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Inflation-targeting framework and the mechanism for achieving the target inflation rate

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Introduction

Central banks must implement a clear framework for monetary policy to achieve their ultimate goals. Over the last three decades, policy challenges within the framework of monetary and foreign exchange targeting have reduced the popularity of these approaches. Gradually, the central banks' interest in inflation-targeting in the monetary policy framework has been increasing as an indicator of the world economy's best performance.

The implementation of the inflation-targeting framework has a specific mechanism: the inflation target is determined and announced. Central Bank predicts the future route of inflation and compares it to the inflation target to identify the extent to which the projected inflation deviates from the target inflation. The Central Bank adjusts monetary policy instruments based on a certain structure and decision-making process to prevent the forecast of inflation from deviating from the inflation target and consequently to keep the inflation rate within the inflation target range. In this framework, the Central Bank must pursue accountability and transparency by setting a specific communication policy to keep inflation within the target range by controlling inflation expectations.

Considering the global experiences in inflation-targeting and Iran's experiences in monetary policy in the framework of monetary and exchange targeting, the Central Bank of the Islamic Republic of Iran, in June 1399, in an official statement changed its monetary policy framework into inflation-targeting.

Shifting the monetary policy framework to inflation-targeting

A. The ultimate goals of monetary policy

Monetary policy can pursue a variety of goals or objectives. Generally, the most important goal of monetary policy is to maintain price stability or to control inflation. But also, monetary policy in many countries pursues stabilizing production (economic growth). In recent years, especially after the global financial crisis in 2008, maintaining financial stability has become one of the important policy goals of monetary policy. Therefore, as the main custodian of monetary policy, the Central Bank may simultaneously pursue diversified goals, including maintaining price stability, maintaining production stability, and maintaining financial stability. Note that simultaneously achieving all of these goals may be unattainable, and in specific situations, prioritizing goals can be useful for implementing monetary policy.

B. Conventional monetary policy frameworks

Central banks need a framework to implement their monetary policies to achieve the desired goals. Specifically, the monetary policy which includes the intermediate purpose (nominal anchor) and operational purpose (instrument). Since monetary policy's effects on the ultimate goals appear with a delay, monetary policymakers decide and implement two intermediate target layers as a hierarchical structure. This hierarchical structure breaks down long-term goals into short-term and more evaluable goals and successfully pursue the final goals in a controllable process. Three conventional monetary policy frameworks used by central banks to implement monetary policy is:

- Exchange-targeting framework
- Monetary-targeting framework
- Inflation-targeting framework and Inflation-Forecast Targeting (IFT)

At present, the inflation targeting monetary policy framework is recognized as the best international performance due to the better efficiency of inflation-targeting than monetary-targeting and exchange-targeting.

C. Changing the framework of Iran's monetary policy to inflation-targeting

According to the upstream documents and five-year development plans, since the Second Plan, monetary units' targets became the official framework of monetary policy, and the goals of money growth were announced in the programs. Monetary targeting framework. The Third Plan was relatively successful but not continuous. Due to the significant deviation of liquidity growth rate performance from the Fourth Plan's targeted values and the elimination of quantitative targets in the Fifth Plan, this policy framework also failed to control inflation.

Given the above, as well as global experiences in the field of monetary policy and the need for regular and at the same time flexible and effective policy frameworks in controlling inflation and assisting production, the Central Bank of the Islamic Republic of Iran, in June 2016, in an official statement shifted their monetary policy framework into inflation-targeting.

Structural requirements of the inflation-targeting framework

A. The relative independence of the Central Bank in monetary policy

The independence of the central bank does not mean complete independence from the government. No central bank can be completely independent of government influence. Still, one of the requirements of inflation-targeting is that the central bank can conduct monetary policy with a degree of independence. This relative independence of the central bank in monetary policy is manifested in two ways:

- **Independence in monetary policy tools**
- **Lack of government financial control over monetary policy**

Advancing the operation of government budgets within the framework of sound financial rules will provide conditions for the government not to face large and continuous deficits. As a result, the government's need to withdraw forcefully from the central bank, which leads to financial domination, will be eliminated. Also, suppose the domestic financial markets are deep enough to attract government bonds in the face of a significant budget deficit. In that case, conditions will be provided that the central bank does not have to buy most of these bonds to finance the government, and as a result, the central bank's financial domination will be eliminated.

B. Select goals that are consistent with inflation-targeting

In the context of inflation-targeting, monetary policy's key goal is to achieve target inflation, such as the European Central Bank, which has a single mission. It does not mean that no goal other than inflation can be pursued in this context, but any other monetary policy goals can only be pursued if consistent with the inflation target.

C. Are the structural requirements of the inflation-targeting framework provided in Iran?

The implementation of monetary policy in the context of inflation-targeting requires a hierarchy, and at the top of it are issues such as mission specification, policy appointments, and delegations. The two main pillars of macro policies are related to the financial and monetary sectors. Based on the separation and appointment of these policies to the executive bodies and the delegation of powers, their mission and scope of authority are determined, and central bank independence can be raised. The Central Bank of Iran has upgraded its monetary policy instruments' scope by implementing open market operations since the winter of 2019.

