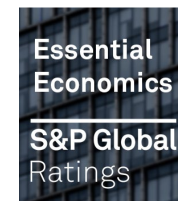
Emerging Markets: Have Policy Rates Deviated From Simple Taylor Rule-like Prescription?

October 27, 2022

This report does not constitute a rating action

Contacts

Satyam Panday
EM Chief Economist
1 California St, San Francisco, CA
satyam.panday@spglobal.com



Follow us on LinkedIn and subscribe

As average emerging market economies' (EM) headline inflation rates look to be leveling off, some major EM central banks (Brazil, Chile, Poland, and Hungary) have recently signaled that a peak may have been reached in their current rate hike cycle. China (low growth and low inflation) and Turkey (despite 80%+ inflation) were already easing. In others, where rate hikes continue apace, chorus for a pause is growing louder. The argument for a pause is that monetary policy works with a lag-- the net impact of quickly accumulated rate hikes in 2022 is likely to show up in the next 6-12 months. Having raised rates aggressively to address inflation, wariness on sacrificing growth too much is setting in.

Simple Growth-Inflation Policy Rule

To evaluate and describe central bank monetary policy rate moves, monetary policy rules are now frequently used and referred to by financial market participants, economists, and by central bankers themselves. Such rules are advocated for EMs even more so as the need for greater monetary discipline in EM economies has been generally stressed against the backdrop of their relatively high inflation and low policy credibility. That said, no one policy rule with particular parameters emerges as optimal for any single country, let alone all countries. But over the years, simple policy rules designed with inflation-growth tradeoff functional form have presented as clear favorites.

Consider, for example, the frequently used Taylor rule. While the rule is a compromise between academic complexity and policy-influencing simplicity, it still is handy in providing a rough sense of whether policy rate is at a reasonable level or where the direction of travel may be in the near term-- not just for advanced economies but also increasingly for inflation targeting EMs (that do not have fixed exchange rate).

In this blog, we use a forward looking variant of original Taylor rule with the following specification:

$$Int(t) = r^* + inf_targ + p\,[inf_exp(t) - inf_targ] + (1-p)\,[output\ gap(t)]$$

In the above equation, int(t) is the nominal policy rate at time t which responds to deviation of one-year ahead Inflation expectation (inf exp) from central bank's inflation target (inf_targ), the output gap which is the difference between the actual output of an economy and its potential output as percentage of potential output, the long-run neutral real rate of interest (r*), and the central bank's inflation target.

While individual central banks' behavior may be better defined by a non-linear rule or one that includes other variables, the Taylor Rule as specified above should indirectly capture other variables including the exchange rate through its impacts on inflation and output.

