Inflation Targeting

5.23 In recent years,particularly given the trend of globalisation, there is increasing debate on the role of inflation targeting as a framework for implementing monetary policy. Box 5.2 introduces the concept of inflation targeting and explores its relevance for developing economies.

BOX 5.2

Inflation Targeting as a tool for containing inflationary expectations : Its relevance for developing economies

There is an increasing focus on inflation targeting as a framework for implementing monetary policy. Inflation targeting may be defined as a framework for policy decisions in which the central bank makes an explicit commitment to conduct policy to meet a publicly announced numerical inflation target within a particular time frame. Some countries have adopted point targets while others are following a more flexible approach of targeting inflation within a band. Inflation targeting has been adopted by a number of central banks around the world, including those in New Zealand, Australia, Canada, Finland, Israel, Spain, Sweden, and the U.K.

Rationale for Inflation Targeting

Inflation targets may help provide a clear path for the medium-term inflation outlook, reducing the size of inflationary shocks and their associated costs. Since long-term interest rates fluctuate with movements in inflation expectations, targeting a low rate of inflation would lead to more stable and lower long-term rates of interest.

Important considerations

Inflation targeting attempts to relate monetary policy implications on inflation. However, concentrating only on numerical inflation objectives may reduce the flexibility of monetary policy, especially with respect to other policy goals. Since monetary policy actions affect inflation with a lag, inflation targeting would mean that the central bank would need to rely on forecasts of future inflation. Given the uncertainties, an inflexible and undue reliance on inflation forecasts can create policy problems. Therefore inflation targets should leave room for a good deal of flexibility and should be adjusted for volatile (supply-side) components. However too flexible a target reduces the credibility of the central bank.

Pre-requisites for inflation targeting

Countries adopting inflation targeting need to fulfill some pre-requisites before adopting inflation targeting. It is imperative that the central bank should not be constrained to finance the Government Budget and must have an effective monetary policy instrument like the short-term interest rate that is fully market determined. Moreover, transparency and accountability of the Central Bank is essential to anchor inflationary expectations. The Central Bank must possess the ability to forecast inflation and to assess the impact of monetary policy on inflationary expectations.

The country adopting inflation targeting has to select the relevant price index that is to be targeted. Most countries have adopted the Consumer Price Index for this purpose. Countries which are susceptible to external shocks and supply side shocks may target their core or underlying inflation rate rather than the headline inflation. The inflation targeting framework should be forward looking as any monetary policy action has a lagged effect.

Scope of Inflation Targeting in Developing Countries

Developing countries generally have relatively higher rates of inflation. Predicting future inflation is often uncertain. Hence, missing inflation targets is more likely in developing economies than in the developed economies. Moreover, in many developing countries, central bank autonomy is more a statutory than a de facto situation, because its decisions are still governed primarily by the need to finance the fiscal deficit.Therefore, central banks might hesitate to raise interest rates for fiscal reasons, although they would be required to do so to contain inflation.

Inflation Targeting - Is India ready for it?

Based on the experience of some industrialised countries, there is a view that in India also, monetary policy, to be transparent and credible, should have an explicit narrowly defined objective like an inflation mandate or target. While technically this appears to be a sound proposition, there are several constraints in the Indian context in pursuing a single objective. First, the debt management function gets inextricably linked with the monetary management function while steering the interest rates. Secondly, in the absence of fully integrated financial markets, which remain still imperfect and segmented, the transmission channel of policy is yet to evolve fully. Thirdly a fully dependent measure of inflation for targeting purposes needs to be developed. Under these circumstances, it is necessary to carefully measure and balance between possible outcomes, after taking into account movements in a variety of monetary and other indicators.