Inflation Targeting in China?

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Summary

Inflation targeting as a macroeconomic policy was pioneered by New Zealand slightly more than a decade ago. It has since spread to Sweden, Australia, Canada, U.K., and more recently to South Korea and Thailand. It represents a shift of policy emphasis from intermediate variables (money supply, interest rate, exchange rate) to final monetary outcomes – inflation, nominal income, and monetary or financial conditions index (MCI/FCI).

This paper looks at the possibility of applying inflation targeting as a policy in China. It argues that there is some merit of shifting to final monetary outcomes as there are various hazards of using intermediate variables such as the money supply (given the soft peg) and the interest rate (because of the peculiar fiscal and financial environment) in the country.

Despite the appeal of discipline, however, there is a host of operational difficulties of implementing inflation targeting in China, including (1) unpredictable and uncontrollable price components; and (2) regional diversities. The general implication is that monetary policy like inflation targeting is insufficient as a macroeconomic tool. An FCI is proposed instead as a "focus of nominal attention", rather than a target, that may induce behavioural changes in the government agencies and the market participants.