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INFLATION TARGETING IN DEVELOPING ECONOMIES: CREDIBILITY, GOVERNMENT INFLUENCE, AND ITS EFFECTS ON INCOME DISTRIBUTION

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Abstract
This study titled "inflation targeting in developing economies: credibility, government influence and its effects on income distribution" examines the political economy of inflation targeting in developing economies with a focus on institutional credibility, government influence, and distributional outcomes. While inflation targeting is widely promoted as a framework for achieving price stability, its effectiveness in developing contexts remains uneven due to structural and institutional constraints. This research adopts a qualitative research design, utilizing a comparative case study approach with Nigeria as the primary case. Data is drawn from secondary sources, including central bank reports, policy documents, international financial institution publications, and academic literature, and analyzed using thematic content analysis. The study finds that weak institutional credibility, characterized by limited central bank independence and inconsistent policy implementation, undermines the effectiveness of inflation targeting in Nigeria. The findings suggest that inflation targeting in Nigeria operates more as a constrained policy framework than a fully credible commitment mechanism. The study concludes that strengthening institutional capacity, improving fiscal discipline, and enhancing policy coordination are essential for improving the effectiveness and equity of inflation targeting in developing economies. By situating monetary policy within a broader political economy context, this study contributes to a more nuanced understanding of the challenges and limitations of inflation targeting in developing countries.

Keywords:

1.0 Introduction

Since the early 1990s, inflation targeting has emerged as one of the most influential monetary policy frameworks adopted by central banks across the world. The framework is designed to achieve and maintain price stability through the public announcement of inflation targets and the use of monetary policy instruments to keep inflation within a specified range. Inflation targeting gained prominence following its successful implementation in countries such as New Zealand, Canada, and the United Kingdom, where it contributed to lower inflation rates, improved policy transparency, and enhanced macroeconomic stability (Bernanke et al., 1999; Mishkin, 2004).

The growing popularity of inflation targeting has also extended to developing and emerging economies. Countries such as Brazil, South Africa, Ghana, and Chile have adopted some form of inflation targeting framework to address persistent inflationary pressures and strengthen monetary policy credibility. However, the effectiveness of inflation targeting in developing economies remains a subject of debate due to structural weaknesses, fiscal imbalances, shallow financial markets, and institutional constraints that differ significantly from those found in advanced economies (Fraga et al., 2003).

Recent inflation trends highlight the importance of effective monetary policy frameworks in developing economies. Globally, inflation increased sharply following the COVID-19 pandemic due to supply chain disruptions, geopolitical tensions, and rising energy prices. In Nigeria, headline inflation rose from 15.60 percent in January 2022 to 28.92 percent in December 2023 and exceeded 34 percent during 2024, while food inflation reached record levels, placing significant pressure on household welfare and economic stability (National Bureau of Statistics [NBS], 2024; Central Bank of Nigeria [CBN], 2024). In response to these developments, the Central Bank of Nigeria intensified monetary tightening measures through repeated increases in the Monetary Policy Rate (MPR) and signaled a stronger commitment to inflation-targeting principles.

Despite the theoretical appeal of inflation targeting, its successful implementation depends on several institutional and structural conditions. A growing body of literature identifies central bank independence, policy credibility, fiscal discipline, and effective communication as essential prerequisites for achieving inflation targets (Mariscal et al., 2018; Mishkin, 2004). In many developing economies, however, monetary authorities operate within environments characterized by weak institutions, policy inconsistencies, and frequent political interference. These conditions undermine public confidence in monetary policy and weaken the credibility of inflation-targeting commitments.

An additional challenge arises from fiscal dominance, a situation in which government financing needs influence or constrain monetary policy decisions. In many developing countries, persistent fiscal deficits and increasing public debt create pressure on central banks to accommodate government borrowing requirements. Consequently, monetary policy objectives may become subordinated to fiscal considerations, limiting the effectiveness of inflation-targeting frameworks in controlling inflation and maintaining macroeconomic stability (Ahmed et al., 2019; Edwards & Tabellini, 1991).

