

# **Inflation Targeting in Asia**

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## **Summary**

Inflation targeting has become a popular monetary policy framework for the pursuit of price stability among many countries, advanced and developing, since the 1990s (see Table 1.1). Many central banks have explicitly adopted inflation targeting, while others implicitly follow the practice without declaring so. Price stability has, of course, been an important objective for central banks long before the recent enthusiasm for inflation targeting. But inflation targeting goes beyond the declaration of price stability as an objective and is more than a policy rule. It is a framework for central bank accountability and communication. By explicitly defining a numerical target and placing emphasis on the inflation forecast, the central bank is able to justify its actions to the general public. The enhanced transparency and accountability that this entails provides central banks with the flexibility to respond to economic shocks. And it clarifies the outlook for inflation, enabling consumers and businesses to reach well-informed, rational decisions about whether to save or borrow, to invest or consume, and what and when to produce.

There are several reasons for the current popularity of inflation targeting. First, some countries with a history of high inflation have adopted inflation targets as a means of demonstrating a strong commitment to a low inflation policy. If monetary policy is credible and inflation expectations adjust to the target, then the inflation rate can be lowered without incurring excessive adjustment or output costs. Second, an inflation target is a performance criterion to which central banks can be held accountable. Since the objective of monetary policy is presented in numerical terms, policy is more transparent to the public. Moreover, some central banks have further enhanced accountability by inflation targeting, which has led to further strengthening their independence. Finally, inflation targets offer an alternative nominal anchor for countries forced to abandon fixed exchange rate regimes. The International Monetary Fund (IMF) has recommended the adoption of inflation targeting and central bank independence to a number of countries in Asia following the financial crisis in 1997-98.

This occasional paper examines the practice and promise of inflation targeting in Asia. It considers the challenge of implementing such a framework in emerging economies that are small and open to capital movements. Of particular concern is the relationship between the exchange rate regime and the inflation target, since exchange rate movements exacerbate currency mismatches in national balance sheets, pass-through to domestic prices and costs,

and impact on competitiveness. These have led a number of countries in the region to adopt managed floating exchange rate regimes following the Asian crisis. Rapid structural changes also mean that defining price stability and forecasting inflation is not straightforward. The deflationary experience in Japan and the debate over the appropriate monetary framework in that country adds a further dimension to the design and implementation of an inflation targeting regime. The paper analyses these issues before proceeding to detailed case studies of the experiences with inflation targeting in the region. As such, it provides the first comprehensive survey and assessment of inflation targeting in Asia.

The paper suggests that inflation targeting may be a suitable framework for emerging market countries, particularly those with central banks that are legally independent from the government. But the central rate of the target should be higher and the width of the band should be wider than for advanced economies, reflecting more pronounced productivity differentials and measurement biases. And, in view of the possible risks of deflation, the lower bound of the inflation target band should be set at a level sufficiently above zero.

The paper also argues that a narrow focus on price stability, which ignores movements in the exchange rate, should be avoided. Countries in the region may benefit from pursuing both an inflation target and a managed exchange rate regime such as a basket band system. In a basket band system, the central rate is determined by the basket value of the currencies of a country's trading partners, and the rate is allowed to crawl according to changes in the basket value. The greater predictability of exchange rate movements facilitates investment decisions and mitigates against sharp changes in export competitiveness. Moreover, since the policy directions of monetary policy from both currency and inflation targets usually coincide, the presence of bands around both the inflation and exchange rate targets will likely provide room for policy maneuver. But care needs to be exercised in maintaining the compatibility of the exchange rate band and the inflation target, particularly when there are large capital movements. A sound macro-economic policy framework and regional policy co-ordination are therefore critical ingredients for the sustainability of such a regime.

The experience of inflation targeting in Korea, Thailand, Indonesia, and the Philippines, has been a positive one. Although the precise detail of the framework varies between countries, inflation targets have contributed to price stability and policy credibility. But there is still scope for improvement, and Asian central banks can learn much from each other given the common challenges that they each face in implementing their inflation targeting frameworks. To this end, the occasional paper makes a number of recommendations specific to each country. These include suggestions on the width and horizon of the inflation target, the level of the target ceiling, and observations on institutional independence. The paper cautions against viewing inflation targeting as a panacea and notes that monetary policy should be flexible enough to cope with financial instability, especially given the scale of non-performing loans in these countries.