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Monetary Regimes with Two Nominal Anchors: Are they Possible?

Abstract: The traditional approach to monetary policy, which relied on one instrument to achieve a single goal, has proven ineffective during recent periods of global instability. In response to the challenges that this traditional framework could not address, non-standard monetary policy instruments have emerged. While they have somewhat alleviated problems, they cannot be considered a solution, as their long-term application could lead to the emergence of several other imbalances. Therefore, this paper explores a new framework for monetary policy based on two nominal anchors. The analysis focuses on two monetary regimes. The first is based on a modification of the inflation targeting regime, which would additionally include a nominal anchor in the form of an exchange rate. This is not a completely new regime, as some countries have already used an implicit exchange rate target alongside an inflation target. The second regime under consideration is entirely new and would be based on a monetary target and an interest rate target.

Keywords: monetary policy, two nominal anchors, inflation targeting, quadrilateral targeting.

JEL Code: E50, E52, E58.

1. Introductory notes

The traditional approach to monetary policy, which is based on a single instrument and a single goal, typically involves using the short-term interest rate as the main tool of the central bank, while price stability is the primary policy objec-

tive. In this framework, the central bank sets interest rates in such a way that it controls inflation and ensures price stability in the economy.

The short-term interest rate influences the cost of borrowing and saving, thus affecting overall economic activity. An increase in interest rates usually reduces inflation, as borrowing becomes more expensive, which reduces consumption and investment. On the other hand, lowering interest rates stimulates the economy by facilitating access to credit, encouraging consumption and growth.

This traditional approach to monetary policy has been effective for a long time; however, new challenges such as the global financial crisis and the COVID-19 pandemic have necessitated new methods of conducting monetary policy. This has led to the emergence of a whole set of unconventional monetary policy tools, which have been used as the traditional method "one goal, one instrument" has become less effective.

Some of the most well-known unconventional tools include:

1. **Quantitative Easing (QE)**: This tool involves the central bank purchasing government and corporate bonds to increase the money supply in circulation and lower long-term interest rates. QE aims to stimulate consumption and investment, as well as stabilize financial markets.
2. **Forward Guidance**: This instrument involves the central bank communicating its future actions, such as plans for interest rates or other policies. It attempts to shape market and economic agents' expectations, stimulating economic activity even when traditional interest rates are very low.
3. **Negative Interest Rates**: Some central banks have implemented negative interest rates to encourage commercial banks to lend more to the economy, rather than holding deposits at the central bank.

Although these tools can be effective in the short run, they also carry risks, such as increasing financial instability or economic imbalances, so they should primarily be used from a short-term perspective.

Most economists believe that nominal anchors can strengthen the credibility of monetary policy, as Mishkin (2011, p. 10) points out: "The inability of monetary policy to boost employment in the long run, the importance of expectations, the benefits of price stability, and the time-inconsistency problem are the reasons that a credible commitment to a nominal anchor—i.e., stabilization of a nominal variable such as the inflation rate, the money supply, or an exchange rate—is crucial to successful monetary policy outcomes." Adopting a nominal anchor helps stabilize expectations, promoting economic efficiency and growth. However, it

should be noted that not all central banks, like the FED, apply a nominal anchor in their monetary policy.

A large number of countries have experimented with different nominal anchors, such as the money supply, exchange rates, or interest rates. Monetary targeting, which was very effective from the mid-1970s to the mid-1980s, became much less successful over time. Several factors contributed to this: changes in financial structures, the emergence of financial innovations that acted as substitutes for money, changes in the velocity of money, and reduced efficiency of this regime under lower inflation rates, among others. Although nominal exchange rate targeting was extremely useful in the initial phase of disinflation, as time passed, many countries encountered difficulties with this regime, particularly under conditions of considerable capital mobility (Leiderman & Bufman, 2000). Fischer (2001, p. 3) points out: "Each of the major international capital market-related crises since 1994 has in some way involved a fixed or pegged exchange rate regime." Additionally, using interest rates as a nominal anchor has proven problematic during recent inflationary episodes.

