Inflation Targeting Policy: What Role Can It Play In The Recovery Of Morocco's Economic Situation?

La politique de ciblage de l'inflation : quel rôle peut-elle jouer dans la reprise de la situation économique du Maroc ?

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Abstract :

In a turbulent global context marked by instability following the Covid-19 health crisis and the war in Ukraine, Morocco's economic situation had to suffer several damages. Among these impacts is inflation. Faced with price instability, it seems crucial to question the conduct of current monetary policy. In this sense, this article seeks to highlight the importance of rethinking Morocco's monetary policy in order to overcome the effects of the economic recession. Price stability being one of the main objectives of the BAM[1], could only be ensured by the presence of a monetary regime capable of intervening in periods of crisis for the absorption of shocks and likely to bring inflation back to its equilibrium as quickly as possible. As the inflation targeting policy is the most widespread regime in the world today, inflation targeting policy continues to pique the interest of economists. In this paper, it will be a question of highlighting the literature review which has discussed this new regime and of examining to what extent its adoption could allow the regulation of inflation in the case of Morocco as well as the conditions under which non-implementation could constrain its implementation.

Keywords: Inflation targeting policy ; monetary policy ; inflation ; shock absorption ; price instability.

Résumé :

Dans un contexte mondial mouvementé et marqué par l'instabilité suite à la crise sanitaire du Covid-19 et à la guerre en Ukraine, la situation économique du Maroc a dû subir plusieurs dégâts. Parmi ces impacts figure l’inflation. Face à l'instabilité des prix, il apparaît crucial de remettre en question la conduite de la politique monétaire actuelle. En ce sens, cet article cherche à souligner l’importance de repenser la politique monétaire du Maroc afin de surmonter les effets de la récession économique. La stabilité des prix étant l'un des principaux objectifs du BAM, ne pouvait être assurée que par la présence d'un régime monétaire capable d'intervenir en période de crise pour absorber les chocs et susceptible de ramener l'inflation à son équilibre le plus rapidement possible. La politique de ciblage de l’inflation étant aujourd’hui le régime le plus répandu dans le monde, elle continue de susciter l’intérêt des économistes. Dans cet article, il s'agira de mettre en valeur la revue de littérature qui a discuté de ce nouveau régime et d'examiner dans quelle mesure son adoption pourrait permettre la régulation de l'inflation dans le cas du Maroc ainsi que les conditions dans lesquelles sa non-application pourrait limiter sa mise en œuvre.

Mots clés : Politique de ciblage de l'inflation ; politique monétaire ; inflation ; absorption des chocs ; instabilité des prix.

[1] Bank Al-Maghreb

Introduction

The COVID-19 crisis and the war in Ukraine have had significant impacts on inflation and monetary policies around the world. First, with regards to the COVID-19 crisis, many countries have experienced a sharp decline in economic activity due to containment measures and the disruption of supply chains. This drop in economic activity has led to a drop in demand and, consequently, a drop in inflation in many countries.

In response to the crisis, many central banks lowered interest rates and implemented monetary stimulus policies to stimulate economic activity. However, in some cases, such policies have led to higher inflation, causing some central banks to tighten monetary measures.

Regarding the war in Ukraine, geopolitical tensions have also had significant impacts on inflation and monetary policies. Due to economic sanctions and disruptions in supply chains, commodity prices have increased, leading to higher inflation in some countries.

In response to these tensions, some central banks raised their interest rates to curb the growth of inflation. However, such a policy could also have negative effects on economic activity by reducing investment and consumption.

In sum, the COVID-19 crisis and the war in Ukraine have had significant impacts on inflation and monetary policies around the world, causing inflation to fall or rise and forcing central banks to adapt their monetary policy to respond to these changes. Morocco's economy has also suffered several negative effects in terms of inflation and a slowdown in economic activity.

In short, these crises have generated stormy and unprecedented consequences. Soaring prices are one of the main repercussions. Indeed, price stability is one of the key milestones on which the macroeconomic stability of countries is based. Hence the need to revise monetary policy and question the prospects for its accommodation in relation to the specifications of the current state of the Moroccan economy.

In this regard, this article discusses the following question : **In a post-crisis context, should Morocco rethink the conduct of monetary policy in order to overcome the effects of crises?**

The focus of this paper will be the importance of rethinking the conduct of monetary policy in Morocco in order to be able to overcome the effects of the crises, and in relation to the Covid-19 pandemic and the war of Ukraine. We will review the possibilities of monetary policy adjustments in order to return inflation to equilibrium and, consequently, to ensure the objective of price stability. From this perspective, it is therefore a question of treating inflation targeting policy in the light of the literature as a new framework for monetary policy. We will first review the evolution of monetary regimes in the history of the economy and the rise of the inflation targeting policy and its characteristics.Then, we will look at the inflation situation of morocco to highlight the importance of the inflation targeting policy in the macroeconomic stability. Finally, we will discuss the conditions and challenges of setting up this new monetary regime and its adoption in Morocco.

