Exchange Rate Regimes and Inflation Targeting (IT)

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Main Topics

- The Importance of the Exchange Rate Channel in the Monetary Transmission Mechanism
- Increased Exchange Rate Flexibility and IT Frameworks-Some International Perspective
- Coping with Exchange Rate Volatility within an IT Framework- the Israeli Experience
- A Possible Course of Action for Nigeria

The Importance of the Exchange Rate Channel in the Monetary Transmission Mechanism

- In IT regimes changes in the policy rate (PR), or expected changes, ignite the monetary transmission mechanism by affecting financial asset prices.
- One of the most important prices in this regard is the price of foreign exchange (FX)
- In a large group of countries, open including emerging economies that have adopted IT, the exchange rate is a very important channel trough which changes in the PR affect inflation
- It is therefore not surprising to observe the movement of many countries, particularly those that adopted IT regimes, towards more flexible exchange rate regimes

Increased Exchange Rate Flexibility and IT Frameworks-Some International Perspective

Table 1: Inflation Targeting Countries (as of 2003)

Country	Adoption Date		Country	Adoption Date
Australia	1993		Mexico	1995
Brazil	1999		New Zealand	1989
Canada	1991		Norway	2001
Chile	1990		Peru	2002
Colombia	1999		Philippines	2002
Czech Rep.	1997		Poland	1998
Finland	1993		S. Africa	2000
Hungary	2001		Spain	1995
Iceland	2001		Sweden	1993
Israel	1991		Thailand	2000
Korea	1998		U.K.	1992
Turkey	2006		Serbia	2007

Increased Exchange Rate Flexibility and IT Frameworks-Some International Perspective