Beyond concerns about credibility and policy autonomy, inflation targeting also raises important questions regarding income distribution and social welfare. While low and stable inflation is generally associated with improved economic performance, the contractionary monetary policies often employed to achieve inflation targets may increase borrowing costs, reduce employment opportunities, and limit access to credit. These effects are frequently borne disproportionately by low-income households and small businesses, thereby raising concerns about the distributional consequences of inflation-targeting policies in developing economies (Petrevski, 2023).

Although extensive research has examined the relationship between inflation targeting, inflation performance, and economic growth, limited attention has been given to the interaction between institutional credibility, government influence, and distributional outcomes. Much of the existing literature treats inflation targeting as a technical policy framework while overlooking the broader political and institutional factors that shape policy effectiveness. This study addresses this gap by examining inflation targeting through a political economy perspective, focusing on how credibility, fiscal dominance, and income distribution influence the effectiveness of inflation targeting in developing economies, with particular emphasis on Nigeria.

Statement of the Research Problem

Inflation targeting has widely been adopted as a monetary policy framework intended to achieve price stability and anchor inflation expectations. Despite the fact that this framework has recorded relative success in advanced economies, its outcomes in developing economies remain inconsistent. One major issue is the limited institutional credibility of central banks in these contexts. Weak governance structures, policy inconsistency, and low public trust reduce the effectiveness of inflation targeting as economic agents may not fully believe in the central bank's commitment to its targets.

In addition, government influence through fiscal dominance presents a persistent challenge. In many developing economies, large fiscal deficits and reliance on central bank financing limits monetary policy autonomy. This undermines the ability of central banks to strictly pursue inflation targets, as they are often compelled to accommodate government borrowing needs. Consequently, inflation targeting frameworks may become nominal rather than operational, weakening their intended macroeconomic outcomes.

Despite growing scholarship, there remains a gap in understanding how institutional credibility, fiscal pressures, and distribution outcomes interact within inflation targeting policies in developing economies. Addressing this gap is essential for evaluating the real effectiveness of the framework and for designing policies that balance macroeconomic stability with social equity.

Research Questions

1. How does institutional credibility influence the effectiveness of inflation targeting in developing economies?
2. To what extent does government influence affect the implementation of inflation targeting?
3. Does inflation targeting contribute to inclusive economic growth or widen income inequality?

Aim and Objectives

The aim of this study is to examine the political economy of inflation targeting in developing economies by analyzing the roles of institutional credibility, government influence, and distribution outcomes.

Objectives of the Study

1. To assess the impact of institutional credibility on the effectiveness of inflation targeting.
2. To examine the extent to which fiscal dominance constrains monetary policy autonomy.
3. To evaluate whether inflation targeting promotes macroeconomic stability alongside inclusive growth.

Literature Review and Theoretical Framework

Conceptual Clarification

Target inflation

Instead of viewing inflation targeting as a technical policy, it is appropriately understood as an institutional commitment within a broader political and economic structure. In practice, the success of inflation targeting depends less on the formal announcement of targets and more on whether economic actors perceive the central bank as both capable and willing to enforce those targets over time. This shifts the focus from formal policy design to credible outcome.

Institutional Credibility

Institutional credibility in this context is not fixed. It evolves through policy interactions, consistency in decision making, and the alignment between announced targets and observable outcomes. In developing economies, credibility is often undermined by policy reversals and structural constraints such as weak financial systems and external shocks.

Fiscal Dominance

Fiscal dominance should also be understood beyond its narrow definition as government interference. It reflects a deeper structural imbalance in which fiscal authorities, due to revenue volatility and debt pressures, systematically restrict monetary policy choices. Under such conditions, inflation targeting becomes an easy target to short-term macroeconomic stabilization needs rather than long-term price stability.

