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Setting the Goalpost for Monetary Policy Amidst the Global Pandemic: A Review of the Inflation Target for 2021–2024

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Introduction

The inflation target has served as an important guidepost for the Bangko Sentral ng Pilipinas (BSP) in its monetary policy formulation since the adoption of the inflation-targeting framework in 2002. This policy framework has worked fairly well in the country, helping stabilize actual inflation, anchor inflation expectations, and increase BSP's accountability and transparency (Guinigundo, 2017).

However, at the onset of the COVID-19 pandemic, the ensuing "great lockdown" and the subsequent significant contraction in economic output as well as in productive capacities, domestically and across the globe, have presented a considerable challenge to monetary policy formulation. Authorities have responded with unprecedented fiscal and monetary stimuli to support the economy. Of late, some early signs of a pick-up in economic activity are starting to manifest but the recovery appears tentative as uncertainty remains elevated. Against this backdrop, monetary authorities are faced with questions on the role of the inflation target in providing stability and direction in the fragile operating environment during and post COVID-19 pandemic as well as the appropriate level of the inflation target.

In this article, the authors explain the underlying factors that figured into the review of inflation target for 2021 – 2022 and the setting of inflation target for 2023 – 2024.

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[2] See BSP Economic Newsletter No. 10-05 (Sep-Oct 2010) on the Medium-Term Inflation Target for the Philippines by Z.R. Abenoja, D.M. Bautista, and C.F. Ramos for more information.

The process of setting the medium-term inflation target[2]

The determination of macroeconomic assumptions – including the inflation target – that support the budget formulation of the National Government (NG) is governed by the inter-agency Development Budget Coordination Committee (DBCC). In consultation with the BSP, the DBCC sets a fixed inflation target over a multi-year period.[3] This helps promote a longer-term view on inflation, anchors inflation expectations, and fosters greater flexibility in economic decision-making. The inflation target is expressed as a point target with a ± 1.0 percentage point (ppt) tolerance interval. The BSP is tasked to publicly announce the DBCC-approved inflation target (see Figure 1). Moreover, given its price stability mandate, the BSP is the primary government agency responsible for keeping inflation in line with the government's target.

Figure 1. Timeline for Setting the Inflation Target

[3] DBCC Resolution No. 2002-01 dated 8 March 2002, DBCC Resolution No. 2006-08 dated 8 November 2006, and DBCC Resolution No. 2010-3 dated 9 July 2010.

The role of the inflation target during this pandemic and in the post-pandemic era

In the ongoing pandemic, the necessary containment measures, the timeline for its resolution and any resulting scarring effects will shape the outlook for growth and inflation over the next few years. Amidst all the uncertainty, the inflation target remains an important anchor for guiding the economy through the downturn and recovery stages. The inflation target constitutes an important guidepost for the BSP. Monetary authorities could continue to provide support to the economic recovery during and after the health crisis via resolute commitment to deliver low and stable inflation.

The factors considered in target-setting for 2021 – 2024

During its meeting in December 2020, the DBCC approved to retain the inflation target range of 3.0 percent ± 1.0 ppt for 2021 – 2022 and to set the same inflation target range for 2023 – 2024.[4] The government was of the view that this inflation target range continues to be an appropriate quantitative representation of the medium-term goal of price stability that is optimal for the Philippines given the current structure of the economy and outlook of macroeconomic conditions over the next few years.

In setting the inflation target, authorities carefully reviewed a number of factors to determine the appropriate inflation target for 2021 – 2024. Foremost of these factors is the inflation outlook. At the time that the target was set, the prevailing assessment suggested manageable inflation environment over the BSP's policy horizon. Similarly, inflation expectations appeared firmly anchored to the inflation target. These provide a strong a case in favor of keeping the target unchanged for 2021 – 2022.