1. Inflation Targeting Policy: The Rise of a New Paradigm

After the break-up of the Bretton Woods regime in the 1970s, several changes have been made to the economic model and the international monetary system. As a result, many economies have faced economic crises caused by price instability among other things. In this case, the oil crises of the 1970s, the crisis in the States of South America and that of Asia, which generated remarkable economic deterioration that persisted over several years following a significant rise in inflation rates. In order to curb their repercussions and their aggravation and avoid their reproduction, much research has been developed.

This work stipulates that price stability is a sine qua non condition for the proper conduct of monetary policy and this by opting for the nominal anchoring policy. To this end, it is a question of setting an intermediate objective for monetary policy in order to establish price stability over the long term. This anchor guides the conduct of the monetary authorities and allows the coordination of the setting of prices, wages and expectations.

At this level, it was important to choose the anchor variables; in this case the exchange rate, monetary aggregates and inflation. Consequently, three regimes result from it, namely the exchange rate policy, the targeting of the money supply (M1, M2 or M3) and inflation targeting. Nevertheless, in the 1970s and 1980s, the anchoring of the exchange rate and then of the monetary aggregates failed to ensure the objective of price stability, several countries were confronted with galloping inflation which reduced the purchasing power of consumers, harmed investment and favored speculative investments. This situation prompted researchers to find an alternative regime represented by the inflation anchor.

Inflation targeting emerged as an alternative to the old traditional approaches. In fact, rather than using interest rates to react to fluctuations in inflation, central banks began setting medium-term inflation targets and using interest rates to achieve those targets. By setting medium-term inflation targets, central banks have been able to reduce market and consumer uncertainty about future price developments, which has helped stabilize inflation expectations.

Inflation targeting policy is a monetary policy strategy that aims to maintain price stability by setting a medium-term inflation target and adjusting interest rates to achieve that target. This strategy became popular in the 1990s, when many countries began to adopt it as a way to fight inflation.

The first country to officially adopt an inflation targeting policy was New Zealand in 1990, closely followed by Canada in 1991. Since then, many other countries have adopted this policy, including Australia, the United Kingdom, Sweden and the United States. Inflation targeting is now considered one of the main monetary policy strategies in the world.

1.1 Inflation Targeting Policy Definitions: Literature Review

In the absence of a theoretical and conceptual basis when it first appeared, inflation targeting policy was defined by economists in several ways. The inflation targeting policy represents a new framework of monetary policy which aims to ensure price stability, but this definition, as broad as it is, turns out to be reductive in the aspects that this policy abounds with.

Faced with the lack of compromise around the meaning of this new monetary regime, the challenge is to list in what follows the main authors who have attempted to attribute definitions adapted to this new policy. The objective is to highlight the key elements that characterize it and to highlight the characteristics useful for its theoretical foundation.

(Leiderman & Svensson, 1995) were the first economists who defined inflation targeting policy. According to them, the inflation targeting policy is "The inflation targeting regime has two characteristics: an explicit numerical inflation target by specifying the index, the level of the target, the tolerance interval, the horizon and the definition of the possible situations under which the monetary authorities will modify the target . . . [and] the absence of an intermediate explicit target such as monetary aggregate targeting or exchange rate targeting."

According to (Masson et al., 1997), "Inflation targeting is based on the definition of an explicit inflation target, a clear and unambiguous indications which constitute the objectives essentials leading to inflation stability[. . .] The inflation forecasting methodology consists of using all the information likely to provide indications on future inflation and implementing a Forward-Looking procedure in order to manage the instrument which will depend on the assessment of the anticipated rate in relation to the predefined target.

On the other hand, the work of (Bernanke & Mishkin, 1997) resulted in the following definition : "Inflation targeting policy is a new framework for the analysis of monetary policy which consists of an official announcement of a target range for one or more horizons." In other words, the IC sits at the transparency level of the central bank. That is to say, the central bank of the country that wishes to adopt the inflation targeting policy must communicate with the public its plan of action, its future orientations and its possible remedial measures.

In addition, in 2004, the European Central Bank (ECB) defined this new monetary regime as follows: « inflation targeting is defined as being a monetary policy strategy aimed at maintaining price stability by focusing on deviations from inflation forecasts against announced targets. »

On the other hand, the implementation of the inflation targeting policy requires the meeting of a certain number of preconditions as follows.

