

Free essay on inflation targeting v s interest rate targeting

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Inflation targeting and Interest rate targeting are two primary and most popular monetary policies across the globe today. Inflation targeting can be defined as a central bank policy that revolves around meeting and adhering to preset and publicly displayed targets for the annual rate of inflation (investopedia 2013). The benchmark used for inflation targeting varies from country to country but is some form of price index of a variety of consumer goods. Most commonly this benchmark is Consumer Price Index (CPI). While Interest rate targeting as a monetary policy regulates and checks the interest rate charged by one depository institution on an overnight sale of balances at the Federal Reserve to another depository institution (investopedia 2013).

Inflation targeting is a relatively new monetary policy when compared to the interest rate targeting. Though interest rate targeting was effectively used as a monetary policy earlier, it is fast being replaced by Inflation targeting as a more potent and useful monetary policy. Off-late more and more developed/ Industrialized and developing nations are adopting Inflation targeting monetary policy to guide their economy. In last two decades it has almost overshadowed the traditional and conventional interest rate targeting method with countries like United Kingdom opting for it over the interest rate targeting approach. The inflation targeting method or approach makes monetary policy much more coherent and transparent and hence lends a credibility to it, unlike interest targeting approach which has been found to be having some real limitations and issues in its approach. This is the prime reason why leading economists have been vying for amendments to the Reserve act to make Inflation targeting the primary approach or method for

its monetary policy.

It has evolved over the years that Inflation targeting is far more practical and pragmatic approach for monetary policy and it certainly holds true when taken in context with the benefits it offers to the limitations that Interest rate policy inherently and intrinsically suffers with. Some of the most important benefits that Inflation targeting bestows are as listed:

Increased Credibility: Inflation targeting is a much more credible, transparent and practical approach compared to other approaches towards monetary policies. It keeps a check on country's inflation and considerably connects people to their economy. An economy sans inflation target often fails to inspire confidence among the people and investors since inflation can hardly be predicted. This (no inflation targeting) could resultantly encourage workers to demand higher wages and firms to put up prices, thus pushing up the inflation (Pettinger 2012). This increased inflation not only takes a toll on purchasing power of the people but also is also capable of holding back the country's overall economic growth. Setting inflation targets give a clear indication and vision of the economy, key policy makers and central banks and thus imbibe confidence, necessary and vital for any economy. Thus the most important benefit that Inflation targeting approach to monetary policy offers is the strict check on the inflation, an economic parameter of paramount importance.

Responds well to Domestic Considerations: Inflation targeting as an approach is linked to the inflation targets for the particular economy and country and hence gives preference to domestic and local considerations unlike the other approaches to monetary policy. This monetary regime

enables monetary policy to focus on domestic considerations and to respond to shocks to the domestic economy (Todorovic & Djordjevic, 2008). Inflation targeting also offers an additional benefit and advantage when compared to other monetary policies like Interest rate targeting where monetary policy strategy relies on a stable money-inflation paradigm, as it remains largely irrelevant due to velocity shocks. The feature in itself has encouraged many economies across the world to change their monetary policies to Inflation targeting approach since this trend and benefit is specific to Inflation targeting method only.

Avoids Boom and Bust: Many countries in the past and many more even today relied/rely on high Inflationary growth. The main issue with high inflationary growth is that it is not only highly unsustainable but also purely impractical and lacks substance. High inflationary growth pushes countries and economies to recession, a trend that has lead many countries to switch over to Inflation targeting approach. An important example of British economy is relevant in this respect. In the past UK economy suffered and encountered many 'boom and bust' economic cycle. The 'Boom and Bust' phrase referring to the fast high inflationary growth and even the faster decline due to the unsustainability of the growth. These 'boom and bust' cycles forced UK to look for alternative and better monetary policy approaches and that is when it adopted or switched to Inflation targeting to ring in sustainable growth and help its economy pull out of recession. Inflation targeting keeps a strict vigil on the inflation for the economy and hence helps it escape 'Boom and Bust cycles'. The central banks or policy makers proper a guidance in the form of inflation targets that help the

country arrest unwanted or exaggerated inflation and hence doesn't let the country get into the loop of highly unsustainable and inflationary growth.

Improves Transparency: Inflation targeting considerably boosts the transparency associated to a country's or economy's monetary policy. It calls for public announcement of quantitative targets, which are specifically meant to fix accountability and transparency. This accountability often strengthens policy-makers' incentives to fulfill the central bank's mandate, thus making the overall monetary policy and its implementation much more efficient and effective. The range of inflation targets set as per the inflation targeting approach calls for increased political will since there are strict targets to be met. This not only allows for a more effective management of expectations, and promotes the discussion and evaluation of monetary policy (Martinez 2008). The increased transparency in turn improves the overall image of the economy, helps build confidence among foreign and domestic investors and also the growth, which though might be slow but is much more sustainable and firm.