The distributional dimension of inflation targeting highlights that monetary policy is not neutral. Policy tools such as interest rate adjustments, liquidity, and exchange rate management redistribute resources across sectors and social groups in ways that are not acknowledged in conventional macroeconomic models.

Theoretical Framework

This study is anchored in three theoretical perspectives:

1. Time Inconsistency Theory (Kydland & Prescott, 1977; Barro & Gordon, 1983)

This theory explains why policymakers may deviate from announced inflation targets due to short-term incentives, leading to higher inflation expectations. Inflation targeting is designed as a commitment mechanism to solve this credibility problem. However, in developing economies, weak institutions reduce the effectiveness of such commitments.

2. Fiscal Theory of the Price Level (FTPL)

The FTPL posits that price stability depends not only on monetary policy but also on fiscal discipline. When governments run persistent deficits, monetary policy becomes subordinate to fiscal needs, leading to inflation. This aligns with the concept of fiscal dominance highlighted in empirical studies (Ahmed et al., 2019).

3. Political Economy Theory of Macroeconomic Policy

This approach emphasizes that economic policies are shaped by political incentives, institutional constraints, and distributional conflicts. It explains why governments may influence monetary policy and why inflation outcomes differ across countries (Edwards & Tabellini, 1991). It also provides a framework for analyzing how inflation targeting affects different social groups.

Together, these theories provide a comprehensive lens for understanding how credibility, fiscal pressures, and political incentives interact to shape the outcomes of inflation targeting in developing economies.

Literature Review

The literature on inflation targeting has evolved significantly over the past three decades, reflecting both its widespread adoption and the growing debate surrounding its effectiveness, particularly in developing economies. Early contributions largely present inflation targeting as a superior monetary policy framework, emphasizing its role in enhancing transparency, anchoring expectations, and reducing inflation volatility. Foundational studies argue that the credibility gained through clear policy targets and communication strategies improves macroeconomic outcomes, especially in economies transitioning from high inflation environments (Bernanke et al., 1999; Mishkin, 2004). However, these early analyses are largely based on the experiences of advanced economies, raising concerns about their applicability to developing contexts.

Subsequent research shifts attention to the institutional prerequisites necessary for the successful implementation of inflation targeting. A central theme in this strand of literature is the role of central bank independence, fiscal discipline, and financial market development. Studies such as Fraga et al. (2003) argue that weak institutional structures significantly reduce the effectiveness of inflation targeting by increasing the likelihood of policy deviations. Similarly, cross-country analyses suggest that countries with stronger governance frameworks are more capable of sustaining credible inflation targeting regimes (Petrevski, 2023). While these studies provide important insights, they often treat institutional quality as an exogenous condition rather than examining how political dynamics shape institutional outcomes.

Another important dimension of the literature focuses on credibility and expectations management. The effectiveness of inflation targeting depends heavily on the ability of central banks to influence expectations through consistent and predictable policy actions. Empirical studies indicate that credibility is not automatically achieved through the adoption of inflation targeting but develops gradually over time (Mariscal et al., 2018). In developing economies, however, credibility is frequently undermined by policy inconsistencies, external shocks, and limited communication capacity. This suggests that inflation targeting may not function as an effective commitment mechanism in contexts where institutional trust is weak.

The issue of fiscal dominance introduces a critical political economy perspective into the analysis. Fiscal dominance occurs when government financing needs constrain or override monetary policy decisions, thereby limiting central bank autonomy. Research in this area demonstrates that high levels of public debt and reliance on central bank financing can force monetary authorities to deviate from inflation targets (Ahmed et al., 2019). Earlier political economy studies further emphasize that inflation in developing countries is often rooted in fiscal imbalances and political instability, highlighting the interdependence between fiscal and monetary policy (Edwards & Tabellini, 1991). Despite this, much of the inflation targeting literature continues to analyze monetary policy in isolation, overlooking these structural interdependencies.

