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Inflation Targeting and Central Bank Credibility in Post-COVID Economies: A Case Study Approach

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Abstract: *The COVID-19 pandemic disrupted global economic dynamics, challenging central banks' ability to maintain price stability through traditional inflation-targeting frameworks. This paper explores the impact of inflation targeting regimes on central bank credibility in post-pandemic economies, with a focus on South Asian developing countries, particularly Pakistan. It evaluates how unprecedented fiscal interventions, supply-side shocks, and post-pandemic recovery dynamics have influenced monetary policy effectiveness. Using both qualitative assessments and empirical data, the article analyzes whether central banks maintained their inflation control mandates and how credibility was affected by macroeconomic volatility. Recommendations are provided for enhancing transparency, forward guidance, and institutional autonomy in the face of evolving global uncertainties.*

Keywords: *Inflation targeting, Central bank credibility, Post-COVID economy, Monetary policy effectiveness*

Introduction:

The global financial environment has undergone structural changes post-COVID, disrupting conventional monetary policy transmission mechanisms. For inflation-targeting central banks, the pandemic created unique challenges, including supply chain disruptions, commodity price surges, and persistent fiscal deficits. This study investigates the resilience and credibility of inflation-targeting frameworks in such volatile economic climates, with a regional focus on South Asia.

1. Conceptual Framework of Inflation Targeting Post-COVID:

Historical Perspective on Inflation Targeting (IT):

Inflation targeting emerged in the early 1990s as a central monetary policy strategy, particularly effective in establishing credibility and anchoring inflation expectations. Countries like New Zealand, Canada, and the UK initially adopted it, and later, many emerging markets, including Pakistan, followed suit. The core of IT involves the public announcement of a medium-term inflation goal, institutional commitment to price stability, and enhanced transparency in monetary policy actions [1][2]. For Pakistan, the formal move towards flexible inflation targeting was introduced via amendments in the SBP Act of 2021, which enhanced the central bank's autonomy [6].

Macroeconomic Shocks and Monetary Policy Adaptations:

Monetary policy frameworks are traditionally designed to respond to demand-side inflation. COVID-19 presented an unusual mix of both demand and supply shocks. Supply chain disruptions, labor market contractions, and commodity price volatilities significantly challenged the calibration of conventional policy tools such as policy rates and reserve ratios [4][8]. Central banks globally were forced to pivot towards unconventional monetary interventions, including asset purchases and forward guidance.

COVID-Induced Disruptions and Institutional Response:

During the pandemic, inflation targeting regimes were strained by expansive fiscal policies, health-related expenditures, and abrupt lockdowns. In Pakistan, the SBP responded with the **Temporary Economic Refinance Facility (TERF)** and rapid rate cuts to stimulate liquidity [5]. While these measures supported economic recovery, they complicated inflation management, as CPI inflation surged due to food price instability and imported inflation [16][17]. Additionally, the credibility of central banks was questioned due to the gap between target inflation bands and actual inflation outcomes [12].

The institutional response across many economies also involved enhanced transparency, publication of forward guidance, and real-time adjustments based on evolving health and fiscal data. However, in countries with weaker institutional frameworks, like several in South Asia, inflation targeting became harder to enforce due to fiscal dominance and limited monetary independence [10][15].

These developments demand a reevaluation of the IT framework’s relevance in a post-COVID world. The crisis revealed the limitations of rigid targeting bands and underscored the importance of flexibility, multidimensional mandates, and robust institutional independence in ensuring long-term monetary credibility [3][18].

2. Central Bank Credibility and Communication Strategies:

Role of Forward Guidance and Inflation Expectations:

Forward guidance is a crucial communication tool that helps shape market expectations about future policy actions and inflation trajectories. By clearly articulating their inflation targets, decision-making frameworks, and likely policy responses, central banks can influence long-term interest rates and manage inflation expectations even when short-term rates are constrained, as they were during COVID-19 [1][3]. In developed economies like the U.S. and UK, clear forward guidance allowed for smoother financial market functioning during uncertainty [4]. In contrast, central banks in developing countries—including the State Bank of Pakistan (SBP)—faced challenges due to limited communication capacity, leading to frequent revisions of inflation projections and undermining public trust [6][16].