1.2 The conditions of the inflation targeting policy

Inflation targeting is the most popular monetary policy framework in the world today. Some economists stipulate that the establishment of the inflation targeting policy requires the meeting of a number of institutional prerequisites which should be supported by the presence of structural prerequisites to ensure their effectiveness. With regards to institutional prerequisites, the studies carried out by (Mishkin, 2000) and (Batini & Laxton, 2007) have arrived at four key elements which constitute this type of precondition: the autonomy of the central bank, its credibility and its transparency as well as exchange rate flexibility.

The implementation of an effective inflation targeting policy requires several prerequisites, in particular :

Central bank independence: Among the prerequisites for the implementation of inflation targeting policy is central bank independence. Some research has focused on examining the link between the degree of independence and inflation. In fact, (Alesina & Summers, 1993) found that central bank independence mitigated inflation for 16 countries in the period from 1955 to 1988. The notion arose in 2000 as a result of developments in new classical school thinking. The independence of the central bank refers to its economic and political autonomy (Debelle & Fischer, 1994). Indeed, the central bank must be independent of the government in order to be able to conduct an effective monetary policy without political pressure (Aguir, A.2018).

Transparency and communication: the central bank should clearly communicate its monetary policy objectives and decisions in order to enhance the credibility of its policy and influence inflation expectations. Several research works have managed to plead the importance of transparency and communication within the framework of inflation targeting policy : (Svensson, 1999), (King & Rose, 2005), (Freedman & Laxton, 2009), (Hammond, 2012), (Ascari et al. 2017) and (Salle*, I. 2013).

Analytical capacity: the central bank must have reliable data and solid analytical tools to monitor inflation and assess the impact of its monetary policy.

Financial stability: an effective inflation targeting policy must take into account financial stability in order to avoid risks for the financial system.

Flexibility: the inflation targeting policy should be flexible to adapt to economic changes and unforeseen events.

Political support: the inflation targeting policy must have the support of political decision-makers and society to be effective in the long term.

Low core inflation: It is important to note that the inflation targeting policy is more effective when core inflation is relatively low. If inflation is very high, an inflation targeting policy may require more drastic measures to achieve inflation targets and this could have negative economic and social consequences.

These prerequisites are important to ensure the effectiveness and credibility of an inflation targeting policy.

1.3 Inflation targeting policy and shock absorption

Inflation targeting policy can play an important role in absorbing economic shocks. Indeed, when an economy is subject to external shocks such as variations in commodity prices or climatic shocks, the inflation targeting policy can help mitigate the effects of these shocks. It can help absorb economic shocks in several ways. In fact, it helps to boost the economic performance (Ftiti et al., 2018).

First, by setting a medium-term inflation target, the central bank can act proactively to prevent excessive inflation or deflation. For example, if inflation threatens to exceed the set target, the central bank may raise interest rates to cool the economy and limit price growth. Conversely, if inflation is low or negative, the central bank may lower interest rates to stimulate demand and avoid a deflationary spiral.

Also, inflation targeting can help stabilize inflation expectations. By clearly communicating the inflation target and the steps the central bank is prepared to take to achieve it, markets and consumers can expect stable inflation over the medium term. This can reduce uncertainty and price volatility, which can help absorb economic shocks.

In addition, by setting a medium-term inflation target, the central bank can take into account temporary fluctuations in inflation that may result from external shocks, such as commodity price shocks or changes in the exchange rate. The central bank can adjust its monetary policy to deal with these temporary shocks, while maintaining its medium-term inflation target.

On the other hand, inflation targeting can also help bolster central bank credibility (Aguir, 2018). If the central bank is perceived as credible in its commitment to price stability, markets and consumers can have confidence in its ability to weather economic shocks and keep inflation under control. This confidence can in turn help stabilize inflation expectations and absorb economic shocks.

Thus, if the central bank has sufficient credibility and economic agents have confidence in the inflation targeting policy, this can help reduce the second-round effects of the economic shock (Jonas et Mishkin 2004). Second-round effects occur when wages and prices increase excessively in response to a temporary increase in inflation. Inflation targeting policy can help avoid these effects by keeping inflation expectations well anchored.

Finally, an inflation targeting policy can also help to strengthen financial stability in the event of economic shocks. Indeed, an effective and predictable monetary policy can help reduce financial market volatility and prevent financial crises.

Inflation targeting policy can play an important role in absorbing economic shocks by helping to stabilize inflation, prevent second-round effects and strengthen financial stability in the event of economic shocks.

