SESSION 1
MONETARY POLICY: CONTEMPORARY ISSUES AND CHALLENGES

Knowledge sponsor: IMF

The first session began with an opening remark by **Mr. Christopher Erceg** | Deputy Director, Monetary and Capital Markets Department, IMF. He briefly introduced the panelists and emphasized the session's focus on discussing key practical challenges faced by emerging market economies in implementing inflation targeting. He also underscored the use of additional tools beyond the policy rate, such as FX intervention and capital flow management to achieve financial stability objectives and the critical role of monetary policy in these evolving times.

Keynote speech

The keynote speech was delivered by **Mr. Athanasios Orphanides** | Professor of the Practice of Global Economics and Management at the MIT Sloan School of Management, on the topic "Modern monetary policy in practice: Principles, challenges and prospects". He discussed the practical aspects of modern monetary policy, including the implementation of inflation targeting, policy objectives and their interpretation, and the governance and institutional framework. Additionally, he explored fiscal-monetary interactions and emphasized the importance of prohibiting monetary financing.

Key takeaways:

- Price stability should be the primary objective of monetary policy - not because it is the ultimate welfare goal, but because it is a precondition for fostering economic prosperity. This is an objective that central banks can be held solidly responsible for.
- In emerging economies, the inflation target may be somewhat higher than in advanced economies due to relatively higher productivity growth during the catching-up process. However, the target should not diverge significantly from those pursued by trading partners and advanced economies.
- What matters most is that the central bank's target is fixed, and the bank has the authority to achieve it. This ensures accountability, transparency, and credibility, while reducing uncertainty, lowering risk premiums, and promoting economic stability and growth.
- Successful implementation of inflation targeting requires both the understanding and commitment of the central bank and the political authorities to maintain a low and stable inflation target that is expected to persist over the long term.
- Credibility and reputation matter. If a central bank is credible, the same shock will not significantly affect inflation expectations two years out, allowing the central bank to pursue a more accommodative policy. However, if the central bank lacks credibility, inflation expectations may shift unfavorably, forcing the central bank to take more aggressive actions, such as raising interest rates significantly.

Panel discussion

The discussion was moderated by **Mr. Christopher Erceg** | Deputy Director, Monetary and Capital Markets Department, IMF, joined by **Mr. Jae Won Lee** | Chief Economist and Deputy Governor, Bank of Korea, **Mr. Zdenek Tuma** | Professor, Charles University, **Mr. Grant Spencer** | Teaching Fellow, Victoria University of Wellington, and **Mr. Athanasios Orphanides** | keynote speaker.

Inflation targets for emerging market economies

- Regarding inflation targets, there is the question of how much flexibility central banks have within their target range. Not all central banks require strict adherence to the midpoint of the target band. However, if inflation is not required to return to midpoint within a reasonable timeframe, the credibility of the policy may be weakened.
- It is possible to start with a higher target, but there must be a clearly defined path toward achieving a lower level of inflation.
- Inflation targets must be well-defined and foreseeable. In transition economies, while initial inflation rates might be higher, it is essential to maintain a stable and clear target. Frequent changes can undermine the effectiveness of inflation targeting and weaken its foundation.
- It is crucial to closely monitor inflation expectations to ensure they remain aligned with the target. If the central bank is credible, a shock will not significantly shift inflation expectations for the future, allowing the bank to adopt a more accommodative policy. However, if the central bank lacks credibility, inflation expectations may move against it. In such cases, it becomes more important for the central bank to act decisively and raise rates more aggressively.

Challenges with recent surge in inflation and central banks' credibility

- Due to ongoing structural shifts, supply shocks are becoming more frequent and persistent. Even a single transitory shock can have spillover effects on other sectors with stickier prices and nominal wages, causing a long-lasting impact on aggregate inflation and cross-country inflation expectations.
- To address this, a more comprehensive approach is needed, combining interest rate adjustments, effective communication, and fiscal coordination to manage inflation effectively.
- Different central banks have different mechanisms and methods for communicating with markets, but once these are established, maintaining consistency is vital. Avoiding abrupt changes is crucial, especially with new governors or regimes, as consistency fosters confidence and credibility in the central bank.
- Inflation targeting is a forward-looking monetary policy, and it is essential to communicate the central bank's expectations for the future. This transparency helps shape market expectations and provides clarity on the central bank's future actions.

- Central bank’s financial independence and a clear framework reinforce potential credibility because markets not only observe inflation and economic performance but also understand the framework’s reliability and capacity. When there is confidence in both the framework and the results, credibility will be established over time.

Fiscal-monetary policy interactions

- Prohibition of monetary financing is a key characteristic of good governance, ensuring that central banks remain independent and focused on their primary objectives.
- The financial independence of the central bank and the personal independence of its decision-makers are crucial. This principle should be upheld regardless of who oversees the government, ensuring that monetary policy remains insulated from political pressures.
- In some countries, constitutional changes have been implemented to grant autonomy to central banks, safeguarding their independence from political influence.
- In Korea, fiscal policy remains relatively neutral with respect to inflation. While fiscal stimulus has been implemented in response to the pandemic, it was relatively moderate compared to other countries, maintaining a manageable fiscal deficit.