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Inflation targeting stabilises economies at expense of higher exchange-rate volatility

UCT PhD investigates interaction of monetary policy, institutions and trade shocks in emerging market economies

University of Cape Town doctoral student Seedwell Hove's PhD research, titled *Monetary policy, institutions and terms of trade shocks in emerging market economies*, finds that monetary, fiscal and financial institutional structures are important for the success of inflation targeting in emerging market economies (EMEs).

Hove's PhD thesis investigates the role of institutions for inflation targeting policy and the appropriate monetary policy responses to terms of trade shocks in EMEs. "The continued missing of inflation targets by most EMEs which have adopted inflation targeting has raised questions on whether institutional structures really matter for inflation targeting," said Hove.

The thesis contributes to existing literature "by taking stock of the intrinsic role played by monetary, fiscal and financial institutional structures in the achievement of inflation targets since the adoption of inflation targeting in EMEs", said Hove. It also provides a firm framework that is useful for understanding the role of institutional structures in monetary policy.

He found that improvement in institutional structures help in the achievement of inflation targets. Hove said: "Countries with more independent central banks, strong fiscal institutions and developed financial systems have higher chances of achieving their inflation targets than countries where these institutions are weak. Central banks should therefore continue to reform their institutional structures in order to achieve sustainable price stability."

Hove explained that “the heightened volatility of commodity prices in the 2000s coupled with the widespread adoption of inflation targeting in many EMEs has ignited debates about the relative suitability of inflation targeting in dealing with terms of trade shocks compared with other regimes such as monetary targeting and exchange rate targeting”. His findings further show that the consumer price index (CPI) inflation targeting regime performs better than monetary targeting and exchange rate targeting regimes in reducing macroeconomic volatility in emerging market economies. Inflation targeting is thus the appropriate monetary policy response to terms of trade shocks.

However, inflation targeting regimes stabilise the economies at the expense of higher exchange rate volatility. The CPI-based inflation targeting regime achieves higher welfare than non-traded inflation targeting and exchange rate targeting. “This implies that emerging market economies that are prone to terms of trade shocks should adopt inflation targeting in order to achieve macroeconomic stability and enhance welfare,” said Hove.

Hove holds a BSc (Hons) and an MSc in Economics from the University of Zimbabwe. He will receive his doctoral degree in Economics on 14 December 2012 at 10h00.

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