In short, inflation targeting policy is a monetary policy approach that aims to maintain a specific rate of inflation. By maintaining specific inflation targeting, inflation targeting can help anchor consumer and investor price expectations and prevent excessive inflation or deflation. Indeed, by maintaining price stability, inflation targeting can also contribute to maintaining financial stability by reducing asset price volatility and avoiding speculative bubbles.

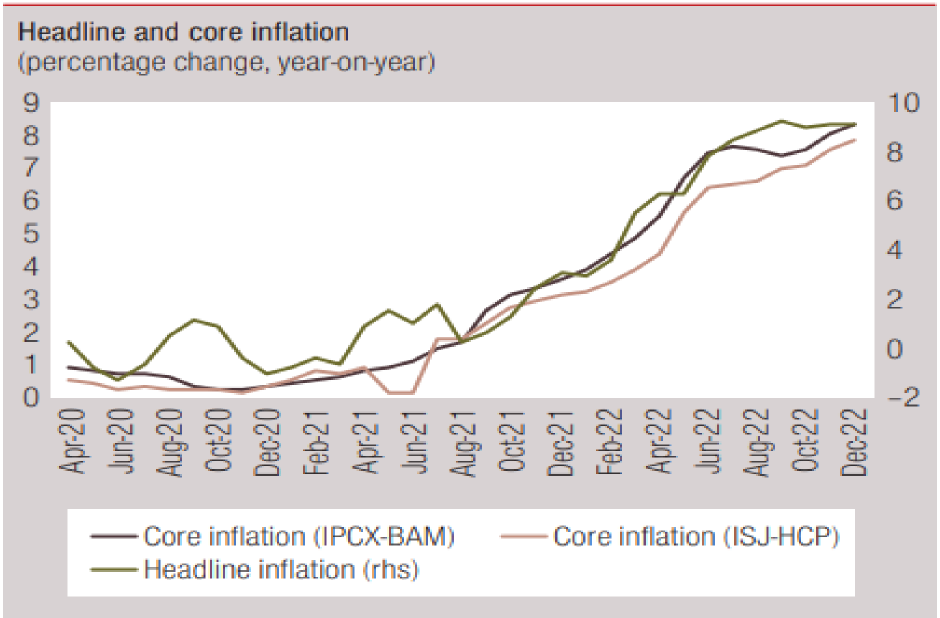
Overall, inflation targeting can help maintain macroeconomic stability especially with regards to price stability.

2. Inflation targeting policy and effects of covid-19 and the war in Ukraine

2.1 Overview of the inflation situation of the post-covid period in Morocco :

Price pressures that started to build at the end of 2021 grew stronger in 2022, reaching a peak of 8.3 percent in December (Figure 1). In fact, the rate of inflation in Morocco is at its highest point in thirty years.

Figure N° 1 : price pressures have gradually intensified, and now go well beyond energy and food items



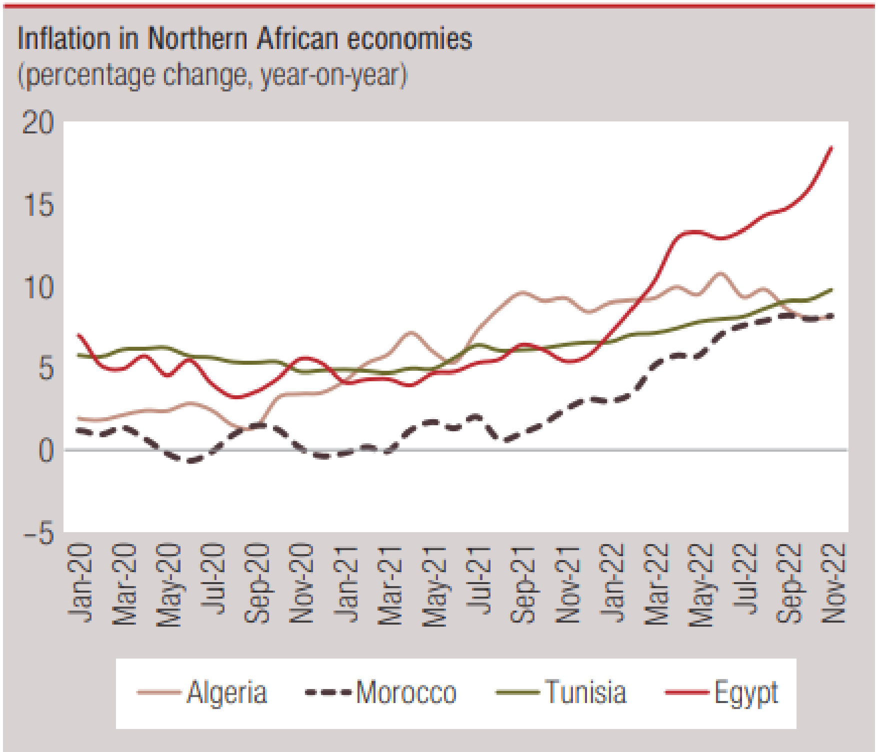
Source : HCP, BAM, WB

Exogenous supply variables, such as the rise in commodity prices globally and the fall in domestic agricultural production, have been the primary drivers of this inflationary increase.

