

Inflation targeting frameworks in Asia

The more open the economy and the less ingrained inflationary expectations, the greater the scope for discretion over target rules

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Despite the voluminous literature on the subject, the only definitive conclusion that can be reached is that in the absence of strong capital controls, currency intervention should not be framed as a specific target for the exchange rate.

Such targets invariably tempt speculators by offering them the infamous one-way option.

Exchange rate and monetary policy strategies must involve a 'fairly high' element of flexibility rather than a single-minded defence of a particular rate.

One way this flexibility might be achieved is via a band-basket-crawl or BBC regime, whereby a country loosely targets its trade-weighted or effective exchange rate.

Singapore and India are two well-known and successful practitioners of BBC-type regimes in Asia (though there are important differences in the way both countries operate their regimes).

In contrast, following the East Asian financial debacle of 1997-98, four of the five crisis-hit countries - South Korea, Indonesia, Thailand and the Philippines - have instituted monetary policy arrangements fashioned around an inflation objective (Malaysia being the obvious exception).

Korea was the first to do so in April 1998, the Philippines did so in January 2000, while Thailand did so in May 2000. While Indonesia is supposed to have implemented an inflation targeting framework in 1999, there are reasons to doubt the degree to which Bank Indonesia is committed to this regime; there appears to be a degree of ad hocism in Indonesia's approach to monetary policy.

Conventionally, an inflation targeting regime ought to be accompanied by a flexible exchange rate, with the interest rate used as the monetary policy instrument. In fact, Korea, Thailand and the Philippines seem to be pursuing a 'flexible' or 'soft' inflation target.

This involves either maintaining a fairly broad annual target band for core inflation (such as 0 to 3.5 per cent, as in Thailand), or a narrow target that only needs to be achieved gradually over time rather than as soon as possible (for instance, 2.5 to 3.5 per cent over a three-year period in Korea).

Choosing a longer target horizon or a fairly wide short-run inflation target effectively implies that the central bank is placing some weight on other objectives such as output and exchange rate stability.

There are obvious benefits in operating an inflation target regime with a degree of flexibility. There is significant margin of error in policy rules that are written down in the form of a mechanical operational instruction.

This in turn suggests the need for a degree of discretion. In addition, some flexibility in operating an inflation targeting regime is desirable because there is uncertainty about the link between policy instruments (exchange rate and interest rate) and policy outcomes (inflation) - not to mention other types of uncertainty, including those inherent in forecasting inflation.

Exchange rate stability

With such a flexible inflation targeting approach, as long as the country's inflation outlook remains consistent with the medium-term inflation target range, the monetary authority has space to use its judgment to judiciously react to meet other objectives (like output and employment growth) and respond effectively to various shocks in the interim.

While the desire for output and employment stability is self-evident, a degree of exchange rate stability may also be warranted, as sharp exchange rate cycles can compromise the growth of those sectors of an economy which depend on international trade. An even more controversial question is whether an inflation targeting central bank should pay heed to potential asset price bubbles. This is an issue facing many central banks around the world.

On the other hand, too many objectives or too much flexibility in implementing an inflation target invariably violates the 'KISS principle' - 'Keep It Simple, Stupid!' - which suggests that monetary policy should be communicated to the public in the most straightforward manner.

Lack of monetary policy clarity may thus diminish the central bank's credibility and worsen the output-inflation trade-off that the country is faced with.

In addition, responding too heavily and frequently to currency movements in the short term can risk transforming a flexible inflation target to a de facto 'soft' currency peg (that is, a currency peg that is not formalised by a currency board regime like in Hong Kong), which in turn tends to be crisis-prone.

This may be especially the case in some Asian economies where there are concerns of a reversion to soft exchange rate pegged regimes that are undervalued (as is apparent by the massive reserve build-up in the region).

While the exact balance between flexibility and rigidity will no doubt vary between countries (and possibly over time within a country), broad rules of thumb suggest that: the less credible the monetary authority (that is, the greater its inflation-fighting track record), the less its technical ability, and the lower its political independence, the more advisable it is to pre-commit to a 'strict' or 'hard' inflation target (that is, preference of a rule over discretion).

Trade-offs between objectives

Conversely, the more open the economy and the less ingrained inflationary expectations in the country, the greater the scope for discretion over strict inflation target rules.

Regardless of the extent of flexibility or discretion that is pursued, it is imperative that the inflation-targeting monetary authority clearly articulate to the public its priorities (with inflation taking precedence over all others), as well as the time frame over which it is committed to returning inflation to its target.

The inflation targeters in Asia have thus far not faced significant trade-offs between inflation and other objectives in view of the fact that the global economy has, until recently, been in a sustained deflationary environment.

In other words, given that inflation has never really threatened to overshoot its predetermined band, the regional central banks have been largely free to use monetary policy to attain other goals such as smoothing exchange rate changes (as they have been doing thus far).

But how will they perform in a less benign environment when inflation is high and they are faced with sharper trade-offs? Only time will tell.

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