The prevailing view in the literature is that the use of two nominal anchors in the long run is not sustainable. For example, Leiderman and Bufman (2000, p.78) highlight that "the coexistence of multiple anchors—whether a crawling currency band together with an inflation target, or an inflation target together with a target for monetary aggregates—sooner or later becomes a source of policy conflict, which may damage policy credibility."

However, the use of a single nominal anchor was effective in the past, but has recently been shown to be less successful. Given that crises have occurred in the past and will surely occur in the future, the question arises as to whether innovations in monetary policy regimes are needed, as recent crises have confirmed that the traditional approach is no longer effective. Apart from the policy of negative interest rates by the ECB and some other central banks, there have been no significant innovations in monetary policy since the emergence of inflation targeting in 1989.

Central banks often have multiple objectives, such as controlling inflation, stabilizing exchange rates, and supporting economic growth or employment. A single nominal anchor may not fully capture the complexity of these objectives. Two main reasons are often cited for considering this approach:

- In an economy experiencing both inflationary pressures and currency instability, an inflation target alone may not be sufficient to stabilize the economy;
- In countries facing external shocks (e.g., commodity price volatility or capital inflows/outflows), exchange rate stabilization may be necessary to ensure macroeconomic stability.

By using two nominal anchors, such as inflation and exchange rate targets, central banks might be able to simultaneously achieve internal stability (price stability) and external stability (currency stability).

The application of monetary regimes with two nominal anchors is rare, but present. For example, it is used in many emerging markets that follow an inflation targeting regime.[1] Also, some Caribbean economies have dual nominal anchors, as they maintain both money and foreign exchange targets (Tarron & Sukrishnalall, 2011).

Therefore, the aim of this paper is to determine whether it is feasible to apply a two nominal anchor regime. Typically, monetary authorities use one nominal anchor—a variable that provides a clear reference point for guiding policy actions. However, the concept of conducting monetary policy with two nominal anchors raises questions about whether it is practical or beneficial.

This paper consists of five parts. After the introductory notes, the second part examines the advantages and disadvantages of two nominal anchors. The third part is dedicated to analyzing the application of two nominal anchors in an inflation targeting regime. The fourth part presents the foundations of a completely new monetary policy regime, which would try to simultaneously target interest rates and the money supply, and the paper concludes with final considerations.

2. Some challenges of using two nominal anchors

Nominal anchors are key reference points used by central banks to guide monetary policy. These anchors serve as a target for monetary authorities, providing clarity and credibility to the policy framework. Traditionally, central banks have relied on a single nominal anchor:

[1] An example could be Israel, where monetary policy has been based on both a crawling exchange rate band and an inflation target during the 1990s.

- **Inflation Targeting**: The most common anchor in modern monetary policy. Central banks commit to keeping inflation within a specific range or around a target level (e.g., 2% annually). This approach is based on the idea that stable inflation leads to economic stability and encourages investment, savings, and efficient resource allocation.
- **Exchange Rate Targeting**: Some countries, particularly those with small and highly open economy, tie their currency value to that of a more stable or internationally dominant currency (e.g., the US dollar or euro). This is intended to anchor expectations about inflation and currency stability.
- **Monetary Aggregate Targeting**: This involves targeting the growth of a broad measure of the money supply, such as M2 or M3, based on the assumption that money supply growth influences inflation.

Using a single nominal anchor allows the central bank to focus its efforts on a clear policy target, aligning expectations and minimizing uncertainty.

However, relying on a single nominal anchor can expose a country to risks. For example, if the target anchor (say, inflation) fails due to unforeseen supply-side shocks, having a second nominal anchor (like an exchange rate peg) could help cushion the economy against volatility. By diversifying policy tools, the central bank can better respond to a wider range of economic conditions.