Figure 1 : Developed Countries Exchange Rate Regimes, 1991,1999,2006

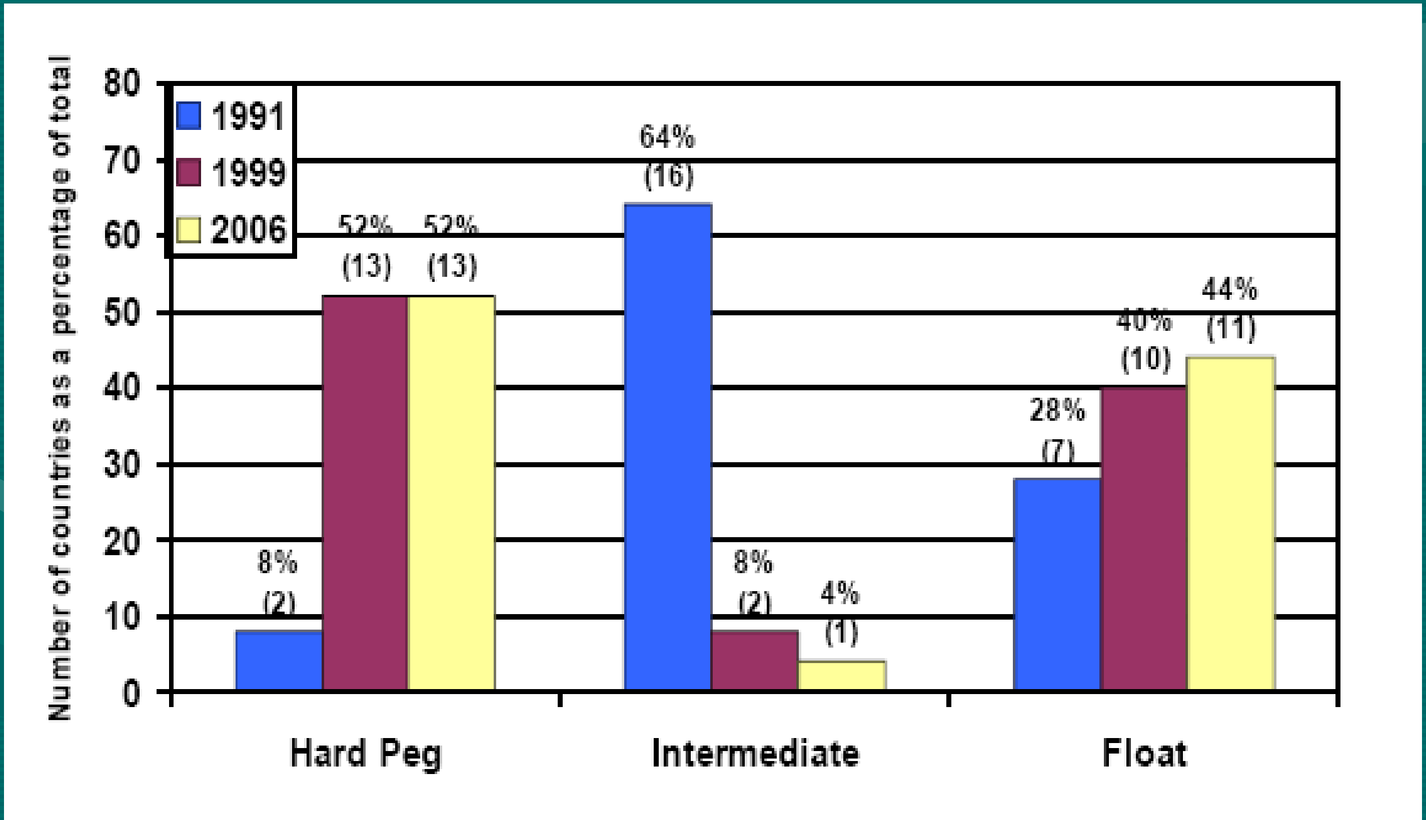

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