The mechanism for implementing the inflation-targeting framework

The implementation of the inflation-targeting framework has a specific mechanism: the inflation target is determined and announced. Central Bank predicts the future route of inflation and compares it to the inflation target to identify the extent to which the projected inflation deviates from the target inflation. The Central Bank adjusts monetary policy instruments based on a certain structure and decision-making process to prevent the forecasted inflation from the inflation target and, consequently, keep the inflation rate within the inflation target range. In this framework, the Central Bank must pursue accountability and transparency by setting a specific communication policy to keep inflation within the target range by controlling inflation expectations.

1. Determining the inflation target has the following topics:
    - Determining inflation target reference
    - Inflation target index
    - Inflation target time horizon
    - Inflation target type
    - Inflation target level
    - Determining the inflation target by the Central Bank of the Islamic Republic of Iran

The Central Bank of the Islamic Republic of Iran, in June 2016, simultaneously with the official announcement of shifting the monetary policy framework to target inflation, announced its inflation target as follows:

A) Inflation target index: average annual inflation rate based on the consumer price index

B) Inflation target time horizon: one-year time horizon

C) Inflation target type: point with amplitude

D) Inflation target level: 22% with a range of +/- 2%

- Is the 22% inflation target appropriate at the beginning of the implementation of inflation-targeting in Iran?

In response to this question, it should be noted that the Central Bank has implemented inflation-targeting in Iran under certain conditions. After a period of inflation stability in the range of 10% (from April 2016 to July 2018), Iran's economy encountered an inflation shock due to the withdrawal of the United States from the JCPOA and the escalation of economic sanctions. The inflation rate in September 2019 with a figure of 48.9% has reached its peak. Then during a downward trend has reached the range of 36% in May 2020 (inflation-targeting period). Besides, the degree of financial dominance in the Iranian economy, the government's financial situation, and its monetary consequences in the current situation are practically incompatible with inflation-targeting in the single-digit range but can naturally be consistent with higher inflation targets.

2. Inflation forecast: Inflation expectations as a nominal anchor

Given the delay in the effectiveness of the monetary policy, inflation-targeting must necessarily be forward-looking. A change in monetary policy tools must be as a precaution before inflation rises. Therefore, in the framework of inflation-targeting, the Central Bank's inflation forecasting and inflation expectations play a key role in monetary policy. If inflation expectations deviate from the inflation target, the monetary policymaker must react appropriately to change the instrument of monetary policy to align inflation expectations within target inflation.

3. Monetary policy tools in inflation-targeting
   I. Policy interest rate
   II. Policy interest rate corridor

A. Interest rate corridor's ceiling: The interest rate corridor has a ceiling rate for the policy interest rate in which the Central Bank finances the banks overnight.

B. Interest rate corridor's floor: The interest rate corridor has a floor rate for the policy interest rate. Interest rate corridors have made it possible for banks to deposit surplus reserves with the central bank. Deposit these reserves with the Central Bank has a certain rate that determines the corridor's interest rate floor.

III. Establishment of interest rate corridors in the interbank market by the Central Bank of the Islamic Republic of Iran

A. 22% interest rate ceiling: interest rate ceiling is set at 22%, and banks and non-bank credit institutions can reduce their reserve deficit through overnight credit from the Central Bank at an interest rate of 22%, subject to provide sufficient documents.

B. 10% interest rate floor: The interest rate floor is set at 10%, and banks and non-banks credit institutions can deposit their surplus reserves with the Central Bank overnight at an interest rate of 10%.

4. The monetary policy decision-making process in the context of inflation-targeting
5. Setting the Central Bank Communication Policy in the direction of accountability and transparency

Recommendations

Communication should be two-way. It means that the central bank, in addition to informing market participants and the general public, must pay attention to the opinions and suggestions of market analysts, experts, and professors of economics in the mass media. Today, central banks are faced with a wealth of opinions reflected in blogs, television channels, and the press that have a great impact on the public mind. The Central Bank's paying attention to experts' solutions and responding to criticism can be helpful in some cases.

An important task of the Central Bank is to explain its limit of its missions and its ability to achieve its monetary policy goals to the general public. Informing about the limitations of the monetary policymaker's is necessary to avoid false expectations and, consequently, the Central Bank's loss of credibility.

Given the lack of transparency in Iran's monetary policy decision-making process, it is better to take measures to improve transparency in the Monetary and Credit Council meetings. In this regard, holding a press conference after the meetings of the Monetary and Credit Council, while reviewing the approvals of the council, can help to gain a general understanding of the causes and logic of decisions. Also, if the conference comes to an end with questions and answers, it can increase information transparency. The publication of the council meetings' minutes can also provide more details on how monetary policy decisions are made.

The level of literacy and public awareness about economic issues is a problem, especially for central banks in developing countries, in relation to their communication strategies. The greater is the general understanding of the economic and central banking issues, the more efficient the Central Bank will be in controlling expectations. Therefore, it is necessary for the Central Bank to take steps to increase public awareness of key economic concepts. Using tools to promote central banking concepts and allocate part of the Central Bank portal to educate economic concepts to the general public in simple language (including instructional videos and reports and brochures) can help the public to understand monetary policy issues.

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