In some cases, using two anchors may enhance the credibility of the central bank's commitment to stability. For example, combining inflation targeting with a currency peg may signal to international investors and domestic actors that the central bank is serious about both price and exchange rate stability. This could anchor expectations in a way that might lead to lower inflation and greater market confidence.

Despite these potential benefits, using two nominal anchors presents significant challenges. The main issues lie in the trade-offs, complexity of policy implementation, and risk of conflicting goals. The most significant risk associated with using two nominal anchors is the possibility of conflicting objectives.

Using two nominal anchors can limit a central bank's ability to respond flexibly to changing economic conditions. For instance, if one anchor is linked to the exchange rate (such as under a currency peg), this may tie the hands of the central bank in adjusting interest rates to manage domestic economic conditions. A focus on two anchors could thus lead to a policy of "forced" decisions, where the central bank has to choose between conflicting goals.

The communication of monetary policy to the public, markets, and investors becomes more complex when two nominal anchors are in place. Typically, clarity and transparency are critical for the success of monetary policy. When two targets are used, it becomes more challenging to explain why a particular policy is being pursued or what the central bank's primary focus is in a given situation. This ambiguity can undermine the effectiveness of policy and potentially lead to confusion or misinterpretation by market participants.

In practice, using two anchors would likely require close coordination between different policy tools, such as interest rates, foreign exchange interventions, and communication strategies. This requires high levels of institutional strength and policy coherence, as well as a deep understanding of how changes in one anchor (e.g., inflation) might affect the other (e.g., the exchange rate). For example, adjusting interest rates to control inflation could inadvertently affect exchange rates, and vice versa. Effective coordination is essential but difficult to achieve.

Despite all the limitations, regimes with two nominal anchors were not so rare. Prior to adopting the euro, many EU countries employed both inflation targeting and exchange rate stability as dual anchors. The European Exchange Rate Mechanism (ERM) required countries to maintain their currency exchange rates within a specific band relative to the European Currency Unit (ECU). At the same time, countries were pursuing inflation reduction strategies to meet the Maastricht criteria for joining the euro. While this approach had its limitations, it was seen as a useful framework for transitioning toward a more integrated European monetary policy.

Hong Kong's monetary policy, which involves a currency peg to the US dollar alongside inflation control measures, provides an example of a dual anchor system. The Hong Kong Monetary Authority (HKMA) has had to balance exchange rate stability with domestic inflation control, using interest rates and foreign exchange interventions. This system has helped stabilize the Hong Kong dollar while striving to maintain low inflation, though the city remains vulnerable to external shocks due to its reliance on the dollar peg.

The Swiss National Bank (SNB) has used two nominal anchors in recent years: a commitment to low inflation and the management of the Swiss franc's value. To avoid excessive appreciation of the franc, which could harm the Swiss economy, the SNB has used foreign exchange interventions to keep the currency from appreciating too much. Simultaneously, it has maintained inflation targets consistent with its price stability mandate. The dual focus has allowed Switzerland to

manage its exchange rate and inflation, but this has involved ongoing challenges in maintaining balance between the two anchors.

It can be concluded that the ECB also uses a soft version of the two nominal anchors. Namely, within the ECB's monetary framework, there is a target inflation rate, but also an indicative value for the monetary aggregate M3. Additionally, many countries operating under an inflation targeting regime also use an exchange rate policy. In most cases, the exchange rate is implicitly a nominal anchor.

3. Two Nominal Anchors in an Inflation Targeting Regime

While discretion is a viable option in countries with high credibility of monetary policy authorities, the inflation targeting regime can anchor inflationary expectations when credibility is imperfect. In the inflation targeting regime, the initial theoretical assumption is that the central bank should have no other goal besides the inflation target, as this would lead to conflicting objectives and a potential threat to price stability. Therefore, the initial assumption is that a free-floating exchange rate policy is pursued within this regime. Mishkin and Savastano (2001) explained the rigid stance on exchange rate policy in inflation targeting regimes, highlighting that even where there is high exchange rate pass-through to domestic prices, concerns exist that systematic interventions in the foreign exchange market could undermine the credibility of the inflation targeting framework.

