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BOX 04
Monetary Policy Accountability and Inflation Targets

Introduction

Monetary policy accountability necessitates a central bank to explain and justify its monetary policy decisions and their impacts to its stakeholders. This justification is important because it confirms that the central bank remains independent while being transparent and trustworthy. Central bank accountability strengthens the trust among people, businesses, and investors, confirming that its decisions are guided by economic reasoning rather than political or external influences. This trust helps keep inflation expectations anchored and inflation stable. That, in turn, strengthens the confidence in economic policymaking. Conversely, a weak accountability framework can undermine confidence, leading to inflationary risks and economic instability.

Effective accountability measures involve clear oversight, transparency, and performance evaluation. Central banks are increasingly required to publish reports on the economic outlook and the rationale for monetary policy decisions, along with the external factors influencing outcomes. Greater accountability of central banks results in improvements in their governance arrangements, policies, operations and interaction with key stakeholders. In this regard, research shows that countries with accountable and transparent central banks generally have low and stable inflation rates and better economic performance (Mishkin, 1997). However, too much scrutiny can sometimes make decision-making slow or overcautious, preventing a central bank from taking bold but necessary actions during economic crises (Goodhart, 2010).

Central bank independence and greater accountability are intrinsically linked with each other (Adrian and Khan, 2019). Transparency and accountability are prerequisites for central bank independence, providing the basis for sound monetary policy. Transparency requires central banks to regularly provide information about their decisions to the government, the public and other policymakers through channels, such as publishing reports or testifying before legislative bodies.

Importance of Central Bank Accountability During Inflation Target Breaches

Inflation targeting is a monetary policy framework, where a central bank is provided with a specific inflation target to be achieved within a given period of time. By conducting monetary policy, mainly by adjusting its policy interest rates, central banks attempt to keep inflation within a targeted level, and that reduces uncertainty and smoothes business cycle fluctuations. However, central banks are not always able to keep inflation within the agreed targeted levels. This could be due to various reasons, including administered price adjustments and supply-side disruptions arising from domestic sources or globally. Strong accountability is essential, particularly when inflation deviates from its target, for enhancing public confidence and bringing inflation back to its target level. Central banks must explain the causes of deviation, take corrective actions, and maintain transparency in their policy decisions. Legal frameworks are often in place to guide these actions, ensuring that central banks remain responsive and effective (Adrian and Khan, 2019).

Understanding the causes of inflation target breaches helps both central banks and governments design more effective policies to restore stability. Considering historical experiences, external shocks like oil price hikes, supply chain disruptions, and global uncertainties are among the common factors for inflation to deviate from its target, but it can occur due to domestic factors as well. For example, the Bank of Canada cited commodity price rises as the leading cause for an inflation hike in 2008 and noted the effects of global financial turmoil on inflation control (Bank of Canada, 2008). Similarly, the Reserve Bank of New Zealand explained how supply-side factors, including a hike in consumption taxes, caused a hike in inflation in 2011, and further went on to explain how inflation was expected to be affected in the aftermath of an earthquake

(Reserve Bank of New Zealand, 2011). Some central banks, such as the Czech National Bank, even allow temporary deviations in their mandates when faced with major economic shocks (Rusnok, 2018). Moreover, in the context of developing economies, supply shocks are often large and more frequent than in developed economies. Therefore, supply-related factors can commonly account for inflation deviations from the respective targets in developing economies.

The speed at which inflation returns to target depends on the economic context and the effectiveness of the policy measures taken. For instance, researchers have found that changes in interest rates, in general, take 18–24 months to influence inflation. This could be longer or shorter depending on a country's economic and financial market context. Central banks must also be prepared to use additional tools, such as liquidity management and forward guidance, especially when inflation is driven by supply-side factors. Some policies from the government side are also complementary to managing inflation, especially on the supply side factors. Short-term policies, such as taxes and administered prices, as well as long-term policies to address weather-related issues, play a crucial role in addressing the temporary volatility of food and energy inflation. However, it should also be noted that supply-side issues are transient in general and will naturally correct over time. On the other hand, if inflation deviations are persistent, irrespective of the drivers of such deviations, central banks are bound to act to re-anchor inflation expectations and bring inflation back to the target levels as early as possible. Accordingly, central bank communications play an important role in conveying these messages to various economic stakeholders.

