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Monetary policies for developing countries: The role of institutional quality

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Abstract

Weak public institutions, including high levels of corruption, characterize many developing countries. We demonstrate that this feature has important implications for the design of monetary policymaking institutions. We find that a pegged exchange rate or dollarization, while sometimes prescribed as a solution to the credibility problem, is typically not appropriate for countries with poor institutions. Such an arrangement is inferior to a Rogoff-style conservative central banker, whose optimal degree of conservatism is proportional to the quality of institutions. Finally, we cast doubt on the notion that a low inflationary framework can induce governments to improve public institutions.

Keywords: Corruption; Central bank; Inflation; Exchange rate

JEL classification: E52; E58; E61; E62; H50

1. Introduction

Textbook discussions of monetary policies do not usually separate developing from developed countries. Are there important features about developing countries that might suggest that the optimal design of monetary policies should be different? In this paper, we study one particular feature that is prevalent in developing (and transition) economies, namely weak public

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governance. Obviously, developed countries are not immune to this problem, but it is far less prevalent than in many developing countries. Surprisingly, the consequence of this feature on the design of monetary policy has not been systematically examined. This paper aims to fill this void, and to demonstrate that the effect is not trivial.

As many developing countries lack credibility in their monetary policy, a subject heavily studied in the literature, a conventional wisdom is that these countries should peg their currency to a major currency from a low-inflationary country, adopt a currency board, or dollarize. Our analysis in this paper, however, will show that when weak institutions are considered these policies are not necessarily appropriate.

Our theory combines useful ingredients from two different strands of the literature. The first strand is on the design of monetary policy, which is too voluminous to be referenced completely here, but includes, as seminal and other important contributions, Kydland and Prescott (1977), Calvo (1978), Barro and Gordon (1983), Rogoff (1985), Barro (1986), Alesina and Tabellini (1987), Cukierman (1992), Svensson (1997), Walsh (1995), and Benigno and Woodford (2003).[1] In this paper, we make use of a framework developed by Alesina and Tabellini (1987), where the government's objective function includes provision of public goods in addition to minimizing inflation and output fluctuations. The second strand studies the causes and consequences of weak institutions, in particular, corruption. This literature includes work on the effects of institutions on development (Rose-Ackerman, 1975; Shleifer and Vishny, 1993; Mauro, 1995). Wei (2000, 2001), Bai and Wei (2000), Fisman and Wei (2004) and Du and Wei (2004) investigated the consequences of corruption for international capital flows, tax evasion, and stock market volatility. As far as we know, these two strands of the literature have not been married before. In other words, none of the papers in the literature that we know of has examined the implications of weak institutions, including widespread corruption, for the design of monetary policies.

For the purpose of our paper, we model weak institutions as an erosion of a government's ability to collect revenue through formal tax channels. This may arise through outright theft by tax officials or practices whereby tax inspectors collude with taxpayers to reduce the latter's tax obligation in exchange for a bribe. Under an inflation targeting framework, we study how the socially optimal level of the inflation target is affected by weak institutions. We further examine the implications for the design of several other monetary frameworks, including a currency board, dollarization, and a Rogoff-type conservative central banker, and rank them in terms of social welfare. We also examine the authorities' incentive in strengthening institutions from a political economy perspective.

Several interesting results emerge from the analysis. First, the optimal inflation target is higher for a country with poorer institutional quality. Hence, an inflation target of 1–4%, that is common among advanced industrialized countries and might be called "international best practice," is generally not something to be emulated by developing countries.

Second, pegged exchange rate, currency boards, or dollarization are often prescribed as ways to solve the lack of credibility problem. However, these monetary regimes are typically not very credible themselves and are likely to fail (often associated with a currency crisis) in countries with weak institutions.

Third, a Rogoff-type conservative central banker is generally preferable to a mechanical inflation target of 1–4% and to most exchange-rate-based monetary arrangements. In equilibrium, the optimal degree of central bank conservatism is proportional to institutional quality. Thus, developing countries with lower institutional quality should have less conservative central

[1] See Persson and Tabellini (1990) and Berger et al. (2001) for surveys of the literature.