Fuel costs rose by 45.3 percent year over year in November, and food items with unpredictable prices rose by 16.1 percent.

Core inflation, which measures pricing pressures across the basket of goods and services included in the CPI, has also risen to 7.6 percent, which is more concerning than the fact that core inflation averaged 5.5 percent in the second quarter and 3.5 percent in the first.

Figure N° 2 : Morocco's inflation took longer to take off but has converged to regional peers

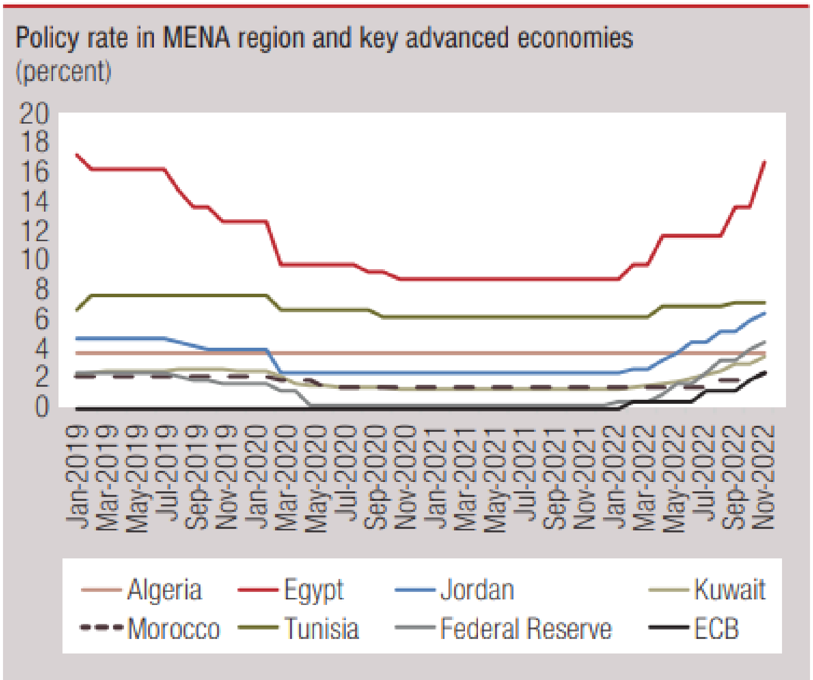


Source : HCP, BAM, WB

Despite two policy rate increases since September by Bank-al-Maghrib (BAM), the monetary policy is still accommodative. BAM has successfully managed to keep inflation under control for the past 20 years while gradually lowering interest rates. The central bank's Council tightened the policy rate by 50 basis points in September and again by that same amount in December, ending that cycle.

Historically, in spite of this step, the policy rate is still weak and much lower than that of regional peers (Figure 3).

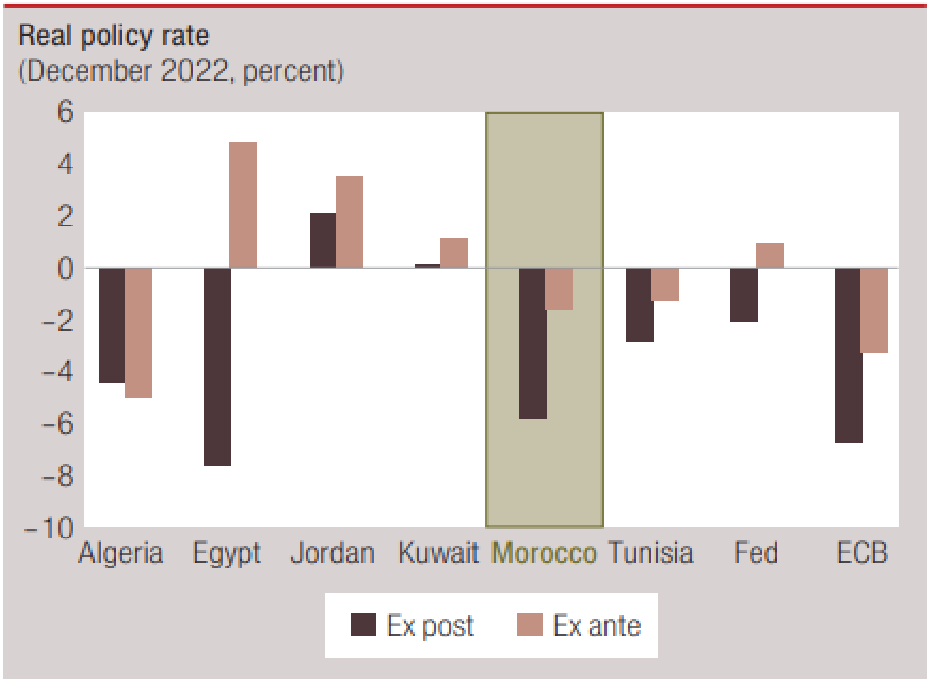
Figure N° 3 : Morocco's approach rate stays nearly low notwithstanding the climb