Monetary Policy Accountability Provisions under the Central Bank of Sri Lanka Act No. 16 of 2023 (CBA)

The Central Bank of Sri Lanka Act No.16 of 2023 (CBA) provides for strong monetary policy accountability, as well as operational independence for the Central Bank. Section 26 of CBA states that the Minister of Finance and the Central Bank shall sign a Monetary Policy Framework Agreement (MPFA) setting out the inflation target to be achieved by the Central Bank. As per the MPFA, if the Central Bank fails to maintain the Colombo Consumer Price Index (CCPI)-based quarterly average inflation within a margin (±2 pps) around the inflation target of 5% for two consecutive quarters, it must submit a report to the Parliament through the Hon. Minister of Finance. This report needs to be made available to the public and must include an explanation of the reasons for the deviation, corrective actions to be taken by the Central Bank, and an estimated timeframe for bringing inflation back to the target range. Further, according to Section 27 of CBA, the Central Bank needs to publish a report once in six months, explaining recent movements in inflation, sources of inflation and medium-term projections for inflation and key risks to such projections. In addition, under Section 80 of CBA, the Central Bank should inform the public regarding the implementation of its monetary policy and the achievement of its objects at least once in every six months. The Monetary Policy Report is published in fulfilment of the requirements in Sections 27 and 80 above. Accordingly, CBA marks a historic milestone in economic policymaking in Sri Lanka, as the Central Bank has been granted the necessary operational independence to maintain price stability, while making it accountable for its actions and achieving the price stability objective.

Sri Lanka's Experience with the Recent Inflation Target Breach and Accountability Measures

Sri Lanka's inflation fell below the target by more than two pps in the second, third and fourth quarters of 2024, mainly due to supply-side factors, such as reduced electricity and fuel prices, and lower food inflation. Further, appreciation of the Sri Lankan rupee also contributed to low inflation. This prompted the Central Bank to submit reports for deviation of inflation from its target to the Parliament

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and make them available to the public, as required by CBA. The first such report, relevant for the second and third quarters of 2024, is now publicly available on the Central Bank Website, while the report relevant for the third and fourth quarters of 2024 has been submitted to the Hon. Minister of Finance and will be available for public access in the period ahead. Moreover, since inflation continued to remain below the target by more than two pps during the first quarter of 2025 for the same reasons mentioned above, the Central Bank will submit a similar report relevant for the fourth quarter of 2024 and the first quarter of 2025 as well. As per the latest projections, the Central Bank, while observing that the deflationary conditions have commenced easing from March 2025, expects the ongoing deflation to be transitory and inflation to return to ±2 pps within the target by the third quarter of 2025, unless there are substantial deviations in economic conditions underpinned by the data, assumptions and judgments used in arriving at these projections.

Global Experiences with Inflation Target Breaches and Accountability Measures

Examples of accountability measures regarding inflation target breaches can be observed among various central banks worldwide. As mandated in the Bank of England Act 1998, the Remit for the Monetary Policy Committee of the Bank of England requires that the Governor write to the Chancellor of the Exchequer if inflation deviates by more than 1% on either side of the target. In 2022, inflation in the UK exceeded 10% due to the Russia-Ukraine conflict and rising energy prices, prompting a series of communiques by the Governor to the Chancellor. Similarly, the Reserve Bank of New Zealand Act 2021 necessitates regular publication of Monetary Policy Statements, which as specified in the Monetary Policy Committee Charter, need to explain reasons for inflation deviations. In 2022, when inflation recorded a steep increase, surpassing 7%, the Reserve Bank of New Zealand explained inflation trends, deviations from the target, and the policy response in its Monetary Policy Statements. The Reserve Bank of India Act 1934 (amended 2016) requires the central bank to submit a report to the government if inflation remains outside the target range for three consecutive quarters. Inflation in India exceeded the target in 2022 with the global inflation surge. This prompted the Reserve Bank of India to submit a report to the government explaining the reasons and outlining corrective measures. The Federal Reserve regularly reports to Congress on its policy actions, despite not being legally required to justify breaches. These accountability measures not only ensure transparency but also reinforce trust in central banks' efforts to control inflation.

Concluding Remarks

Accountability in monetary policymaking is essential for maintaining price stability and improving public confidence in monetary policymaking. By establishing clear targets for inflation, explaining deviations, and taking corrective actions, central banks can enhance their credibility and maintain price stability and support economic growth. Whether dealing with external shocks or internal policy missteps, central banks must remain transparent and responsive to ensure achieving and maintaining price stability. In Sri Lanka, medium-term inflation expectations remain broadly aligned with the 5% target, reflecting the confidence among economic agents over monetary policymaking. Communication strategies like publishing semi-annual monetary policy reports, and the accountability measures mandated in CBA, have been instrumental in establishing such public confidence.

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