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Emerging markets must stay focused on inflation

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Inflation targeting has become the monetary policy framework of choice for emerging markets. Following the lead of developed countries, most emerging market central banks have adopted frameworks in which their priority is to maintain price rises at a target level or within a specified range. Many others are moving towards such a system.

Inflation targeting has a good track record of delivering price stability and anchoring inflation expectations. This is valuable in emerging markets, where high inflation is especially pernicious as it hits the poor very hard.

Even as its popularity has spread, inflation targeting has come under sharp attack in the aftermath of the global financial crisis. Central bankers in developed economies are being pilloried for focusing too much on price stability, ignoring asset market bubbles and failing to prevent the worst crisis seen for a generation.

Many emerging markets have weathered the crisis quite well but their central banks also face pressure to abandon inflation targets. Critics argue that targeting inflation could be damaging in these economies if it means ignoring sharp exchange rate fluctuations and boom-bust cycles in equity and housing markets.

There is no doubt that asset-market booms in advanced economies fuelled the global financial crisis. This has given rise to the notion that, in addition to their goal of price stability, central banks should be given a further explicit objective of puncturing asset-price bubbles in order to maintain financial stability.

There is, however, deep tension between central banks having multiple objectives and the operational independence needed to achieve the inflation target. Broader objectives invariably mean more political interference and less credibility in maintaining low inflation.

This tension is heightened in emerging markets, where central banks have traditionally been responsible for a broad array of social and economic goals in addition to price and financial stability. Some objectives, such as exchange rate management, already complicate the conduct of monetary policy. Capital controls provide some breathing room, but they are porous and often impose many other costs on the economy.

How should emerging market central banks juggle these objectives? Certainly, inflation targeting frameworks can be improved to pay heed to signs of asset price and credit booms. Indeed, better models of inflation forecasting should incorporate the effects of market booms on financial wealth and private consumption.

But it is not realistic to expect monetary policy to prevent asset bubbles by itself. The main instrument of monetary policy, the policy interest rate, is best used to target inflation. If central banks are to be given more responsibilities to moderate credit cycles and help to prevent asset price bubbles, they will need new tools.

There are other instruments better suited to managing asset price booms - prudential regulatory policies to make leverage in housing and other asset markets more costly, tighten up lending standards and increase capital and liquidity requirements. These instruments should be developed and better co-ordinated with policy interest rates to manage inflation.

The bigger concern is whether central banks can maintain operational effectiveness and their independence if they have "mandate creep" - that is, more and more objectives. Indeed, the independence of these institutions, which hangs by a thread in the best of times, is now under assault around the world. Even the US Congress is taking steps to increase oversight of the Federal Reserve. In these circumstances, increasing the responsibilities of central banks could make them more vulnerable to political pressure and erode their credibility, especially in emerging markets where public finances are strained and the institutional framework is weak.

In many emerging markets, central banks are among the most wellmanaged and trusted public institutions. It is tempting to give them more responsibilities. But this should be done with great caution, for it could make them less effective at the one thing they have proven good at - controlling inflation.

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