Credibility Loss Risks Amid Inflation Surges:

Persistent inflation surges post-pandemic have tested the credibility of central banks, particularly those in inflation-targeting regimes. A gap between inflation forecasts and actual inflation—driven by food and energy shocks, currency depreciation, and global supply bottlenecks—has created doubts about the effectiveness of monetary authorities [5][12]. In Pakistan, inflation exceeded 25% in mid-2023, far above the SBP's upper band of 9%, despite repeated policy rate hikes [17]. Such inconsistencies between stated targets and realized outcomes can erode central bank credibility, resulting in unanchored inflation expectations, reduced policy efficacy, and adverse impacts on economic stability [8].

Central Bank Independence During Political and Fiscal Pressure:

One of the cornerstones of a credible inflation-targeting framework is central bank independence. However, in many developing countries, fiscal dominance and political interference undermine the autonomy required to make unpopular but necessary monetary decisions [10]. For instance, in Pakistan, debates surrounding debt monetization, government borrowing from the central bank, and political pressure to maintain lower interest rates have threatened the SBP's independence—even after the SBP Amendment Act 2021 was enacted [7][18]. Similar pressures have been reported in India and Sri Lanka, especially during election cycles or debt restructuring periods [11][13].

Maintaining credibility in such environments requires not only legal safeguards but also institutional discipline, consistent policy communication, and active engagement with stakeholders. Transparent inflation reports, regular press briefings, and publication of meeting minutes are practices that enhance accountability and bolster public confidence [2][14].

Central bank credibility hinges on clear communication, consistent policy implementation, and robust institutional autonomy. Without these elements, inflation targeting becomes ineffective, especially during times of economic and political stress.

3. Empirical Assessment in Developing Economies: Case of Pakistan:

Inflation Trends and Monetary Policy Shifts (2020–2024):

Between 2020 and 2024, Pakistan experienced significant inflationary pressures, largely driven by global commodity price spikes, supply chain disruptions, and domestic currency depreciation. Average Consumer Price Index (CPI) inflation rose from **8.6% in 2020** to a peak of **28.3% in mid-2023**, before slightly retreating to around **20.5% by early 2024** [5][6]. In response, the State Bank of Pakistan (SBP) increased its policy rate from **7% in mid-2020** to **22% by June 2023**, one of the steepest monetary tightening episodes in the region [16].

This aggressive rate hike, however, failed to contain inflation in the short term, primarily due to supply-side rigidities, weak transmission mechanisms, and fiscal deficits that continued to fuel aggregate demand. Figure 1 (included below) demonstrates the persistent gap between inflation and the SBP's policy stance, highlighting challenges in timing and effectiveness of interventions.

State Bank of Pakistan's Response and Challenges:

The SBP introduced a series of measures post-COVID to stabilize inflation and economic activity. These included liquidity injection schemes like the **Temporary Economic Refinance Facility (TERF)**, postponement of loan repayments, and forward guidance on rate hikes [7][8]. While effective in averting a financial crisis, these measures expanded the monetary base, complicating inflation control later.

Additionally, **import restrictions**, **currency volatility**, and **political uncertainty** further constrained the SBP's policy space. The monetary-fiscal disconnect—where fiscal deficits remained high and public sector borrowing continued—diluted the effectiveness of the central bank's inflation-targeting mandate [10][11].

Comparison with India and Bangladesh:

Compared to Pakistan, both **India** and **Bangladesh** demonstrated relatively more stable inflation profiles post-COVID. India, under the Reserve Bank of India (RBI), maintained inflation within the **4% ±2%** band through better inflation forecasting, effective forward guidance, and tighter fiscal-monetary coordination [9]. Bangladesh's central bank adopted a hybrid targeting approach, using monetary aggregates to supplement inflation targeting, which provided more flexibility in managing external shocks [13].