Source : IMF

Besides, the real (ex-ante and ex-post) interest rate has not yet arrived at the lower bound of its assessed unbiased level, In fact, it stays negative even after the fixing (figure 4).

Figure N° 4 : In real terms, the policy rate remains negative

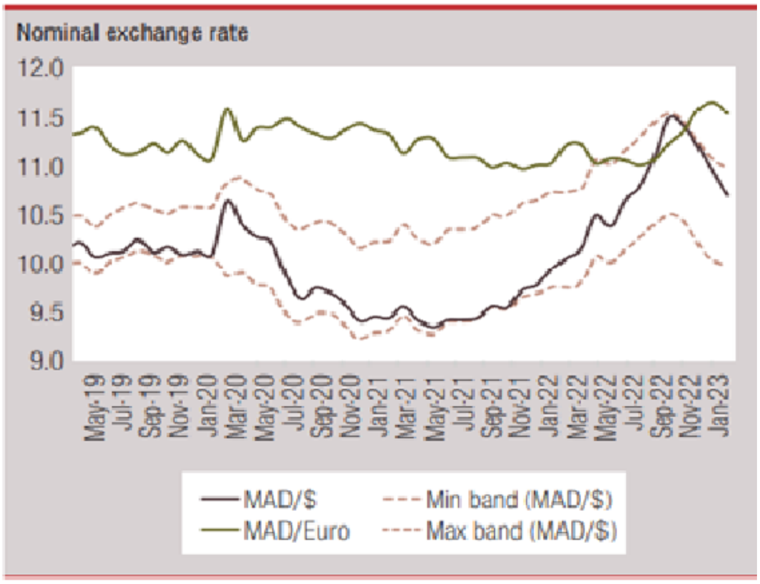


Source : IMF

This means that BAM has picked a reasonable methodology, selecting not to overcompensate to the inflationary flood, a choice that is legitimate by the idea of the shocks as of now gone through by the Moroccan economy. Without a doubt, these shocks have been started essentially on the stock side, and the result hole has turned negative, suggesting that request factors are logical not to assume a prevailing part in the inflationary flood. However, if high inflation persists and price pressures continue to spread throughout the economy, threatening the solid anchoring of inflation expectations achieved in recent years, the optimal monetary response to the shocks could be a further tightening in the future.

It is understandable that the tightening of monetary policy has not yet clearly affected inflation and the exchange rate. Between September and October, right after the first interest rate hike, the CPI annual growth rate dropped from 8.3 percent to 8.1%, but it returned to 8.3% in November and December. In spite of the fact that it is still right on time to measure the effect of the fixing, there are different motivations to contend that the financing cost passthrough could be restricted in Morocco, as the country's expansion rate not entirely settled by its past levels and by outside factors (Lahlou and Bennouna, 2022). From 3.6% in the third quarter to 4.8% in the fourth, BAM surveys indicate that inflation expectations have continued to rise. In recent months, the global weakening of the US dollar has contributed to an appreciation of the dirham in comparison to the dollar (Figure 5).

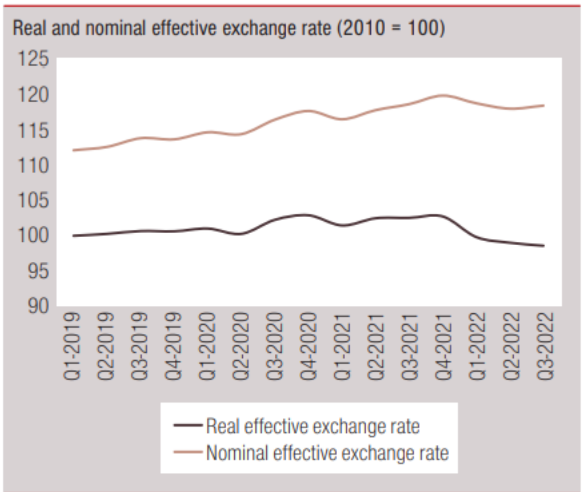
Figure 5 : The dirham has fluctuated around the US dollar's upper limit



Source : BAM

In the course of the initial 3/4 of 2022, the real effective exchange rate deteriorated by 4.2 percent and the nominal effective exchange rate devalued by 1.9 percent (Figure 6). In fact, it has remained close to the fluctuation band's upper bound.

