The Effectiveness of Monetary Policy: Evidence from a Set of Emerging Market Economies

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Abstract

This paper ascertains the effect of changes in the domestic interest rate on exchange rate movement, using monthly data from a set of emerging market inflation targeting (IT) countries and non-IT countries. The central banks are responding to the exchange rate movements in addition to the other core variables, namely, inflation gap and the output gap. No evidence to support the fear-to-float phenomenon in our study. In addition, countries with a high degree of financial openness are more responsive to the movement in the exchange rate, but this has weakened the effectiveness of disinflationary policy. This suggests that the policy makers should behave pre-emptive and necessitate the exchange rate adjustment as alternative policy choice, in the calculus of formulating policy rule. The policy makers can opt for mixed strategy. The speed of adjustment toward the long run equilibrium was faster, ranging from 9.50-22.36 months when the heterogenous endogenous break and persistency were accounted for.

Keywords: Taylor Rule; Inflation Stabilities; Exchange Rate; Emerging Market Economies

JEL codes: E31, F31, E43

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