Inflation Targeting Approach in Monetary Policy

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In News

Inflation targeting is a central banking policy that revolves around **adjusting monetary policy to achieve a specified annual rate of inflation.** The principle of inflation targeting is based on the **belief that long-term economic growth is best achieved by maintaining price stability, and price stability is achieved by controlling inflation.**

Features of Inflation Targeting

- Inflation targeting primarily focuses on maintaining price stability, but is also believed by its proponents to support economic growth and stability.
- Inflation targeting can be contrasted to other possible policy goals of central banking, including the **targeting of exchange rates, unemployment, or national income.**
- All of the tools of monetary policy that a central bank has, including open market operations and discount lending, can be employed in a general strategy of inflation targeting.
- Interest rates can be an intermediate target that central banks use in inflation targeting. **The central bank will lower or raise interest rates based on whether it thinks inflation is below or above a target threshold.**
- The benchmark used for inflation targeting is typically a price index of a basket of consumer goods, such as the **Consumer Price Index.**
- Stable inflation **reduces investor uncertainty**, allows investors to predict changes in interest rates, and anchors inflation expectations. If the target is

published, inflation targeting also allows for **greater transparency in monetary policy.**

- Critics argue that exchange rate targeting or nominal GDP targeting would create more economic stability.
- Some countries have chosen inflation targets with **symmetrical ranges around a midpoint (4%+/-2%)**, while others have identified only a target rate or an upper limit to inflation. Most countries have set their **inflation targets in the low single digits.**
- A major advantage of inflation targeting is that it combines elements of both “rules” and “discretion” in monetary policy. This “**constrained discretion**” framework combines two distinct elements: a **precise numerical target for inflation in the medium term and a response to economic shocks in the short term.**

Other Approaches of Monetary Policy

- **The exchange rate targeting regime** means that the central bank pegs the value of the national currency to the exchange rate (basket of currencies) of the country (countries) with a low inflation rate, i.e. an intermediate goal of monetary policy is a certain level of or change in the exchange rate.

[In order to effectively use this regime, the **country should have a substantial volume of gold and foreign exchange reserves** to counter shocks in the foreign exchange market].

- The monetary targeting regime uses one of the money supply indicators as an intermediate target. The **instruments for regulating the banks’ liquidity** are the main tool for achieving the monetary policy objectives.