Inflation Targeting as a Monetary Policy Framework: A Critical Appraisal

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Abstract: Inflation targeting has been adopted as a monetary policy framework by many economies – particularly emerging and advanced countries. Although several researchers have argued that it is a recommended policy measure to curb inflation in a prospectively high inflation-saddled economy, other scholars think otherwise. A critical review of the arguments for and against inflation targeting as a tool of ensuring price stability in presented in this paper. Accordingly, the paper points out that the targeting framework has been established and proven effective in several countries, but it is arguably not satisfactory enough. The paper recommends that a realistically attainable percentage – usually a flexible target range and a time-lag for achieving the target should be set. This is because over-ambitiousness on the part of monetary authorities can invariably lower the economic prestige, credibility and monetary policy independence of a country particularly if the set-target becomes unattainable. Notwithstanding, developing countries need to create an enabling environment in terms of strong financial markets and commitment to price stability alongside establishing a well-developed forecasting framework in order to reach the desired effects of inflation targeting.

Keywords: Price Stability, Exchange Rate, Developing Countries, Advanced Countries

1. Introduction

One of the primary objectives of monetary policy in any given economy is to protect the value of domestic currency in order to achieve sustainable growth levels. Like fiscal policy, monetary policy is used to control economic and financial stability of an economy. Inflation Targeting (IT) is one of the most widely used monetary policy strategies applied to achieve the goal of price stability. Proponents of IT will argue that it is an effective way of ensuring institutional commitment to lower inflation rates, improving communication, transparency and accountability in monetary policy and the central banking system (Mishkin and Posen, 1997; Bernanke, et al, 1999; Fraga, et al, 2003). Critics however contend that there are better alternatives to this approach and that the gains from inflation targets are dubious (McCallum, 1996; Svensson, 1997). Moreover, the recent global financial crisis has raised further questions about the adequacy of IT.

This paper seeks to contribute to the debate on the arguments for and against inflation targeting as a monetary policy framework. Based on a critical review of existing literature on IT with examples from case studies, the paper is further segmented into three sections. The following section presents a concise background on IT. Section three will present a critical analysis of IT as a monetary policy framework for stabilization. The final section gives the conclusion of this paper.

2. Inflation Targeting: Background and Motivation

High Inflation rate is one of the most persistent and exasperating macroeconomic problems facing almost every economy around the world. Monetary authorities across countries are adopting several measures to curb this menace; one of such measures is inflation targeting (IT). Based on the quantity theory of money, inflation is literally viewed as a rise in general price level in an economy. Inflation can lead to price instability, hence causing severe macroeconomic complications- ranging from exchange rate problems to balance of payments deficits and fall in GDP amongst several others.

Though not also without faults, it is argued that monetary targeting, exchange rate pegging or nominal GDP targets can be considered as alternatives to IT (McCallum, 1996). These alternatives also contain loopholes which are in fact related to the issue of trade-off between unemployment or output and inflation, time-inconsistency problem, et cetera. (Mishkin and Posen, 1997). Moreover, Mishkin (2000) sites that Latin American and East Asian countries that relied on alternative monetary policy strategies like pegged exchange-rate regimes had found themselves in severe financial crisis in the 1990s.
Mishkin and Posen (1997) have also outlined the reasons why many countries have chosen IT as a monetary policy strategy. Monetary policy actions desired to increase output or reduce unemployment in fact lead to higher inflation in the short run. Hence, the commitment to price stability as the main macroeconomic policy objective in economies across the globe is escalating. Mishkin and Posen (1997) also emphasize that ensuring price stability will promote well-functioning economic systems such that living standards can be improved. More so, hyperinflation tends to create uncertainties in current and future price levels thereby making it more difficult to reach production decisions, thus, leading to a decline in investment and productivity – then the list of repercussions become endless.

To Mishkin and Posen (1997), inflation targeting involves the public announcement of a medium-term numerical target value of inflation with commitment on the part of monetary authorities to achieve this set target during a given time period. Hazirolan (1999) rightly points out that inflation targeting is not meant to affect current inflation but to observe and regulate future price stability after a thorough disinflation period. A vast amount of empirical literature is available on the desirability of inflation targets especially for advanced countries; however, empirical works for developing countries are rather scant which is largely due to paucity of data; we would therefore present a critical review of the studies at our disposal in the next section.

3. The Inflation Targeting (IT) Argument: A Critical Appraisal

To begin with, Mishkin and Posen (1997) extensively examined IT experiences in the first three countries that experimented with this approach to monetary policy – New Zealand, Canada and United Kingdom. They also included Germany whose monetary policy regime is actually monetary targeting but with dominant features of IT. All targeting countries had set an annual inflation target range between 0% and 4%. The authors find that all countries have been able to maintain low rates of inflation and ensure monetary policymaking transparency while using rigid policy rules without harming the real economy in the face of economic development. New Zealand was the first to formally adopt IT across the globe; it was a country with initially high and erratic inflation but successfully had low inflation alongside high economic growth rates after the adoption of an IT regime. The key reason for Germany and Canada’s success is the commitment to transparency, flexibility and communication of policy strategies to the public. Unlike the other three countries that were mainly driven by disinflationary pressures; foreign exchange rate crisis motivated the UK to adopt IT.