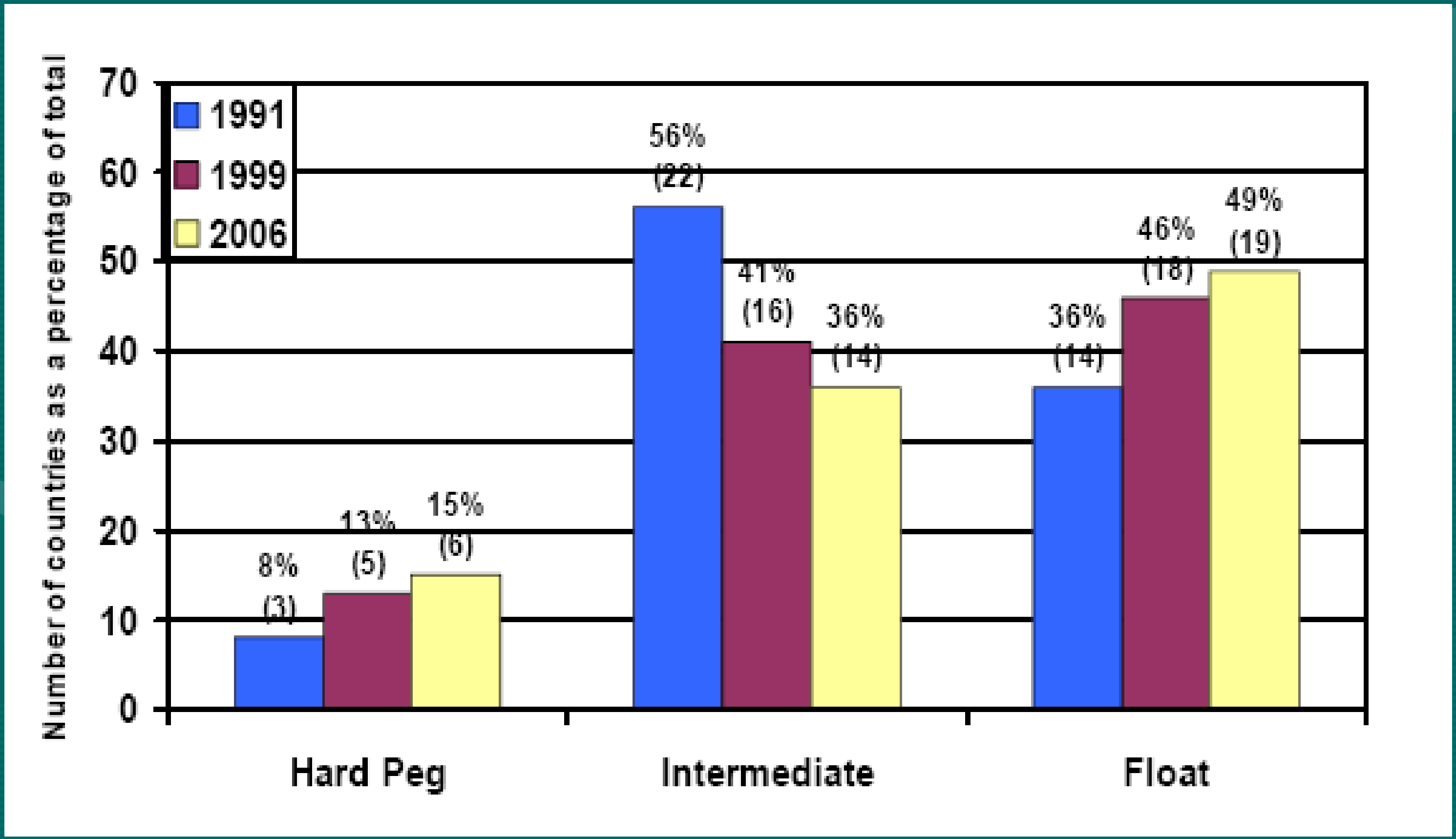
Figure 2 : Emerging Market Countries Exchange Rate Regimes, 1991,1999,2006