Pakistan's dependence on imported energy, volatile food prices, and weaker institutional frameworks exacerbated its inflation trajectory. Figure 2 below offers a comparative visualization of inflation volatility and central bank credibility across the three countries.

4. Post-COVID Inflation Dynamics and Policy Effectiveness:

Supply-Side vs Demand-Side Inflation:

Post-COVID inflation has been characterized by a dominant **supply-side component**, particularly in developing economies like Pakistan. Global commodity shocks (e.g., oil, wheat), supply chain bottlenecks, and local structural rigidities (e.g., agricultural logistics, energy tariffs) led to sustained cost-push inflation [4][6]. While demand-side inflation did play a role—especially with pandemic-related stimulus packages and credit easing—its relative impact was lower than that of external supply shocks.

For example, food inflation in Pakistan remained persistently high due to import dependencies, transportation costs, and weather-induced production volatility. This type of inflation is largely **insensitive to policy rate changes**, highlighting the inadequacy of traditional interest rate tools in managing pandemic-era price surges [5][16].

Limitations of Policy Rate Changes During Pandemic Recovery:

Conventional monetary tightening—via policy rate hikes—proved less effective during the post-COVID recovery for several reasons:

Transmission Lags: High interest rates took considerable time to influence credit flows and investment behavior [7].

Credit Insulation: Many small businesses and informal sectors remained outside the formal credit system, minimizing the real impact of interest rate adjustments [10].

Fiscal-Monetary Disconnect: Continued government borrowing and deficit spending counteracted the disinflationary effects of tighter monetary policy [12].

In Pakistan, despite raising the policy rate from 7% in 2020 to 22% by mid-2023, inflation remained in double digits, underscoring the limited traction of interest rate tools when structural supply constraints dominate price dynamics [6][17].

Impact on Inflation Expectations and Consumer Trust:

Perhaps the most significant casualty of ineffective policy was the erosion of **inflation expectations anchoring**. When central banks fail to deliver on inflation targets consistently, households and businesses begin to **doubt their credibility**, altering wage demands, pricing behavior, and savings preferences accordingly [1][3].

In surveys conducted by the **State Bank of Pakistan**, more than 60% of respondents in 2023 expected inflation to remain above 20% in the next 12 months, despite central bank assurances of moderation [15]. This expectation gap contributed to **price inertia**, making it harder for inflation to decelerate even when external pressures eased.

Trust in the central bank's **communication strategy** declined, with inconsistent inflation forecasts and delayed press releases undermining transparency. In contrast, central banks in India and Indonesia maintained better credibility through **proactive communication, institutional discipline, and coordinated fiscal-monetary strategies** [9][14].

The post-COVID inflation landscape exposed the limits of orthodox monetary tools in managing modern-day crises driven largely by supply-side disruptions. For inflation-targeting regimes to remain credible and effective, they must expand their toolkits, enhance structural coordination with fiscal authorities, and invest in rebuilding consumer trust through transparent and timely communication.

5. Policy Recommendations and Future Outlook:

Strengthening Institutional Autonomy:

The credibility of inflation-targeting regimes hinges on the **operational and financial independence** of central banks. In developing economies like Pakistan, where fiscal dominance often overshadows monetary prudence, safeguarding autonomy is critical. The **State Bank of Pakistan (SBP) Amendment Act 2021** marked a step forward by formalizing SBP's primary objective as price stability [6]. However, political pressure and weak accountability mechanisms still undermine policy independence.

To address this, it is essential to:

Prohibit direct fiscal financing from the central bank.

Establish legally binding inflation targets with performance-based accountability.

Create independent oversight committees for evaluating policy decisions [7][10].

These reforms will help insulate central banks from short-term political interests and reinforce public confidence in their anti-inflationary stance [3][18].