Using a three-variable unrestricted vector autoregressive model of core inflation, GDP growth and interest rate, the authors attempted to answer the question as to whether the reasons for success of IT in these countries were as a result of the forces (disinflation measures) in place before the target was implemented. They found that inflation had declined since the adoption of the target without any significant effect on output growth. There was flexibility in such a way that central banks could deviate (in their own discretion) from the target in response to supply-shocks. It is worthy of note that these countries had formally implemented IT only after they had succeeded in lowering their inflation rates from higher levels. This extensive study by Mishkin and Posen (1997) can be criticized for restricting its research on inflation targets to developed countries only.

Consequently, the study by Ball and Sheridan (2003) compared improvements between targeting and non-targeting countries using a sample of 20 OECD economies for 1990-2001. They find no significant difference in economic performance among the IT and non-IT countries using a wide range of economic indicators (inflation, output and interest rate). Therefore, IT does not change the behaviour of policy instruments, hence an irresponsible change in economic outcomes. It is argued that flexible IT stabilizes inflation and output. The authors however find no evidence that IT reduces inflation variability or improves output stabilization— the standard deviations are in fact higher for targeters than for non-targeters. In fact, output is found to be even more stable for non-targeters than for targeters. Thus, the authors’ findings suggest that IT does not matter since both targeters and non-targeters have experienced similar reductions in inflation with non-targeters having more stable output.

The question lies within the fact that will or has inflation targets worked for developing countries? Mishkin (2000) argues that inflation targeting can allow monetary authorities to focus more on domestic issues and respond proactively to shocks affecting the domestic economy. Like an exchange rate regime, the author adds that it is easily understood by the public and is therefore highly transparent. Mishkin (2000) studied inflation targeting in emerging-market economies (EMEs) with special reference to the recent experience of Chile. Chile was the earliest EME to adopt IT in 1990 due to a high annual inflation rate of over 20%. It is worthy of note that Chile also had an exchange rate peg in its policy regime, meaning that alternatives to IT can be implemented in tandem.
However, Chile’s central bank made it clear that where potential conflict exists in the two policy approaches, IT would take precedence. The author admits that though IT may be appropriate for some, it is not necessarily a panacea and may be ineffective in many other EMEs. Like in the aforementioned developed countries, Chile also lowered its inflation rate prior to the adoption of IT. The adoption of IT saw a successful decline in inflation from over 20% in 1990 to 3% in 2000 which was achieved through gradual hardening of the targets over time (Mishkin, 2000). A high output growth of 8% was visible until 1998 (at 2.9%) when the economy experienced a recession due to huge negative terms of trade shock and the reluctance of the Chilean central bank to conduct exchange rate depreciation in this regard—financial crisis can lead to a trade-off between inflation volatility and output volatility. The Chilean experience also had transparency and accountability issues as it failed to conduct inflation forecasts and produce inflation reports for the public’s awareness.

Although Svensson (1997) claims that inflation targets need not distort inflation-output variability, this has a policy implication in that it is erroneous for a country to solely pursue disinflationary objectives to the detriment of other economic variables like output—as seen in Chile’s experience. Mishkin (2000) also illustrates with Brazil’s implementation of IT following its currency crises in 1999. Brazil maintained an inflation rate below 10% despite exchange rate shocks, but it is doubted whether Brazil will be able to see through the success of IT due to its deeply-entrenched fiscal issues. It can be inferred that the role of exchange rate and the fiscal position of developing economies is critical to the success of IT. Mishkin’s work would have benefited more with an empirical analysis of the Chilean and Brazilian cases of IT.

Another event-study by Levin, et al (2004) also confirms that like in advanced countries, IT effects in EMEs have also been gradual and are therefore not associated with immediate adjustments in inflation expectations. Although IT-implementing EMEs have succeeded in reducing average inflation, its volatility is rather high with under-shooting or over-shooting of inflation target bands due to high sensitivity to global economic instabilities as well as the intricacies associated with inflation forecasts and control in developing economies. The authors illustrate the standard deviations of inflation from the targets’ midpoints for some selected EMEs and OECD countries in the following table:

The figure above exhibits wider standard deviations for EMEs than for advanced countries. Brazil and South Africa are the worstly performing EMEs in terms of inflation volatility, with South Korea as the best IT-performer in EMEs. The authors contend that the success of EMEs in inflation reduction cannot be solely attributable to IT because there have been generally downward inflationary trends globally and the long-term sustainability of this success is to be further investigated. Arguing in the same vein, Fraga, et al (2003) present the following results on inflation trends and the success of inflation targeting between developed countries and EMEs. Average inflation has been relatively lower in both categories of countries explaining that inflation targeting has relatively been successful across the globe with relatively larger deviations in EMEs.
Muhanna (2006) also assesses the viability of adopting IT as a monetary policy framework in developing countries using South Africa (SA) as a case in point. Given daunting inflationary trends during that period, South African Reserve Bank (SARB) had to adopt an inflation target range of 3-6% in year 2002. He concludes that the adoption of IT has been a huge success in SA as inflation was reduced from 11.3% in 2002 to 4.2% in 2004. This success was triggered by the discipline in government expenditure, slower rates of increases in food and energy prices alongside the recovery of the rand exchange rate. Though based on forecasting, Muhanna (2006) adds that IT can clarify the objectives of the central bank and lower the uncertainties about future directions of monetary policy. He explains that not only did inflation targeting improve inflation performance, it also strengthened SARB’s mandate to focus on price stability alongside improvements in accountability and transparency in SA’s monetary policy. Moreover, it has also eased the synchronization of monetary policy objectives with other policy measures like fiscal policy in ensuring better overall economic performance in SA – this is evident in the country’s fiscal discipline. Muhanna’s study has been based on a review and can be applauded for his important conclusions, his work can however be criticized for not actually carrying out any empirical analysis to reinforce or validate his findings. Furthermore, the unreliability of inflation targeting lies within fact that it depends on future forecasts and predictions. When erroneous forecasts are made, it affects the credibility of monetary authorities and the success of meeting targets. Besides, IT policy-changes only become effective in the long-run which may be rather late given uncertainties related to the economic ambience particularly in Less Developed Countries.

Monetary authorities can focus on an objective that is most important from a long-run standpoint using IT alongside restricting political pressures on the pursuit of short-term objectives which are rather inflationary – e.g. seigniorage (McCallum, 1996). He also adds that IT can be a preferable approach in terms of facilitating communication between the central bank and the general public. Nevertheless, McCallum (1996) contends that a more superior mechanism other than IT can be the growth rate of nominal GDP. This leading contender as McCallum (1996) suggests, can yield superior cyclical behaviours in output and employment along with a reasonable inflationary position that will be stable in the long-run. The author does not however give a definite proof of this statement. Nevertheless, he recognizes the fact that both approaches to monetary policy share similarities in terms of operational logistics in supply-shock caveats.

Svensson (1997) argues that IT can simplify monitoring, evaluation and implementation of monetary policy as it allows for emphasis on the achievement of low and stable inflation. Nonetheless, this is a drawback as well; because the central bank can neglect other vital economic variables like output stabilization as seen in the Chilean case. The author also admits that inflation targets can be difficult to implement given that central banks have no full control over inflation due to uncertainties. Moreover, inflation targeting solves or affects future inflation pressures and not concurrent inflationary problems which are affected largely by previous monetary policy decisions.

On the accountability and transparency argument, Svensson (1997) argues that the imperfect control over inflation can make monitoring and evaluation very difficult to understand by the public. More so, in the instance of failure to meet inflation targets, the central bank can simply admit or write a statement that ‘such failure was due to factors beyond its control and should not be held accountable for the aberration’. The simplicity of IT is also justifiable if it involves one stabilization goal – inflation; but when additional short-run stabilization goals like output or employment are incorporated, inflation targeting becomes a complex monetary strategy to deal with. Svensson (1997) also finds that the lesser the emphasis on output stabilization, the faster and easier it will be for monetary authorities to adjust inflation forecasts towards long run inflation targets. Logically speaking, IT as a monetary policy regime becomes questionable for developing countries having GDP growth issues as against advanced countries with already well-established GDP growth levels.

4. Conclusion

In sum, low and stable inflation is one of the most important pre-requisites for the economic success of any given country irrespective of its level of development. High inflation is detrimental to economic stability; hence, IT allows for inflation stabilization. IT can therefore be used to ‘lock-in’ the benefits of previous disinflation strategies in the face of unexpected economic shocks – like the exchange rate shock experienced by the UK. The targeting framework has been tested and proven effective in several countries, but it is arguably not sufficient enough. Therefore, a realistically attainable percentage (flexible target range) and time-lag (say 5 years) for IT should be set as over-ambitiousness on the part of monetary authorities can amongst major economic side-effects, lower the economic prestige,
credibility and monetary policy independence of a country particularly when the target becomes unachievable. The pre-requisite for inflation targeting is that an economy must have institutional commitment to price stability, central bank’s independence, strong financial market, well-developed and satisfactory forecasting framework and a high degree of transparency which many developing countries are deficient in. Given that a few countries have only recently begun experimenting with inflation targeting, it is worth admitting that this essay is constrained with the fact that much empirical research on IT-experience in developing economies is scant. In general, the time-range on which inflation targets in respective countries have been implemented is not sufficient enough to make undisputable value judgments concerning the desirability of inflation targeting in LDCs – future research should be directed towards that path.

Bibliography