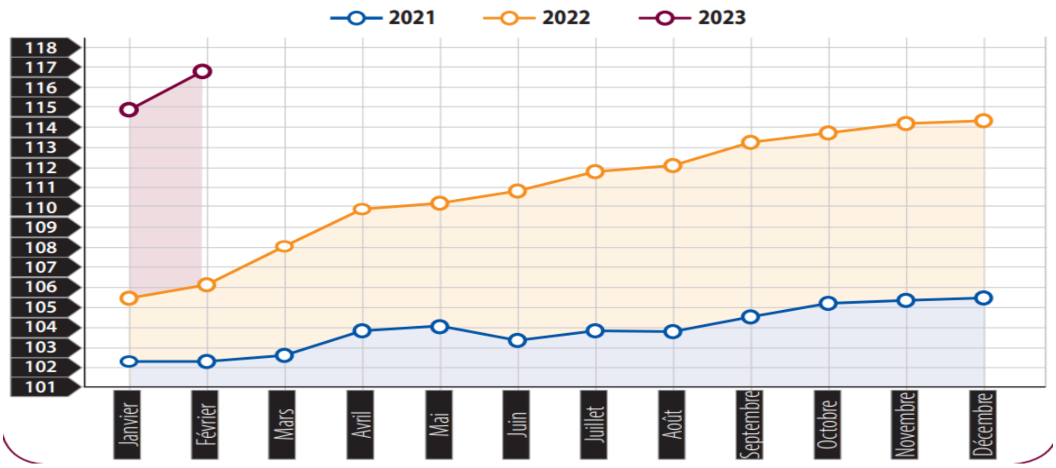
Figure N° 6 : The decrease of the effective and nominal exchange rate



Source : BAM

In February 2023, there was a 1.7% increase in the consumption price index when compared to the previous month. This variety is the consequence of the 3.9% increment in the list of food items and of the stagnation of the record of non-food items. In February 2023, the price index of consumption increased by 10.1% when compared to the same month in the previous year. When compared to the same time period in 2022, the index average increased at a rate of 9.5% during the first two months of 2023 (Figure7).

Figure 7 : Monthly evolution of the consumer price index



Source : HCP

2.2 Inflation targeting policy to improve the situation :

Adopting an inflation targeting policy can help Morocco overcome the effects of covid-19 and the impacts of Ukraine's war in several ways.

First, by maintaining price stability, inflation targeting can help mitigate the effects of inflation and deflation on the Moroccan economy, which is particularly important in times of crisis (Svensson 2010). By maintaining a specific rate of inflation, inflation targeting can also help anchor consumer and investor price expectations, which can help stabilize markets.

Second, the inflation targeting policy can help bolster the credibility of Morocco's central bank and bolster investor and market confidence in the country's macroeconomic stability. This can help attract foreign investment and support economic growth.

Finally, in targeting policy can help coordinate monetary policy with fiscal policy, which can be particularly important in times of crisis. By working closely with the Moroccan government, Morocco's central bank can help ensure consistency between monetary and fiscal policies, which can support economic recovery.

In sum, the adoption of the inflation targeting policy can help strengthen Morocco's macroeconomic stability, mitigate the Covid-19 crisis and the impacts of Ukraine's war, and support long-term economic growth.

However, it is important to take into account the potential challenges of adopting this policy.

3. Challenges of the adoption of the inflation targeting policy for Morocco

Before discussing the issues related to the development of the inflation targeting policy in Morocco, it seems important to review the historical evolution of its monetary policy.

Indeed, the evolution of monetary policy can be divided into three main periods: before the 1980s, the 1980s and 1990s, and since the 2000s.

Prior to the 1980s, Moroccan monetary policy was characterized by strong state intervention in the economy, with a system of exchange controls and a directed credit policy. Morocco's central bank was created in 1959, but it had little leeway to conduct an independent monetary policy until the late 1970s.

In the 1980s and 1990s, Morocco began to adopt a more liberal monetary policy by gradually reducing trade restrictions and adopting financial liberalization policies. The central bank has started to use more sophisticated monetary policy instruments such as interest rates to achieve its macroeconomic stabilization goals.