Adheres to Traditional Stabilization Goals: Inflation targeting does not ignore traditional stabilization goals unlike the interest rate targeting approach. The most important stabilization goal that Inflation targeting responds well to is that inflation targets could substantially increase the flexibility of the central bank to respond to or tackle the declines in aggregate spending, since the decline would cause the inflation rate to fall considerably, in some cases even below the floor of the target range, and this will automatically simulate and enable the central bank to loosen monetary policy without any fear that its action could trigger a rise in inflation expectations. This feature empowers

the central bank with a sense of flexibility, which goes a long way when the policy-makers under the guidelines from the central banks make monetary policies. This keeps a check on excessive spending and inflation both and helps economy a great deal.

The reason is self-explanatory in establishing and proving the immense faith that countries are putting in Inflation targeting as an effective, efficient and credible approach to monetary policy and this in turn helps understand why many developed and developing countries are switching over to this strategy to design their monetary policies. These reasons clubbed with the limitation that interest rate targeting suffers with, make it much more preferable over interest rate targeting method. Some of the most glaring and massive limitation that interest rate targeting suffers from are:

Context of Positive price changes: First and foremost limitation that interest rate-targeting framework suffers from is the framing of policy under the context of positive price changes and non-zero interest rate. In the context of both these parameters the interest rate targeting even when constrained by Taylor-type rules may leave the price level (or the inflation rate) indeterminate (Cargill & Guerrero 2006).

Lack of Transparency: Interest rate targeting unlike inflation targeting is closed and hence lacks transparency and accountability. The constant guessing game that it promotes by its close-mouthed approach creates unnecessary volatility in financial markets and arouses uncertainty among producers and general public (Mishkin 2004). Interest rate targeting as a method or framework fails to communicate well with all the stakeholders. The strategy in itself thus lacks transparency and accountability, which

adversely hits the efficiency of the policy makers and increases corruption. Moreover, Interest rate targeting method is based on the capability of individuals rather than good institutions unlike the inflation based targeting. This again, could be a potential breeding ground for corruption and opaqueness in the system which has bad effects on the overall health of the economy.

The points clearly and vividly explain how inflation-targeting scores over interest rate targeting and how economies and countries, which have switched to inflation targeting, have benefited from it. Though there are many countries that have adopted inflation targeting, many have still stuck to the conventional interest rate targeting.

New Zealand was the first nation to adopt Inflation targeting in December 1989 (Jahan 2012). It was only after the economy stumbled and failed it hard to recover from a high inflation of over 10% that the country felt the need to change its monetary policy and hence migrated to Inflation targeting. The new framework was established through The 1989 Act, which proposed six principles for the country's economy to adhere to, and this kick started its journey towards implementation of inflation targeting. Over the last 27 years, New Zealand's economy has shown resilience and has still remained strong. The framework under the inflation targeting has helped New Zealand a great deal in reducing inflationary expectations. It has delivered price stability and has kept Inflation under the wraps. It has made government and the banks responsible much more accountable and has indeed ensured that the objectives and modus operandi of policy are clearly understood by the public and financial markets (Brash 1999).

The new regime or system has given a sense of stability to the New Zealand dollar exchange rate. The fluctuations in the exchange rates have drastically declined and reduced to lend much more credibility to the currency. New Zealand has also improved its fiscal policy due to the inflation targeting approach or framework to the monetary policy and has even inspired improvement in New Zealand's dismal record of fiscal performance. Most importantly, New Zealand's economic growth has increased and improved big way since it changed its monetary policy to Inflation targeting. Its economic growth has been markedly better than OECD countries and its inflation less than them. Thus it would be fair enough to say that New Zealand did benefit a lot from formulation of new monetary policy driven by Inflation targeting.

Hammond, Roger, and IMF; 2010-2011

The figure above shows the 14 countries in increasing order of their Inflation targeting adoption dates and their respective inflation data for the year of 2010. The inflation has been moderate in all these countries and the data in the table corroborates the claim. New Zealand as shown in the figure was the first country to adopt Inflation targeting.

On the Contrary, Tanzania, an African nation uses Interest rate targeting for its monetary policy. The economy has been extremely volatile and has suffered some serious setbacks. The inflation rate in Tanzania has remained largely unchecked and unbalanced and has shown very little signs of slowing down. The inflation rate of the country was a staggering 19. 80 percent in December 2011 (Taborda 2013). Though various liberalization measures have been undertaken by the government to boost investor confidence,

there has been no real enthusiasm due to lack of accountability and credibility, a feature that Interest rate targeting fails to induce. Even after all the efforts by the government, economic growth has largely remained constrained to a lowly 4%. This clearly goes on to show that Interest rate targeting is a far less effective approach to monetary policy than Inflation targeting.

The National Bureau of Statistics (NBS), 2013

The inflation data of Tanzania shows the greatest problem of Interest rate targeting following nations. The inflation rate was a whopping 19.8 percent in December 2011, as per the graph. Even though it has moderated off late, it is still above the maximum limits of all the Inflation targeting nations. Therefore, it can be safely said and concluded that Inflation targeting offers much more when compared to interest rate targeting. Even though Interest rate targeting has been adopted by many countries conventionally, its limitations and the benefits of inflation targeting are becoming clearer day and day and that can be inferred from the fact that more and more countries are crossing over the bridge to adopt Inflation targeting and their economic success stories say the rest.

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