Increased Exchange Rate Flexibility and IT Frameworks-Some International Perspective

- On the one hand, the importance of the exchange rate channel in the transmission monetary mechanism.
- Coupled with the essential role that credibility plays in IT regime, limit very much the scope for central bank intervention in (CBI) in the FX market
- The problem with limiting too much the exchange rate flexibility is that, in Mishkin's words:

"*...runs the risk of transforming the exchange rate into a nominal anchor for monetary policy that takes precedence over the inflation target, at least in the eyes of the public*" (*Mishkin, 2000*).

Coping with Exchange Rate Volatility within an IT Framework- the Israeli Experience

On the other hand FX markets in emerging economies (EMS), with:

a. relatively thin ,FX markets
b. pronounced shocks
c. large flows of capital , are exposed to potential substantial exchange rate volatility

Coping with Exchange Rate Volatility within an IT Framework- the Israeli Experience

- This in turn may impact adversely the profitability of firms which are eventually reflected in a deterioration of banks' and other financial institution's balance sheet.
- The above dilemma explains why some counties have tried some type of middle of the road approach

Coping with Exchange Rate Volatility within an IT Framework- the Israeli Experience

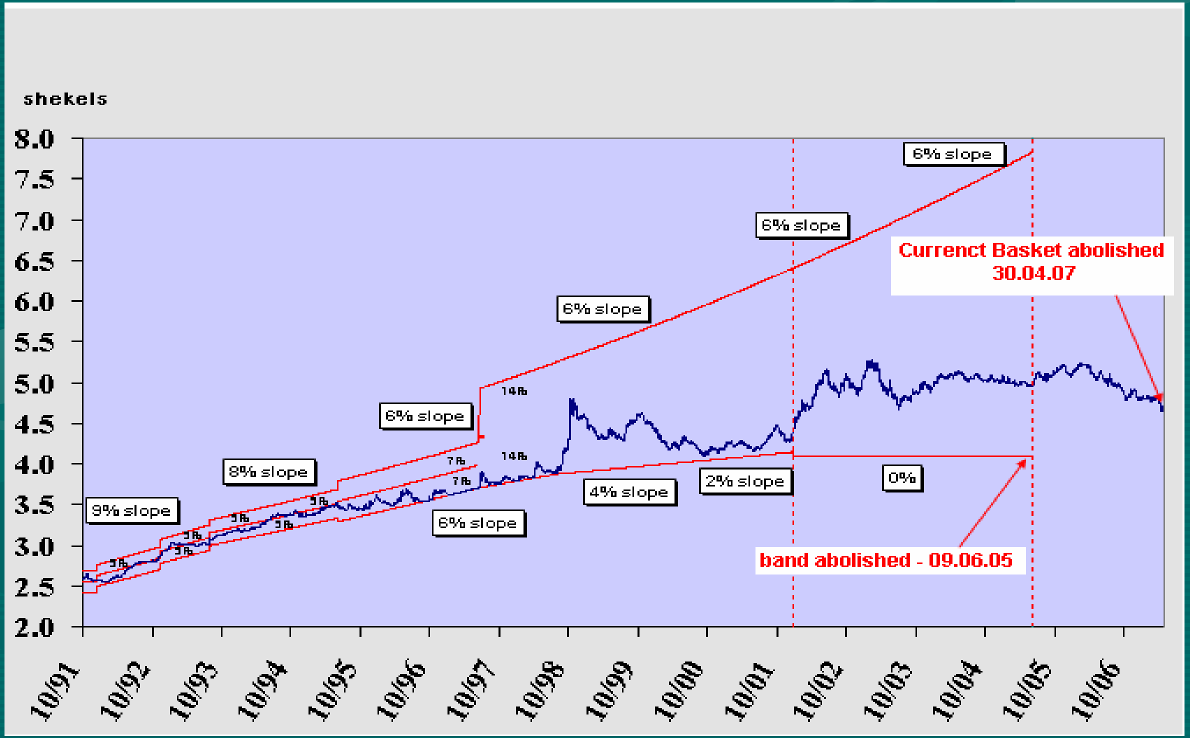
Table 2: FX intervention policies – some international experience

Country	Interventions: Y/ N	Note
Australia	**Y**	quite frequently (except of 1993-97); last in Aug 07; relatively transparent
Canada	**Y (N)**	quite frequently till 1998; since 1995 internal rules; new strategy since 1998 – but not tested in practice; formerly MCI
Chile	**Y**	till 1999 crawling peg; gradual FA liberalisation; interventions in 08-12/2001 and late-2002 / Jan 2003; relatively transparent
Hungary	**Y**	±15% band; great challenges
Israel	**Y (N)**	last in 1997; since 1986 widening crawling band
Korea	**Y**	quite frequently
Mexico	**N**	crawling peg failed in 1994
New Zealand	**Y**	In 2007 for the first time since 1985 (new mandate with clarified rules); till 1999 an MCI;
Poland	**N**	free floating since April 2000
Sweden	**Y**	June 2001; otherwise rarely; attempt to create rules
Great Britain	**N**	ERM crisis in 1992; no MCI!

Coping with Exchange Rate Volatility within an IT Framework- the Israeli Experience

Israel tried unsuccessfully the middle of the road approach by a FX band regime

Figure 3: The FX Regime-a Brief Account



Coping with Exchange Rate Volatility within an IT Framework- the Israeli Experience

- It was forced to abandon this approach and the Bank of Israel(BOI) has not intervened at all in the FX market for more than eleven years.
- Nevertheless the FX volatility of the exchange rate in Israel is remarkably low by both historical and implied(forward looking) volatilities

Coping with Exchange Rate Volatility within an IT Framework- the Israeli Experience

