Inflation Targeting: Notes for UPSC Economy

Inflation targeting is basically a monetary policy system wherein the central bank of a country (RBI in India) has a specific target inflation rate for the medium-term and publicises this rate.

Inflation target is an important concept in the economy segment of the IAS Exam. The details found in this article will be useful for candidates writing the exam

How is Inflation Targeting done?

A central bank seeks to readjust its monetary policy by doing inflation targeting. This is done by raising or lowering interest rates based on above-target or below-target inflation, respectively. The conventional wisdom is that raising interest rates usually cools the economy to rein in inflation; lowering interest rates usually accelerates the economy, thereby boosting inflation. The first three countries to implement fully-fledged inflation targeting were New Zealand, Canada and the United Kingdom in the early 1990s, although Germany had adopted many elements of inflation targeting earlier.

What are the benefits and drawbacks of Inflation Targeting?

Like all monetary policy instruments, inflation targeting comes with its fair share of benefits and drawbacks, they are follows:

Benefits

- Inflation targeting allows monetary policy to "focus on domestic considerations and to respond to shocks to the domestic economy", which is not possible under a fixed exchange-rate system.
- Transparency is another key benefit of inflation targeting. Central banks in developed countries that have successfully implemented inflation targeting tend to "maintain regular channels of communication with the public".
- An explicit numerical inflation target increases a central bank's accountability, and thus it is less likely that the central bank falls prey to the time-inconsistency trap. This accountability is especially significant because even countries with weak institutions can build public support for an independent central bank.

Drawbacks

- There is a propensity of inflation targeting to neglect output shocks by focusing solely on the price level.
- Leading economists argue that inflation targeting would maintain or enhance the transparency associated with a system based on stated targets, while restoring the

balance missing from a monetary policy based solely on the goal of price stability, thus neglecting other factors of an economy as well.

Relevant Questions for Inflation Targeting

Why is inflation targeting important?

Inflation targeting means Central Banks are responsible for using monetary policy to keep inflation close to the agreed target (usually around 2%). Inflation targets were introduced to help reduce inflation expectations and help avoid the periods of high inflation which destabilised global economies in the 1970s and 80s.

How does inflation targeting operate when there is inflation?

Inflation targeting is a monetary policy where the central bank sets a specific inflation rate as its goal. The central bank does this to make you believe prices will continue rising. It spurs the economy by making you buy things now before they cost more. Most central banks use an inflation target of 2%.