The majority of countries that use inflation targeting are highly open economies, characterized by free movement of capital, significant foreign direct investment inflows, and a high share of foreign trade in GDP. For these countries, external shocks can have a significant impact on the domestic economy. Thus, the exchange rate plays a significant role in the transmission mechanism of monetary policy. As Svensson (2000) notes, in an open economy, the real exchange rate will affect the relative price between domestic and foreign goods, and foreign disturbances will be transmitted through the exchange rate, for instance, changes in foreign inflation, foreign interest rates, and foreign investors' foreign-exchange risk premiums.

In such conditions, for small and highly open economies, large fluctuations in the exchange rate, particularly depreciation of the domestic currency, can lead to rising prices of imported inputs, which spill over into higher inflation. There is an additional exchange rate channel to inflation in that the exchange rate affects domestic currency prices of imported final goods. In the context of rising

prices of many goods, it is realistic to expect a decrease in purchasing power and demands from unions to adjust wages according to changes in the exchange rate. This channel is particularly present in emerging market economies, where workers, despite receiving wages in the domestic currency, essentially look at how much their salary is worth in foreign reserve currency. This channel, pressuring for wage increases, opens another channel through which exchange rate changes affect inflation growth.

From all of the above, it is clear that changes in the nominal exchange rate impact the inflation rate. In such circumstances, standard monetary policy instruments used in an inflation targeting regime may not be sufficiently effective, and there is a high risk that inflation could exceed the targeted zone. It is also important to keep in mind that most countries entered the inflation targeting regime after the previous monetary framework did not yield satisfactory results. This means that inflationary experience may still be present in people's memories, which could lead to a resurgence of inflation expectations, potentially undermining the effectiveness of the regime.

As Fischer (2001, p. 5) states, "for countries open to international capital, it is to be expected that policy in most countries will not be indifferent to exchange rate movements. Many countries that claim to have floating exchange rates do not allow the exchange rate to float freely, but rather deploy interest rates and intervention policy to affect its behavior." Similar views are expressed by Ghosh, Ostry, and Chamon (2016), who argue that inflation targeting is appropriate for emerging market economies that lack other nominal anchors (such as a formal peg) but should be supplemented by judicious foreign exchange intervention, especially in the face of volatile capital flows.

Benes (et al., 2015) suggest that central banks in emerging market economies effectively make decisions under the condition of having two goals – low inflation and a stable exchange rate – and two instruments – the reference interest rate and interventions in the interbank foreign exchange market. For example, Mohanty and Klau (2005) showed that, of thirteen countries applying inflation targeting, the exchange rate was a significant variable in eleven countries. Edwards (2006, p. 2) stated: "At the policy level, very few inflation-targeting central banks openly recognize using the exchange rate as a separate term in their policy rules (that is, Taylor rules). Existing empirical evidence suggests, however, that almost every central bank takes exchange rate behavior into account when undertaking monetary policy." As Fisher (2001) highlights, there is almost certainly a short-run trade-off between the real exchange rate and inflation, analogous to the Phillips curve, although it has not received much empirical attention.

A large number of other empirical studies have indisputably shown that some countries in this regime also have some exchange rate target, which is not publicly announced, and occasionally intervene in the foreign exchange market (Lazić, 2021; Adler, Lama, and Medina, 2018; Fabris, N., 2018; Airaudo, Buffie, and Zanna 2016; Fabris, J., 2015; O'Connell, 2008; Stone, 2003; Svensson, 2000). Essentially, this is the result of fear of a fully free-floating exchange rate, so interventions are aimed at preventing undesirable movements of the exchange rate.