In recent months, upside pressures, owing mainly to supply-side constraints, have pushed up inflation. However, forward-looking information on the inflation outlook still point to an eventual deceleration over the policy horizon as the ongoing price pressures are driven mainly by volatile components of the consumer price index (CPI), e.g., food and energy, rather than a general increase across CPI items. Beyond 2022, it is inherently difficult to generate reliable inflation forecasts given greater uncertainty associated with forecasting over longer time horizons. Nonetheless, it can be expected that future inflation would largely be influenced by the structural changes that the ongoing health crisis could engender and the pace of adaptation to the "new normal".

The DBCC and the BSP also undertook a detailed assessment of supply and demand factors that could influence the evolution of prices, going forward. On supply-side factors, authorities looked in particular at key commodities such as oil and food items. The future trends for both oil and food prices continue to be uncertain with the COVID-19 pandemic remaining central to the outlook for commodity prices. The pace of economic recovery after the pandemic will be a primary determinant of future trends in commodity prices. Major supply shocks (e.g., geopolitical tensions, adverse weather conditions, and disease outbreaks) could also trigger price spikes and thus, cannot be completely ruled out.

- Global oil demand is seen to revert to its pre-crisis level by 2023 and increase gradually thereafter, given the assumptions that COVID-19 has been contained and world output has returned to its 2019-level in 2021 (IEA, 2020). However, a protracted pandemic and slow global recovery could flatten the growth trajectory of world oil consumption. Moreover, possible structural shift towards remote working may reduce demand for oil as necessary travels become less (World Bank, 2020a). In terms of oil supply, the gradual reopening of economies could provide incentive for US oil producers to re-invest after curtailing its production in Q2 2020. The policy direction of the Organization of Petroleum Exporting Countries (OPEC) and its allies over their

[4] The press statement can be accessed via www.bsp.gov.ph/SitePages/MediaAndResearch/MediaDisp.aspx?ItemId=5641.

oil production levels likewise remains key to oil price trends. Moreover, unplanned maintenance works in major oil-producing facilities and geopolitical tensions could also hamper supply and affect petroleum prices.

- Meanwhile, global and local food prices would be influenced by a number of factors including weather and climate conditions, pace of adjustments in input prices (e.g., oil, chemicals, and fertilizers), growth of biofuel production (a source of demand for key food items), livestock disease outbreaks, if any, and even trends for major currencies such as the US dollar.

Finally, the prospects for global and domestic economic activity were among the key considerations in the review of the inflation target. The prevailing view leans towards a long, uneven, and uncertain global economic recovery (IMF, 2020). There also remains considerable uncertainty if and how global trade and supply chains would evolve. If external demand remains sluggish, it could drag exports and tourism as well as pose a risk to remittance inflows.

In the domestic sphere, the community quarantine imposed by the Philippine Government to curb the spread of the virus has affected both domestic supply and demand conditions. Stay-at-home orders particularly for non-essential work and the required physical distancing at essential workplaces have curtailed supply. On the demand side, jobless rate has increased substantially while balance sheets of corporations have weakened implying large losses in income and weaker demand. In turn, persistent weakness in real sector activities could mute demand-pull inflationary pressures over the near term.

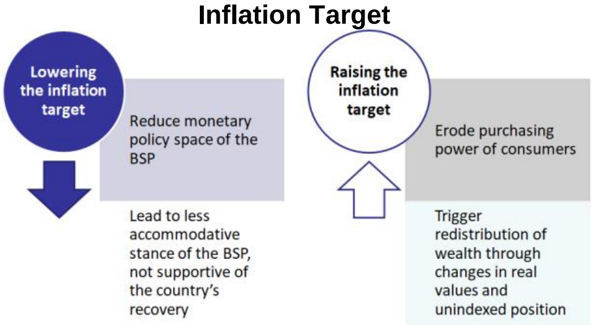
The global pandemic and ensuing containment measures could also have affected the economy's productive capacity. Saunders (2020) argued that reduction in investments (e.g., R&D, capital investments and training) as firms focus on survival as well as the deterioration of the skills of unemployed and rise in discouraged workers could lead to slower recovery in potential output. Scarring from the current unprecedented economic downturn could delay a return to the pre-COVID-19 potential output level.

