

Monetary and Exchange Rate Policy Challenges in Small Open Dual Currency Economy

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SRA2016-1

As a recipient of the SRA Award, I had an opportunity to spend two months at the Graduate Institute of International and Development Studies, Geneva and participate in the junior Visiting Fellowship Programme. During my research stay, I had a chance to take the advantage of resources and services that the Institute offers like library and databases, interaction with faculty members and students and enhance my dissertation.

In my doctoral research I study challenges that central banks (CBs) in emerging market economies with high level of euroisation face when conducting monetary policy in a response to foreign and domestic shocks. The research is focused on the trade-off between floating exchange rate that serves as an external shock absorber, and the policy of intervention in a foreign exchange (FX) market in order to prevent sharp exchange rate movements and protect price and financial stability of the economy. Emerging market inflation targeting (IT) economies face serious challenges related to exchange rate policy. First, due to significant exchange rate pass-through, sharp movements in the exchange rate may threaten the primary objective, i.e., achieving the inflation target. Second, a high level of financial euroization imposes risks to financial stability in the case of local currency depreciation since loans denominated in foreign currency are taken by borrowers whose earnings are denominated in the local currency. In this case, a sharp depreciation of the local currency will increase the risk of default of debtors whose loans are pegged to or denominated in foreign currency. A high level of euroisation and exchange rate pass-through limit the potential use of exchange rate depreciation for improving competitiveness and, consequently, the current account balance of a country.

As a consequence, CBs in many emerging markets tend to intervene in the FX market in order to reduce excessive short-term volatility of the exchange rate. Interventions are typically not aimed at influencing long term exchange rate trends. Rather, they are often viewed in these countries as an additional monetary policy instrument for achieving balance between two important goals,

maintaining both price and financial stability. Since the exchange rate depreciation has, in principle, the opposite effects on the current account and financial stability, it is essential that the toolkit and measures of monetary and macroprudential policy be well calibrated.

My doctoral research is aimed at investigating whether the central bank in a small open economy with inflation targeting regime should use FX interventions as complementary monetary policy instrument together with the key policy rate and to what extent. The main goal is to identify how the level of euroisation affects central banks' decisions on the key policy rate when two situations are compared: 1) key policy rate is the only monetary policy instrument and 2) central bank uses interventions in the FX market as an additional instrument. Besides that, the research aims to answer the question whether the introduction of interventions in the FX market will have an impact on the CB's welfare function. This topic is particularly relevant for emerging market economies in Central, Eastern and Southeastern European region that are highly euroised, but pursue IT regime. Those CBs tend to intervene more heavily in the FX market compared to countries that are not highly euroised.

During my research stay at the Graduate Institute, I was working on the extension of the small open economy model that serves as an analytical tool for the analysis of monetary policy responses to foreign and domestic shocks in a small, open IT economy facing a high level of euroization. The model proposed in my research is based on the findings from the Ghosh et al. (2016), which is extended by introducing the country risk premium as a function of the level of euroisation of the liabilities and the costs of lending in foreign markets (foreign interest rate). The extension of the model in this way has helped me to explicitly analyze the effects that high level of euroisation has on the CBs' decisions.

The results obtained from the single-period model suggest that the level of euroisation affects the CB's decision on the interest rate as an optimal response to adverse domestic and foreign shocks. CB's in euroised economies tend to be more restrictive in a case of adverse foreign shocks, and less expansionary in case of adverse domestic shock compared to central banks in economies that do not suffer from the issue of high euroisation. The intuition behind this mechanism is the following. Since the country risk premium is an increasing function of the level of indebtedness, the depreciation pressures coming from adverse foreign or domestic shocks should be more pronounced in euroised economies, and CBs will tend to ease these pressures by implementing

more restrictive monetary policy (in a case of adverse foreign shock) or less expansionary policy (in a case of adverse domestic shock). Model also suggests that the introduction of interventions in the FX market as an additional monetary policy instrument will result in an increase of the level of welfare in the economy.

During my research stay, I had a chance to discuss my work with my professor of contact as well as other faculty members and overcome the issues I was dealing with and obtain valuable feedback that helped me to extend the model and enhance my dissertation.