However, it should be noted that early adopters of inflation targeting and present-day inflation targeters among advanced countries have generally adopted floating exchange rates in part to avoid potential conflicts between price stability and exchange rate objectives. Nevertheless, it is important to note that fluctuations in the exchange rate are much less pronounced in most of these countries than in emerging economies that are in an inflation targeting regime. On the other hand, monetary authorities in emerging market economies often lack full policy credibility, which results from a poor inflation history and, in some cases, a lack of sufficient independence in the past.

As Ghosh et al., (2016) argue, if two policy instruments are available (the policy interest rate and foreign exchange market intervention), then they should be used in tandem to achieve both price stability and exchange rate objectives. Almost inevitably, the exchange rate holds greater significance in emerging market economies than in advanced economies, as explained in the previous section. As a result, even if central banks in emerging market economies do not set a specific exchange rate target, most of them have an implicit "comfort zone" within which they prefer the exchange rate to remain. Unlike central banks in most advanced economies, central banks in emerging market economies typically operate in a context with two targets and two instruments. They have "two targets" because, in addition to the goals of controlling inflation, they also aim to prevent large, destabilizing movements in the exchange rate. They also have "two instruments", as they can use both the policy interest rate and sterilized intervention to manage these targets

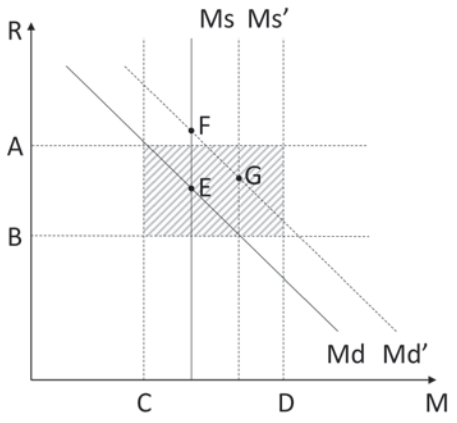
In an emerging market economy where the central bank has not fully regained credibility, FX interventions can enhance the credibility of the central bank's inflation target. Although most of these central banks already use this practice and usually have some implicit exchange rate target, if central banks had their own implicit exchange rate target, this regime would likely be further strengthened by the public announcement of the exchange rate target. This would essentially only make public the existing practice of central banks, and the credibility of both the central bank and the monetary regime could be strengthened with two nomi-

nal anchors. Of course, it is crucial that the inflation target and the exchange rate target are compatible, meaning that their values do not become conflicting objectives. An implicit exchange rate target helps prevent undesirable exchange rate movements from affecting inflation, but it does not have enough impact on inflation expectations because the public is unsure and has no guarantee that the central bank will act to prevent unwanted exchange rate movements.

4. Quadrilateral targeting

Another possibility for pursuing a policy with two nominal anchors is to simultaneously target the money supply and the interest rate. There is a clear assumption in the existing literature that a central bank may target either money supply, and then the demand would determine what the interest rate will be for the given supply, or the interest rate, and then the demand would determine the amount of money demanded for the given interest. The following graph explains how this mode, which I have called quadrilateral targeting, could work.[2]

Figure 1: Quadrilateral targeting



Source: Author

The targeted level of interest rates is the zone from point A to point B, and the targeted level of money supply is the zone from point C to point D. Essentially, the targeted zone is a shaded square. The initial equilibrium exists at point E, at the point of intersection of the supply and demand for money and it is located in the targeted zone. As a result of the increase in money demand, the new equilibrium is now at point F, outside the targeted zone. As a result of the increase in the interest rate, an expansive monetary policy is implemented with the aim of returning the interest rate to the targeted framework and a new balance is established at point G, which is again in the targeted zone.

[2] Quadrilateral targeting is related to the fact that essentially the targeted zone is the quadrilateral shaded as shown in the Figure 3.

A challenge for this regime could certainly arise in situations where a high level of expansiveness or restrictiveness in monetary policy is needed to bring equilibrium point back to the targeted zone. This could potentially lead to destabilizing effects on the economy. Unlike the previous approach (inflation targeting with an explicit exchange rate target), which is more suitable for emerging market economies, this monetary framework is much more appropriate for developed countries, as historically they generally do not experience drastic changes in demand levels that could lead to extreme changes in interest rates for a given level of money supply.