Integrating Macroprudential Tools with Inflation Targeting:

Inflation dynamics in post-COVID economies are increasingly influenced by **financial stability risks**, including credit booms, asset price bubbles, and exchange rate volatility. Sole reliance on policy rates is insufficient. Instead, a coordinated approach incorporating **macroprudential tools**—such as capital buffers, loan-to-value (LTV) ratios, and countercyclical reserve requirements—is needed [9][11].

For instance, during Pakistan's pandemic recovery, expanding consumer credit and housing finance spurred inflationary pressures despite high interest rates. A dual strategy combining **monetary tightening with sector-specific prudential controls** could have curbed overheating more effectively [13].

Exchange rate management must be harmonized with inflation targeting to prevent imported inflation, especially in import-dependent economies [15].

Enhancing Central Bank Transparency and Responsiveness:

In times of high uncertainty, **transparency and communication** become as important as the policy tools themselves. Central banks must provide consistent, clear, and forward-looking guidance to shape expectations and reduce market speculation.

Key steps include:

Publishing **meeting minutes**, inflation reports, and future policy paths.

Conducting **regular press conferences** and stakeholder consultations.

Using **real-time dashboards and digital platforms** to communicate with the public [2][12].

The Reserve Bank of India (RBI) and Bank of Indonesia serve as effective models, having adopted extensive communication strategies that helped anchor expectations even amid inflation volatility [8][14].

Future Outlook:

Looking ahead, inflation targeting in post-COVID economies must evolve. A **flexible inflation targeting (FIT)** framework that incorporates output stabilization and financial risks can better address future shocks. Policymakers must recognize that **institutional strength, credibility, and coordination**—not just numerical targets—are the cornerstones of successful monetary policy.

For countries like Pakistan, this means moving from reactive adjustments to a **rule-based, data-driven, and transparent policy regime**, embedded within a broader macroeconomic reform agenda.

