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Rethinking Inflation: IMF Recommendations Fall Short

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Two trends had been clear in recent years: "the anti-inflationary target moved the employment objective to a secondary position" and, with regards to the instruments, "monetary policy was established as *the macroeconomic policy par excellence*" (Frenkel, 2006). This focus was questioned in the aftermath of the 2008/9 crisis, when some policymakers found themselves challenged by increasing inflation at a period when a supportive monetary stance was demanded. The focus on inflation itself was built on the broadly assumed understanding that stable inflation resulted in a stable output gap (c.f. 'divine coincidence'). This argument is the concern of a deep rethinking, illustrated by Blanchard (2011), who once introduced the benchmark 'divine coincidence' and today questions the coincidence between inflation stability and the output gap. The implicit consequence for central bankers would be that they have to watch both inflation and the output gap, if they care about macro stability.

Roy and Ramos (2012) study the IMF policy recommendations for 26 developing countries in 2010 and find that, regardless of this important rethinking of inflation policies (outside as well as inside the IMF), no fundamental reformulations had been incorporated within the recommendations to developing countries.

First, considering that a significant reduction in inflation levels through monetary policy tightening can have important output costs, it is essential to take into account a cost–benefit analysis. This is especially true in developing countries, where capacity to make use of expansionary fiscal policy might be limited and the threshold of a negative impact of inflation on growth is higher. However, IMF inflation analyses proved to be rather superficial, mostly reduced to one or a few sentences on the inflation source. No debate on the costs of inflation and the costs of the policies proposed was provided. The most complete inflation analyses were done for India and China, but other reports provided almost no consideration of the adequate level of the target.

Second, the recommendations focus on fighting inflation and overlook the broader economic context. The IMF's report written for Colombia was the only one to clearly considerer the economic situation, not just inflation. As they consider the sources of inflation and the need to support economic recovery, the policy recommendations to Colombia seem more coherent.

Third, these recommendations that focus on fighting inflation tend to envision solutions solely through monetary policy (which is designed *per se* to control demand-led inflation only), even in countries where the IMF attributed inflation to supply factors, such as food, or energy prices, exchange rate movements or increases in taxes. Exceptions were some of the larger emerging developing countries, which, with the extra challenge of dealing with excessive capital inflows, were advised to make use of fiscal policies to fight inflation.

In the case of Jordan, the report states that inflation is projected to increase in line with imported commodity (energy and food) prices and advises the Central Bank to tighten monetary conditions if inflation accelerates. A similar recommendation was given to Indonesia, which, apart from having a distinct supply-side inflation, was being challenged by excessive capital inflows—two reasons why a monetary tightening would not be appropriate.

The argument commonly used by the IMF is that monetary policy controls inflation expectations or contains second-round inflation effects. However, why should policymakers fight inflation through its second-round effects or through expectations only? Other policy mechanisms which affect current inflation by being coherent with the inflation source could lower inflation and, therefore, control inflation expectations as well.

Fourth, the choice of the Inflation Targeting regime (IT)—which has been a trend among developing countries—was often praised by the IMF. Although the IT design suits several countries well, some countries do not meet all the assumptions held by the regime's design; therefore, its projected effectiveness generalised over countries should be called into question. However, the analysis of IMF reports shows that it recommends the implementation of the IT regime or welcomes its use regardless of the countries' specificities.

A possible limitation of the use of the IT regime is shown in the case of Moldova. As the report shows, the country has a weak monetary transmission mechanism. In this case, the sole use of monetary policies is limited, as it has little influence in demand conditions.

In the case of South Africa, the report acknowledges another important restriction of the IT regime: that it is designed for forward-looking agents. This is not the case in South Africa, which has relatively sticky inflation series due to the behaviour of backward-looking agents. Nevertheless, the IMF concludes that the regime is positive. In this case, even if the regime were able to have an effect on inflation, this would have to be done through a much tighter policy stance, the higher output costs of which should not be forgotten.

Lastly, countries that were receiving significant portfolio inflows after the global financial crisis faced complex challenges of fighting inflationary pressures. Given this context, the usual increase in interest rates was not the most adequate response. Nonetheless, the IMF recommended monetary tightening in cases such as Peru, India, Indonesia and Thailand, despite recognising that these countries are plagued by excessive inflows of volatile capital.

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