INFLATION TARGETING IN THE POST-PANDEMIC ERA: CHALLENGES AND POLICY RESPONSES

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Abstract

The resurgence of global inflation following the COVID-19 pandemic and the subsequent supply-chain and energy shocks has renewed debate over the adequacy of inflation-targeting (IT) frameworks adopted by most advanced and many emerging-market central banks since the 1990s. This article examines how the classical IT regime, built on the assumption of demand-driven inflation and stable inflation expectations, performed when confronted with a combination of supply shocks, fiscal expansion, and geopolitical disruption. Using a comparative review of recent monetary-policy episodes in the United States, the Euro Area, and selected emerging economies, the article argues that strict adherence to point targets proved less effective than flexible, forward-looking approaches that combine interest-rate policy with communication strategies and macroprudential tools. The article concludes that inflation targeting remains a valuable anchor for expectations but requires structural reform, including wider tolerance bands, greater attention to supply-side indicators, and closer coordination with fiscal authorities, in order to remain credible in an environment of recurring shocks.

Keywords: inflation targeting; monetary policy; central banking; supply shocks; inflation expectations; macroprudential policy

1. Introduction

For roughly three decades, inflation targeting has served as the dominant monetary-policy framework across the developed world, prized for its transparency, accountability, and apparent success in anchoring expectations during the so-called Great Moderation. The framework rests on a central bank's public commitment to a numerical inflation objective, typically around two percent, achieved primarily through adjustments to short-term interest rates. Between 2021 and 2023, however, inflation in many economies rose to levels not observed in forty years, exposing tensions within the framework that had remained latent during a long period of low and stable prices. This article revisits the theoretical foundations of inflation targeting in light of that experience and asks whether the framework, as conventionally implemented, remains fit for purpose.

The motivation for this inquiry is twofold. First, the inflationary episode of 2021-2023 was driven substantially by supply-side factors — pandemic-related disruptions to global value chains, labour-market mismatches, and the energy-price shock associated with the war in Ukraine — rather than by the excess-demand dynamics that standard New Keynesian models typically assume. Second, central banks' policy responses, though eventually successful in bringing headline inflation down, imposed considerable costs in terms of output and financial stability, raising questions about the sequencing and calibration of tightening cycles. The remainder of the article is organised as follows: Section 2 reviews the theoretical underpinnings of inflation targeting; Section 3 discusses the recent inflationary episode and policy responses; Section 4 draws comparative lessons; and Section 5 concludes with policy recommendations.

2. Theoretical Foundations of Inflation Targeting

Inflation targeting emerged in New Zealand in 1990 and was subsequently adopted by Canada, the United Kingdom, Sweden, and eventually most advanced economies, as well as a growing number of emerging markets. Its theoretical justification draws on the time-inconsistency literature, which holds that discretionary monetary policy is prone to an inflationary bias because policymakers face incentives to exploit short-run trade-offs between inflation and employment. A credible, rule-like commitment to a numerical target reduces this bias by anchoring private-sector expectations, thereby lowering the sacrifice ratio associated with disinflation.

In practice, most central banks operate what is often termed flexible inflation targeting, which allows some weight to be placed on output stabilisation alongside the primary price-stability objective. This flexibility is typically implemented through a medium-term horizon for achieving the target, permitting temporary deviations in response to supply shocks so long as expectations remain anchored. The framework's success has traditionally been attributed less to the specific numerical target than to the broader institutional architecture surrounding it: central-bank independence, transparent communication, and regular accountability to elected bodies.

3. The Post-Pandemic Inflationary Episode

The inflation surge that began in 2021 differed from earlier post-war episodes in its origin. Pandemic-related shutdowns disrupted global production networks, shifting consumer demand toward durable goods precisely as shipping and semiconductor bottlenecks constrained supply. Extraordinary fiscal transfers, intended to cushion household incomes during lockdowns, sustained aggregate demand even as output fell, contributing to demand-pull pressures once economies reopened. The war in Ukraine subsequently triggered a sharp rise in energy and food prices, particularly in Europe, compounding an already elevated inflation trajectory.

Central banks initially characterised the inflationary pressures as transitory, reflecting the view, widespread in New Keynesian models, that supply shocks are self-correcting and need not trigger an aggressive monetary response. As inflation proved more persistent than anticipated, and as second-round effects on wages and inflation expectations began to appear, major central banks pivoted sharply toward monetary tightening. The United States Federal Reserve raised its policy rate at the fastest pace since the early 1980s, and the European Central Bank followed a similarly steep trajectory despite the Euro Area's greater exposure to the energy shock and weaker growth prospects.

Emerging-market central banks, several of which had begun tightening earlier than their advanced-economy counterparts, generally fared better in containing inflation, partly because their institutional frameworks had already been tested by prior episodes of currency and commodity-price volatility. Brazil and several Latin American economies raised rates substantially in 2021, ahead of the Federal Reserve, and were subsequently able to begin easing sooner as inflation receded, illustrating the benefits of pre-emptive action even where credibility is less firmly established than in advanced economies.

4. Comparative Lessons

Three broad lessons emerge from this comparative review. First, the distinction between demand-driven and supply-driven inflation matters for policy design but is difficult to operationalise in real time; policymakers require better real-time indicators of supply-chain pressure and labour-market tightness to calibrate responses appropriately. Second, communication strategy proved as consequential as the interest-rate path itself: episodes in which central banks were perceived to be behind the curve saw larger increases in long-term inflation expectations, requiring more aggressive subsequent tightening to restore credibility.

Third, the interaction between fiscal and monetary policy warrants closer attention; expansionary fiscal stances pursued simultaneously with monetary tightening partially offset the latter's disinflationary effect, lengthening the adjustment period.

These findings suggest that the strict, narrow version of inflation targeting, focused solely on a point target achieved through interest-rate policy in isolation, is less well suited to an environment characterised by recurring supply shocks and elevated geopolitical risk than the more flexible variants that incorporate macroprudential instruments and explicit tolerance bands.

5. Conclusion and Policy Implications

Inflation targeting has demonstrated resilience as an institutional anchor even through a historically unusual inflationary episode, but the experience of 2021-2023 exposes the limits of a framework designed primarily for demand-driven business cycles. Going forward, central banks would benefit from three reforms: first, wider and more explicitly communicated tolerance bands around the target to reduce the credibility cost of temporary deviations caused by supply shocks; second, greater integration of macroprudential tools to address financial-stability risks without over-relying on the policy rate; and third, more formal mechanisms for monetary-fiscal coordination, particularly during periods of large fiscal expansion, to avoid working at cross purposes. Implemented carefully, such reforms would preserve the credibility benefits of inflation targeting while improving its capacity to withstand the kinds of shocks that are likely to recur in an increasingly fragmented global economy.

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