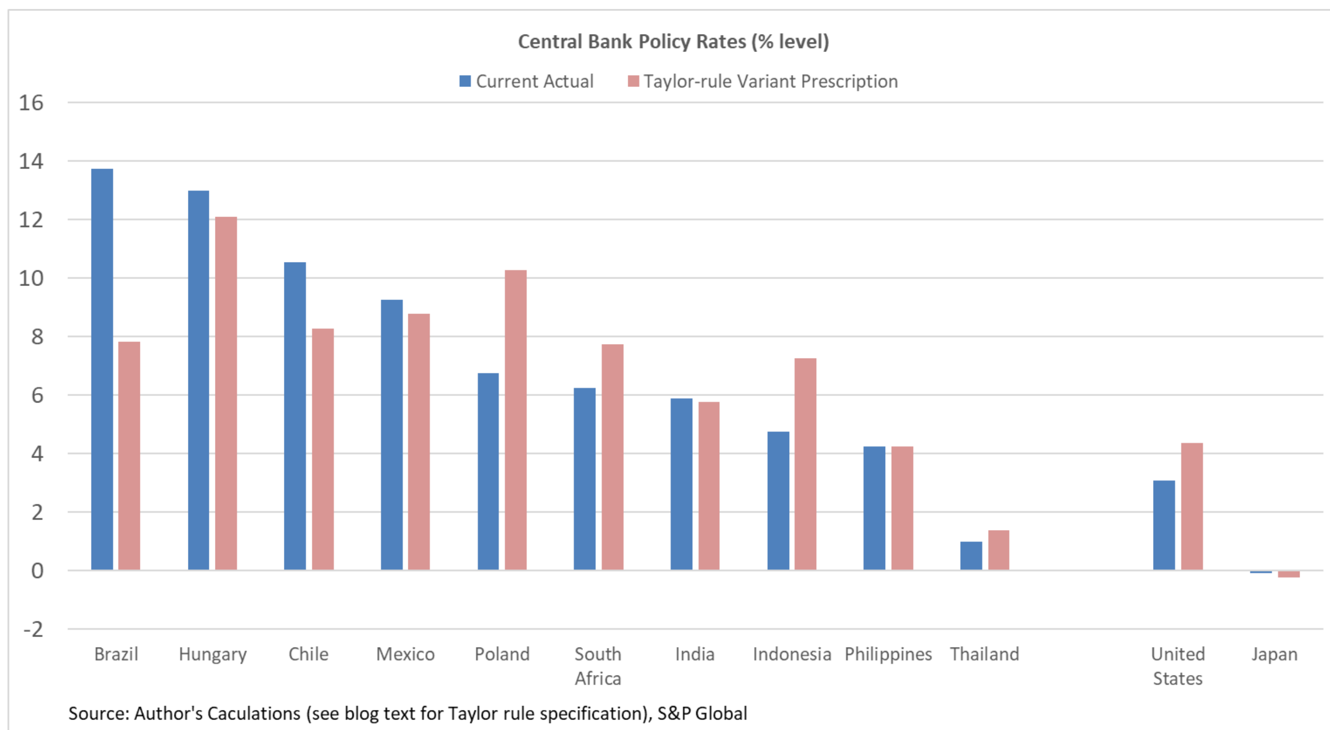
The neutral rate is assumed to be invariant to both the cycle and factors that do not alter long-term saving/investment patterns, thus together with Inflation target acting as an anchor for monetary policy through the cycle. Given the "whatever it takes" spirit to bring down current inflation, the coefficient p on inflation gap is set at 0.75 for this exercise (versus equally weighted Inflation gap and output gap in the original Taylor rule, which was for the US) and inflation expectations takes our 2023 inflation forecasts published last month. We take output gap (4-quarter average in 2022) and back out r* for each country from S&P Market Intelligence EconoSim Global Link model.

So, based on our variant of Taylor rule specification, which EM central bank policy rates have deviated from simple policy prescription? Given the output gap and inflation forecast, what likely is the direction of travel for policy rates from here onwards?

Chart 1

Most Open-Economy EMs Have Stayed Close To Taylor Rule-like Policy Rule

Brazil Appears Over-Compensating While Poland and Indonesia Running Behind



Seven out of ten countries in our sample of EMs were less deviated from prescription in absolute percentage terms when compared with US deviation as the benchmark (chart 1). Brazil appears to have over-done its hiking by a large margin while Poland and Indonesia look to be running behind. Of the central banks that have signaled pause or peak in current hiking episode, the risk for policy rate direction appears tilted downwards for both Brazil and Chile, according to this policy rule while opposite is true for Poland.

An important caveat to this kind of Taylor rule-like assessment framework is that policy guidance can be very different given unobservable variables (real neutral rate, potential output) and unusually more uncertain inflation forecasts. While recognizing they are good overall framework for communicating with general public, a "many model", "horse race among different policy simulation frameworks" approach is likely more confidence-building guide for a policymaker.

For our latest forecasts, see more in our regional outlook reports: APAC, LatAm, EM-EMEA.

Copyright © 2022 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

Australia: S&P Global Ratings Australia Pty Ltd holds Australian financial services license number 337565 under the Corporations Act 2001. S&P Global Ratings' credit ratings and related research are not intended for and must not be distributed to any person in Australia other than a wholesale client (as defined in Chapter 7 of the Corporations Act).

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.