It is important that the money supply and interest rate targets are set at compatible levels, and historical data on interest rate and money supply movements can be useful. The quadrilateral targeting regime is obviously not suitable for all central banks and all situations. It will be more adequate for central banks of developed countries with significant credibility. Also, it will not be suitable in countries where there are significant changes in the demand for money. It is probably more fitting in both stable conditions and recession. With these two nominal anchors, central banks could balance between inflation and economic growth, but in the event of their conflict, a clear priority would have to be given to price stability. In the end, this is just a starting assumption that requires a lot more research before this regime would be either accepted or rejected.

5. Conclusion

The traditional monetary framework, based on a single monetary policy instrument (interest rate) and a single goal (price stability), is outdated and functions well only under stable conditions. Even if we add to this that we live in a time of dramatic acceleration of changes and unprecedented technological development, in the so-called VUCA (Volatility, Uncertainty, Complexity, and Ambiguity) environment (Vučinić and Luburić, 2024) and given that the last major innovation (except perhaps for some non-standard monetary instruments) occurred in 1989, when New Zealand began targeting inflation, the question arises whether it is time for new monetary regimes.

Therefore, this paper analyzes the application of monetary regimes with two nominal anchors. Additionally, considering that in modern conditions, besides price stability, central banks are increasingly focusing on multiple objectives, at least as secondary goals, a framework with two nominal anchors seems much more suitable.

Although the theoretical literature suggests that the use of two nominal anchors is only feasible in the short run, this paper presents a framework for how such a system could be implemented over a longer period. Moreover, there are practical examples of the use of two nominal anchors, such as in many emerging market economies operating under inflation targeting regimes, some Caribbean countries, and even, to a certain extent, the ECB uses a kind of soft version of two nominal anchors.

The use of two nominal anchors in monetary policy is a possible yet complex approach. It may offer some advantages, such as addressing multiple policy objectives and diversifying risks. However, the challenges include the risk of conflicting policy goals, reduced flexibility, and increased complexity in communication and implementation. The key to successful dual-anchor systems lies in a central bank's ability to carefully balance these goals, effectively coordinate policy tools, and ensure clear communication to avoid market confusion. In practice, this strategy works best in environments where external shocks or multiple objectives make a single nominal anchor insufficient, and where institutional strength and credibility allow for the management of potential trade-offs.

Most emerging markets that use an inflation-targeting regime are small, highly open economies, where the exchange rate plays a significant role in the transmission mechanism of monetary policy. In such conditions, exchange rate changes, through the impact on input prices, the rise in prices of imported goods and services, the influence on inflation expectations, and union pressures to maintain wage levels in foreign currency, can significantly hinder or even prevent the achievement of the inflation target if there is no exchange rate management. Therefore, most emerging markets in this regime have some form of an implicit exchange rate target. Hence, this paper proposes the introduction of an explicit exchange rate target, which would further strengthen the credibility of this regime and the achievement of the inflation target. For developed countries in this regime, where exchange rate fluctuations are not significant, the classic inflation targeting regime is feasible.

Another possibility for conducting monetary policy with two nominal anchors is to simultaneously target the money supply and the interest rate. Although literature suggests that it is not possible to simultaneously target both the money supply and interest rates, this paper explains how this regime could function. The quadrilateral targeting regime, as I call it, is clearly not suitable for all central banks and all situations. It would be more appropriate for central banks in developed countries with significant credibility. It is probably more fitting in both stable conditions and recession. In modern conditions, when central banks are

increasingly focusing on multiple objectives, beyond standard price stability, this regime would facilitate balancing between inflation and economic growth, but in the event of conflict, a clear priority would have to be given to price stability. This is just a starting assumption that requires much more research before it can be confirmed as feasible or dismissed as a theoretically inapplicable concept.

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