Table 3: Volatility and Spreads

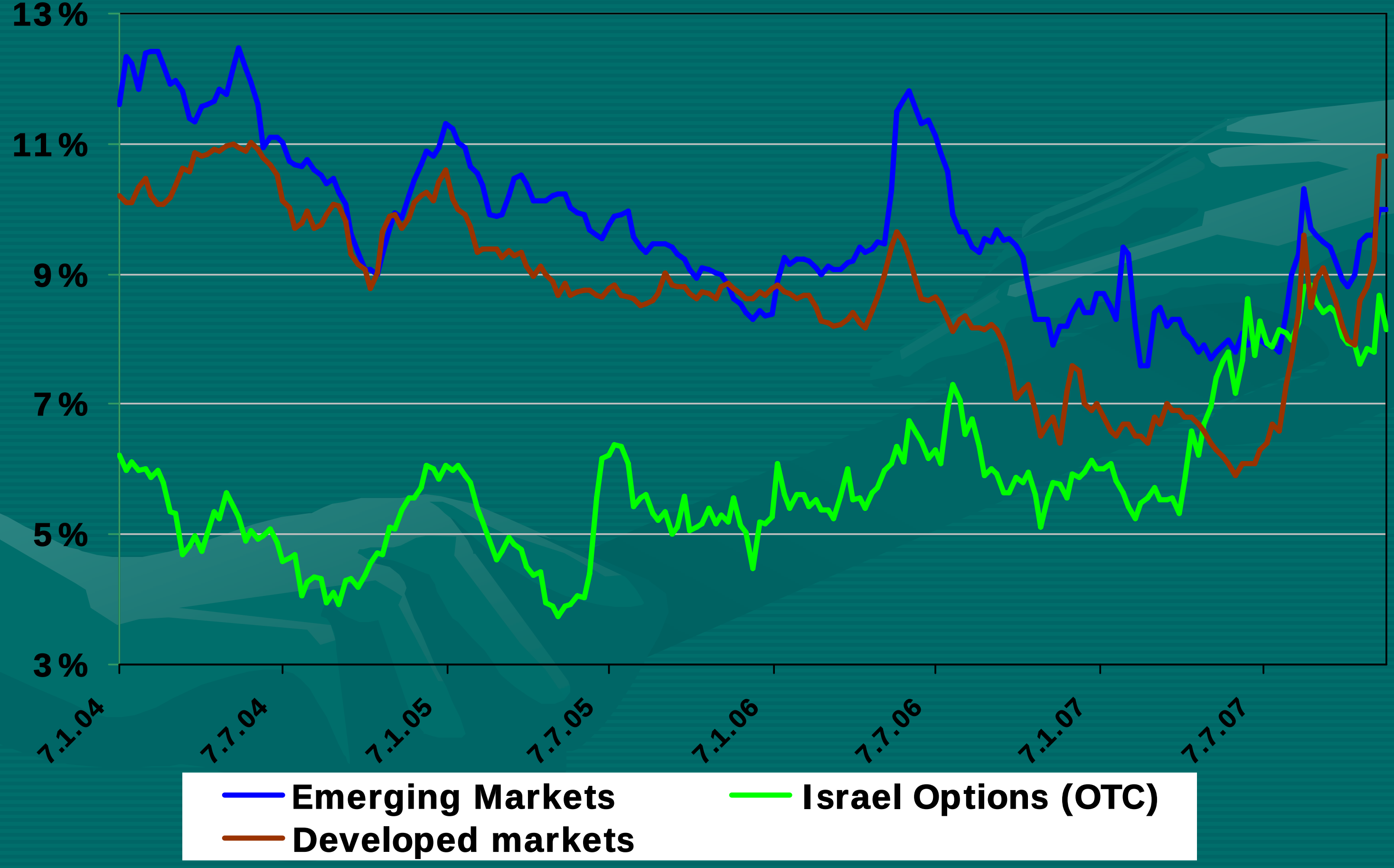
(percent)

	Volatility (10 day moving average, %)						Interbank bid-offer spread (estimated)	
	2002	2003	2004	2005	2006	2007[a]	2006	2007
NIS	***7.8***	***7.3***	***4.2***	***4.8***	***5.5***	7.0	***0.07***	***0.07***
euro	8.7	10.1	10.5	8.9	7.4	7.1	0.01	0.01
Japanese yen	9.5	7.9	9.3	8.6	7.8	7.8	0.02	0.03
Canadian dollar	5.8	8.7	8.7	7.8	6.9	7.4	0.02	0.04
Swedish krona	9.4	10.8	11.5	10.0	9.6	7.8	0.04	0.04
Norwegian krona	9.1	11.3	12.0	10.1	9.6	7.7	0.04	0.05
New Zealand dollar	9.6	10.2	13.7	10.0	10.9	11.5	0.05	0.07
Czech koruna	10.7	11.1	12.4	10.4	8.5	6.6	0.12	0.12
Hungarian forint	9.8	13.8	13.0	10.5	11.2	10.2	0.12	0.11
Polish zloty	8.9	10.2	11.3	12.5	10.5	8.8	0.09	0.11
S.African rand	18.0	19.5	20.1	14.8	14.9	13.5	0.09	0.06

[a] based on the period from January 1 to Sepember 3 .

