EMERGING MARKET PERSPECTIVES

Sticking to the Target

An inflation-targeting regime remains the best path through challenging times

Leonardo Villar

Since first adopted in 1990, inflation targeting has been generally successful as a monetary policy strategy. Most countries that adopted it have reduced inflation and inflation volatility. In the case of several emerging market economies, inflation targeting has also allowed them to turn procyclical monetary policies, which tend to amplify economic upswings and deepen downturns, into countercyclical action, contributing to GDP growth stabilization.

My own country, Colombia, is a good example. We introduced inflation targeting in 1999 after three decades of stable but stubbornly high inflation. Before its introduction, the central bank had to cope with complex mechanisms of indexation, which perpetuated inflation, and was forced to use the exchange rate as the nominal anchor of the economy amid relatively high inflation and a volatile balance of payments. Under these conditions, the central bank had little choice but to respond to external cycles and shocks with procyclical monetary policies to stabilize the exchange rate.

Game changer

Once Colombia adopted inflation targeting, countercyclical monetary policy responses became feasible for the first time. The authorities began allowing the exchange rate to fluctuate, thus acting as the first line of defense against external cycles and shocks. This was evident in the monetary responses to the global financial crisis in 2007–09 and the COVID-19 shock in 2020. During both episodes, the authorities allowed the domestic currency to depreciate while relying on the credibility of the inflation target, rather than the exchange rate, as the main nominal anchor of the economy.

The inflation-targeting strategy also proved successful in dealing with the strong inflationary shock we faced in 2014–16 when Colombia endured a simultaneous drop in terms of trade after the oil price collapse, a severe drought, and other supply shocks. As a result, annual nominal depreciation reached 68 percent in 2015, and inflation went from about 3 percent in mid-2014 to 9 percent in July 2016, only to fall back to the 3 percent target years later without a major sacrifice in output. The credibility of monetary policy and the relative stability of long-term inflation expectations were instrumental in making this adjustment successfully.

Post-COVID challenges

Emerging market economies with inflation targeting are facing extremely difficult challenges in the current post–COVID-19 environment. The inflation-targeting regime relies heavily on the authorities' credibility when it comes to keeping inflation close to the target, and this has not happened since 2021.

Again, Colombia is a good example. Inflation rose from less than 2 percent in 2020 to 13.1 percent in 2022, the highest level since we adopted inflation targeting. This increase was driven largely by food prices, which rose at a yearly rate of nearly 28 percent in 2022 in response to both domestic and international supply shocks.

A strong aggregate demand recovery also pushed inflation upward. Colombia's GDP grew by more than 10 percent in 2021 and 8 percent in 2022, and its widening current account deficit is close to a historical record, despite the beneficial terms of trade experienced in 2022. Excess demand has also led to an upward trend in core inflation, which, excluding food and government-regulated prices, went from 2.5 percent in 2021 to 9.5 percent in 2022.

A sharp depreciation of the domestic currency has also played a role in the inflation trends. By the end of 2022, the Colombian peso had depreciated 38 percent compared with early 2021. This depreciation is higher than in most other countries in Latin America and has gone hand in hand with a deterioration in investors' country-risk perception during the past two years, when fiscal deficits were much larger than those of our regional peers.

Different indexation mechanisms are also affecting inflation. A key driver is the annual increase in the minimum wage that takes place at the beginning of each year based on observed past inflation. In this respect, 2022 and 2023 have been peculiar, as the minimum wage was raised by 10 percent and 16 percent, respectively, well above headline inflation. These hikes in the minimum wage have contributed to keeping inflation high through their impact on production costs and the typical wage-price spiral—with prices increasing as a result of higher wages, which subsequently rise to compensate for the increase in prices.

Communication and transparency

Under these challenging conditions, monetary policy has experienced unprecedented tightening. So far, Colombia's Banco de la República has raised the policy interest rate from 1.75 percent in September 2021 to 12.75 percent in January this year.

The succession of shocks to inflation since 2021 and the ensuing forced reevaluation of the monetary policy response have also posed a challenge for central bank communications. The large and protracted inflationary impact of those shocks requires a long period of convergence to the inflation target that needs to be explained to the public. Too fast a convergence can be very costly in terms of output and employment, but too long a convergence risks de-anchoring inflation expectations.

The central bank has publicly stated that the tightening process is not over and that it is committed to bringing inflation down to its 3 percent target over a two-year period with an acceptable deviation of 1 percentage point. Fortunately, inflation expectations are broadly consistent with our desired convergence path.

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Credibility anchor

Inflation is expected to decrease fast by historical standards but will probably be above its target rate for the longest period since the inflation-targeting regime was introduced. This will make it harder to maintain the credibility of the target as the main nominal anchor of the economy.

Clearly, the challenges for monetary policy will be particularly difficult during 2023 and 2024. We are expecting a sharp deceleration of economic activity that would shrink GDP growth to a meager 0.2 percent in 2023 as a result of tighter global financial conditions, slower growth in our trading partners, and a much-needed contractionary domestic monetary policy that guarantees inflation convergence toward the central bank's goal.

These challenges are not an argument against the inflation-targeting strategy. Rather, they reinforce the importance we attach to strengthening its anchoring role and the need to pursue a contractionary monetary policy at the current juncture that demonstrates the central bank's commitment to an explicit and credible inflation target.

Inflation targeting, coupled with a floating exchange rate, has served Colombia's economy well. It has helped the country confront economic shocks in ways that were not possible before. We believe that enhancing its credibility remains the best path to overcoming these challenging times. FD

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