Since the 2000s, Morocco's monetary policy has been characterized by greater transparency and central bank independence. In 2002, Morocco passed a new banking law that strengthened the independence of the central bank and gave it an explicit mandate to maintain price stability. Since then, the central bank has used an implicit inflation target approach to guide its monetary policy.

During these different periods, Morocco's monetary policy was influenced by internal and external economic and political events, such as the oil shocks of the 1970s and 1980s, the structural adjustment programs of the 1980s and 1990s, the reforms financial and institutional aspects of the 2000s.

The adoption of the inflation targeting policy presents several issues and potential challenges. Morocco must engage in a process of modifications to its existing monetary policy framework to prepare the ground for the development of the IF. In what follows, we will list the key actions to be implemented to strengthen its institutional and regulatory framework.

Adaptation of the monetary policy framework: the adoption of an inflation targeting policy would require changes in the way the central bank of Morocco conducts its monetary policy, in particular by defining an explicit inflation rate target to reach.

Coordination with fiscal policy: Inflation targeting can be more effective if complemented by appropriate fiscal policy. Therefore, coordination with the Moroccan government would be essential to ensure consistency between monetary policy and fiscal policy.

Communication with the public: the success of the inflation targeting policy also depends on the understanding and support of the public for the objectives of this policy. Therefore, clear and effective communication from the central bank is essential to ensure public acceptance and understanding of the inflation targeting policy.

Taking into account the specificities of the Moroccan economy: Finally, it is important to note that the adoption of an inflation targeting policy must be adapted to the specificities of the Moroccan economy, particularly in terms of external vulnerabilities, dependence on materials and the importance of the informal sector.

In sum, the adoption of an inflation targeting policy by Morocco presents potential issues and challenges, but can also offer advantages in terms of macroeconomic stability and price predictability.

Moreover, Morocco has the necessary conditions for the implementation of the inflation targeting policy, but additional efforts are needed to strengthen its institutional and regulatory framework.

Among the conditions required for a successful inflation targeting policy are: an independent central bank with a clear price stability mandate, reliable and accessible economic data, increased transparency in the communication of monetary policy, and a stable and well-regulated financial system.

In contrast, Morocco has an independent central bank, Bank Al-Maghrib, which has a mandate to maintain price stability and financial stability. However, the transparency of monetary policy communication could be improved. It is also important to note that Morocco has a relatively well-developed and regulated financial system.

In addition, Morocco has implemented a number of reforms to strengthen its institutional and regulatory framework, notably within the framework of the Economic and Financial Reform Program (PREF). However, further efforts are needed to strengthen central bank independence, improve the quality of economic data, and enhance the transparency of monetary policy communication.

In summary, although Morocco seems to be on the way to achieving the necessary conditions for the implementation of the inflation targeting policy, additional efforts are needed to strengthen its institutional and regulatory framework in order to guarantee the success of the inflation targeting policy. In addition, Morocco is part of a process of widening the exchange bands. This commitment can be translated by its futuristic vision to adopt the policy of inflation targeting. In fact, within the framework of the literature, particular importance has been given to the flexibility of the exchange rate to the point that it is considered as an essential prerequisite for the policy of inflation targeting (Ebeke et al.2018).

Conclusion

Inflation targeting policy is a monetary regime that continues to attract particular interest from economists around the world. It represents a new framework for the conduct of monetary policy which consists of targeting a precise rate of inflation, unlike the old regimes which are based on the anchoring of monetary aggregates and the exchange rate. This new monetary regime, according to several international experiences, succeeded in achieving price stability by absorbing economic shocks (Batini et Laxton 2006).

By maintaining specific inflation targeting, inflation targeting can help anchor consumer and investor price expectations and prevent excessive inflation or deflation. Indeed, by maintaining price stability, inflation targeting can also contribute to maintaining financial stability by reducing asset price volatility and avoiding speculative bubbles. Overall, inflation targeting can help maintain macroeconomic stability especially with regard to price stability.

However, the implementation of such a policy requires the meeting of a number of preconditions, including transparency, exchange rate flexibility and central bank independence. Morocco is on track for the adoption of IC. This is salient in its commitment to a process of widening the bands and in its inscription to ensure more room for maneuver for the BAM. Thus, the flexibility of the exchange rate and the independence of the central bank could only reflect the futuristic vision of Morocco to gradually move towards the policy of inflation targeting. Nevertheless, Morocco is called upon to make more efforts to deal with the issues and potential challenges of implementing the inflation targeting policy.

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