More recently, the gradual easing of restrictions has led to initial signs of domestic economic recovery. For example, there are indications of an expansion in the manufacturing sector with the Purchasing Manager's Index (PMI) settling above 50 percent in January and February 2021.[5] Mobility indicators likewise signal increased activity. Moreover, the arrival of the first batch of coronavirus vaccines in the country and the rollout of government's COVID-19 vaccination program could provide a boost to the country's recovery from the global pandemic. Nevertheless, the country is still currently operating below full-employment level with the negative output gap expected to narrow gradually as the economy further re-opens. The timeline of mass vaccination and containment of new variants of the virus as well as economic policy measures remain crucial to the outlook.

The costs of changing the inflation target

With current inflation expectations well-anchored, setting a target for 2023 – 2024 that is different from the current inflation target range could introduce further uncertainty into the system and harm economic prospects. Furthermore, changes to the current target range could bring additional challenges (Figure 2).

Figure 2. The Costs of Lowering or Raising the Inflation Target



[5] The manufacturing indices for January – February 2021 are 52.7 percent and 51.8 percent, respectively, according to the Philippine Institute for Supply Management (PISM) and 52.5 percent according to IHS Markit.

On the one hand, there may be arguments supporting the proposition to set a lower inflation target over the medium term given benign inflation forecasts, expected modest growth in world commodity prices, as well as possible protracted global and domestic economic recovery.6 However, lowering the current inflation target range at this time could reduce the monetary policy space of the BSP to provide further support to the economy given current estimates of low neutral rate of interest and still-weak output growth. Lowering the target range could lead to a less accommodative stance by the BSP during the recovery period. In the post-pandemic era, real sector activities could pick up and generate demand-side price pressures. A lower target range could require the BSP to respond more aggressively to such demand-side pressures compared to what is necessitated by the current inflation target to protect its credibility as an inflation targeter. In turn, this could weaken the recovery and rebuilding process of the country.

On the other hand, raising the inflation target range could bring acute outcomes as higher inflation could erode purchasing power and slow the recovery process. A higher inflation target could also trigger redistribution of wealth as financial contracts are written in nominal terms. Amano, Carter and Terajima (2017) noted that an increase in inflation would redistribute wealth from the household sector to the government because higher inflation reduces the real value of government bonds and unindexed pensions. Furthermore, there are questions in the literature of whether a higher inflation target range could significantly increase a central bank's monetary policy space. Recent research by L'Huillier and Schoenle (2020) and Cotton (2020) argued that the effective extra policy space gained from raising the target is actually less than the intended expansion in policy space. Lastly, Wilkins (2018) pointed out that increasing the inflation target could undermine the credibility of an inflation-targeting central bank and a credible set of unconventional policy tools would be preferred relative to a loss in credibility via higher target. In the BSP's case, it is worth noting, that the conventional monetary policy toolkit remains far from exhausted as the key policy rate is still above the zero-lower bound.

Conclusion

Inflation targeting is an ongoing and evolving framework for monetary policy and would need to take into account the continuing developments in the domestic and global fronts (Guinigundo, 2017). The COVID-19 pandemic, indeed, has defined a new normal in multiple dimensions and the uncertainty surrounding the ongoing health crisis remains high. At the same time, the likelihood of similar shocks materializing in the future is not negligible. Going forward, the BSP, in collaboration with the DBCC, will continue to assess the factors that could affect price and growth dynamics and calibrate, as needed, the inflation target. The BSP will also remain steadfast in its commitment to the inflation target, in line with its mandate of delivering price stability, conducive to a balanced and sustainable growth.

[6] Since the review of medium-term inflation target in the latter part of 2020, price pressures have picked up in January – February 2021, with inflation averaging at 4.5 percent, owing mainly to food supply shocks and rise in international oil prices. Inflation, however, is expected to revert to within target range in 2022 as supply-side pressures subside.

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