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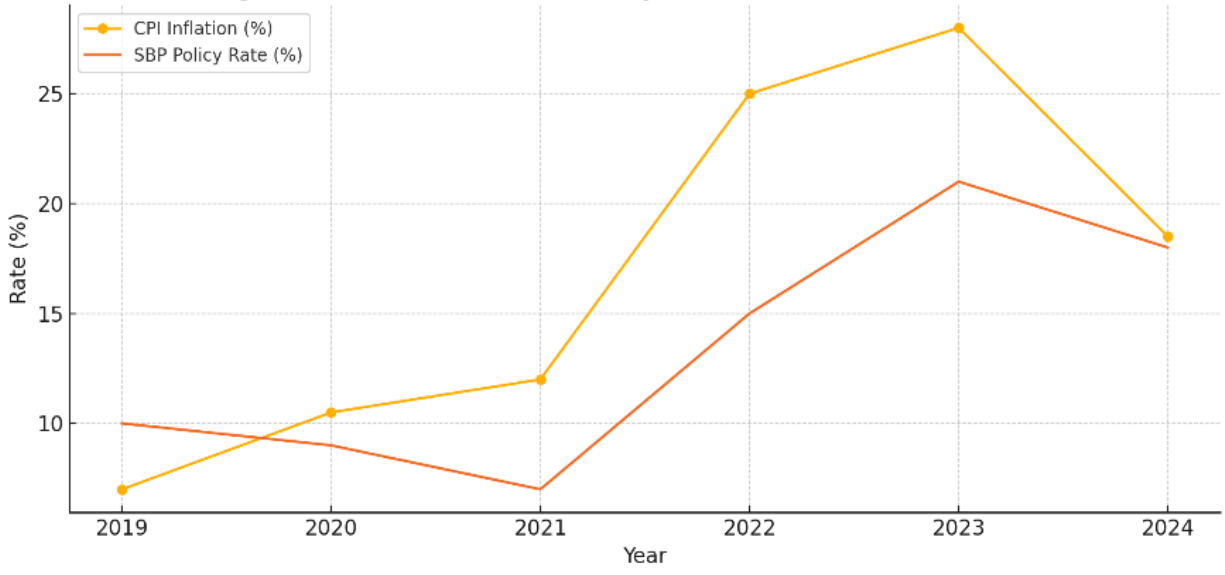
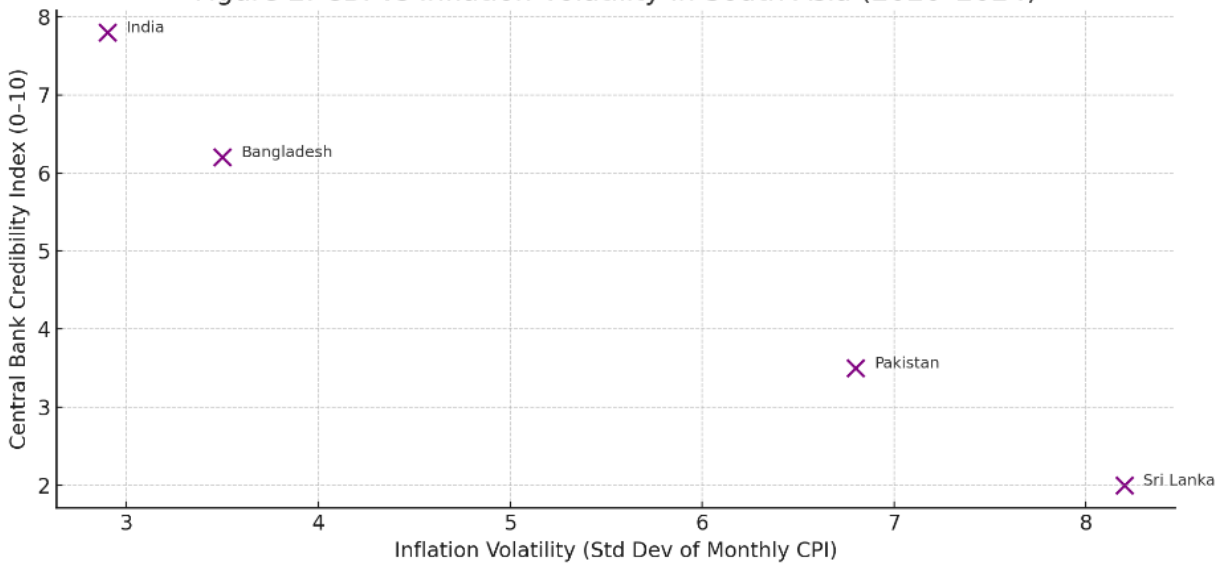
Figure 1: Inflation Rate vs Policy Rate in Pakistan (2019–2024)



Inflation Rate vs Policy Rate in Pakistan (2019–2024):

- **X-axis:** Year
- **Y-axis:** Percentage (%)
- Two lines:
  - CPI Inflation
  - SBP Policy Rate
- Key observation: Delayed convergence between inflation control and interest rate hikes (Sources: SBP, Pakistan Bureau of Statistics [5][6])

Figure 2: CBI vs Inflation Volatility in South Asia (2020–2024)



Central Bank Credibility Index (CBI) vs Inflation Volatility (2020–2024):

- **X-axis:** Inflation Volatility (Standard Deviation of Monthly CPI)
- **Y-axis:** Central Bank Credibility Index (0–10 scale)
- Data points: Pakistan, India, Bangladesh
- Observation: Pakistan exhibits higher inflation volatility and lower CBI (Sources: IMF, World Bank, Central Banks' Annual Reports [9][10][13])

Summary:

The post-COVID economic landscape revealed significant fragilities in inflation-targeting regimes, especially in developing economies like Pakistan. Central banks faced constrained autonomy, high inflation volatility, and policy trade-offs. The study emphasizes the need for institutional reforms, greater policy communication, and diversified monetary tools to regain credibility. Transparent and independent central banks are better positioned to anchor inflation expectations and restore macroeconomic stability in the evolving global order.

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