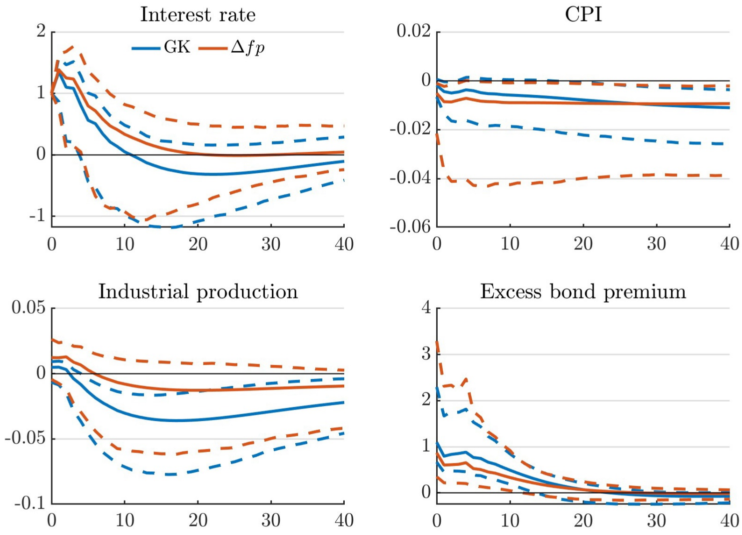
Key Identification in Witheridge

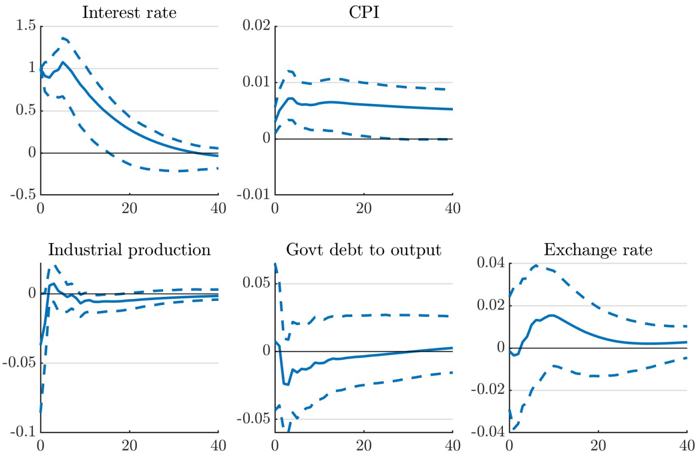
- Do not have good data on interest rate futures
- Do have good data on exchange rates (spot and forward)
- Use covered interest rate parity:

$$\Delta r^c_{t+1} = \Delta fp_{t,t+1}$$

Monetary Policy Shock: Effect in the United States



Monetary Policy Shock: Emerging Countries



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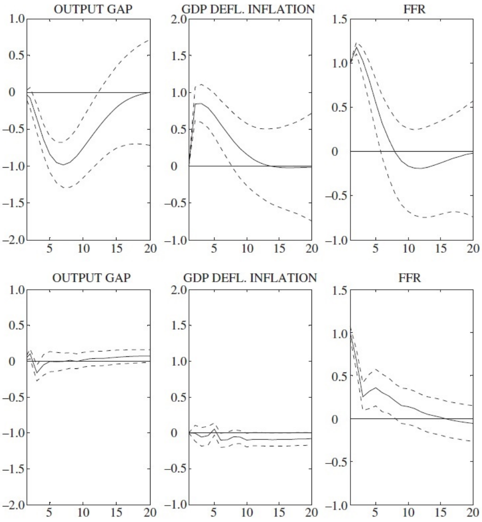
- Can we use spot/forward rates from that period to see effect?

Monetary Policy Shock United States: 1966-1979 (top), 1980-2006 (bottom)



Source: Castelnuovo and Surico (*Economic Journal*, 2010)

How do we interpret monetary shocks?

- Surprise deviations from stationary rule, mean zero
- Problem: Deviation (easing) always good:
  - Lowers inflation*
  - Raises IP*

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- Central bank tries to be hawkish, raises real rates
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- Expected inflation up on impact...
- ... people see through the game, the CB does not?

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- Central bank knows something is wrong (e.g. forex reserves low)
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- Developing economies: output, inflation negatively correlated
- Why reveal information?
  - Might end up with worse situation down the line
- Possible test?

Possible interpretation: 3. Financial repression shock

- Limiting case: Turkey
- Set rates artificially low
- Constrain intermediation, force banks to hold gov't debt, etc.
- Get higher inflation, lower production
- Werning (in progress)
- Possible test: performance of "politically connected stocks" vs. others

Comments on optimal policy

- With lump-sum taxes, not much room for inflation to play a useful fiscal role
- Without long-term debt, Taylor rule can only hurt on fiscal front...
- ... but with long-term debt higher future rates devalue current debt