Coping with Exchange Rate Volatility within an IT Framework- the Israeli Experience

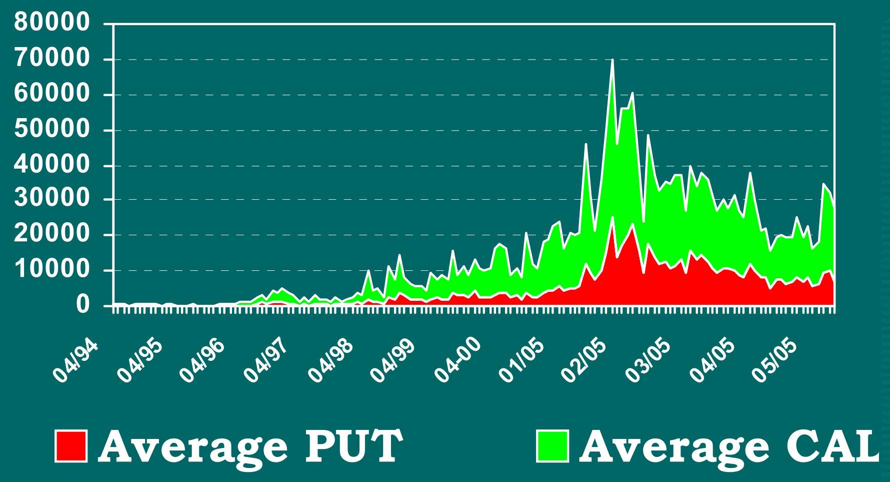
Figure 4: Implied Volatility in FX Options, 2003-2005



Coping with Exchange Rate Volatility within an IT Framework- the Israeli Experience

- An important lesson fro this experience is that it is vital to start a process that leads the public in general and businesses in particular to understand that it is they, not the CB or the Government , which have to cope with exchange rate risk.
- To achieve this goal it is to develop in Nigeria instruments, such as FX forward and future contracts, options, swaps etc., that will enable entities to hedge themselves against FX uncertainty.

Figure 5: Volume of FX Options



A Possible Course of Action for Nigeria

- The CBN can play an important positive role in this regard. The experience of the Bank of Israel involvement in jump-starting the local FX option market can be useful in this regard.
- It is important to have the banking and financial supervisory authorities to support the process of the internalization of FX risk by the various players in the local FX market.
- To these end domestic banks should be induced to take into account that their FX lending to unhedged domestic players, may turn into their currency induced credit risk
- Domestic money and capital markets are utmost importance in their own rights, but experience has shown that their development also contributes much to the well functioning FX market.
- In any well developed FX market currency speculator play an important role in adding debt and liquidity to the market and improving the risk sharing capacity

A Possible Course of Action for Nigeria

- .It is very important in this regard that the FX speculation stabilizing and not destabilizing

In a small open economy, with no capital controls, FX intervention can effect only

$$i = i^* + E(e) + \rho$$

A Possible Course of Action for Nigeria

- Experience in many countries has shown that if the above four elements are in place, speculation will tend to be stabilizing through much of the time.
- In practical terms, for Nigeria, this means that over time the role of the wholesale FX auctions should be reduced and eventually stopped.
- In its stead the CBN could consider auctions of FX forward ,options ,swaps etc
- to jump-start the development of a market for FX hedging instruments.
- -If this endeavor is undertaken ,the operations of the CBN must be very clear
- that the purpose is to aid the establishment of currently missing markets, and not **another form of FX intervention**

Thank You