More recent contributions have begun to explore the distributional effects of inflation targeting, marking a shift away from purely macroeconomic evaluations. While inflation targeting is associated with reduced inflation volatility, its impact on growth and inequality remains ambiguous. Some studies suggest that contractionary monetary policies used to control inflation may impose disproportionate costs on low-income groups, particularly in economies with limited social safety nets (Petrevski, 2023). However, this area of research remains underdeveloped, with limited empirical work linking inflation targeting directly to income distribution outcomes in developing economies.

Empirical Review

International Evidence on Inflation Targeting

Bernanke et al. (1999) examined the experiences of countries that adopted inflation targeting and found that the framework contributed to lower inflation and improved policy credibility. Similarly, Mishkin (2004) argued that inflation targeting can enhance monetary policy transparency and anchor inflation expectations, although its success depends on strong institutional arrangements.

Fraga, Goldfajn, and Minella (2003) investigated inflation targeting in emerging market economies and found that structural vulnerabilities, exchange rate instability, and fiscal imbalances often limit the effectiveness of the framework. Mariscal, Powell, and Tavella (2018) further demonstrated that credibility under inflation-targeting regimes develops gradually and depends heavily on policy consistency and institutional trust.

Ahmed, Aizenman, and Jinjarak (2019) examined the relationship between fiscal dominance and inflation management and concluded that persistent fiscal deficits can undermine monetary policy effectiveness by restricting central bank autonomy.

Empirical Evidence from Nigeria

Early studies on inflation in Nigeria emphasized the role of fiscal and monetary factors. Asogu (1991) found that government expenditure and fiscal deficits significantly contributed to inflationary pressures through increases in money supply. Similarly, Fakiyesi (1996) identified monetary expansion and exchange rate depreciation as major determinants of inflation in Nigeria.

More recent studies have focused on inflation targeting and monetary policy effectiveness. Ozili (2024) argued that successful implementation of inflation targeting in Nigeria depends on central bank independence, policy credibility, fiscal discipline, and effective communication. However, the study noted that these conditions remain only partially achieved.

Karatu et al. (2026) examined the impact of monetary policy instruments on inflation in post-pandemic Nigeria and found that while the Monetary Policy Rate had a significant relationship with inflation, the Cash Reserve Ratio appeared more effective in reducing inflationary pressures. The study concluded that weaknesses in monetary transmission mechanisms limit the effectiveness of conventional inflation-targeting approaches.

The reviewed studies generally agree that inflation targeting can contribute to macroeconomic stability when supported by strong institutions, credible monetary authorities, and fiscal discipline. However, evidence from developing economies, particularly Nigeria, suggests that fiscal dominance, exchange rate instability, weak monetary transmission mechanisms, and institutional constraints continue to undermine policy effectiveness. Furthermore, while existing studies focus largely on inflation performance and economic growth, relatively few examine the interaction between credibility, government influence, and income distribution.

Gaps in the Literature

Most studies treat inflation targeting as a technical monetary framework, neglecting the political and institutional dynamics that shape its outcomes. Secondly, much of the empirical evidence is derived from advanced economies, limiting the generalizability of findings to developing contexts. Existing literature focuses heavily on inflation and growth, with limited attention to how IT affects inequality and social welfare. Finally, lack of country specific and comparative studies (e.g., Nigeria). There is a need for more context-specific analyses that capture institutional and structural differences across developing economies.

This study builds on these gaps by adopting a political economy approach that explicitly examines the interaction between institutional credibility, fiscal dominance, and income distribution. By focusing on Nigeria, it provides a context-sensitive analysis that moves beyond generalized assumptions and highlights the structural constraints that shape inflation targeting outcomes in developing economies.

Methodology

Research Design

To capture the nuance of Nigerian fiscal politics, this study utilities the qualitative lens blending interpretive analysis with an exploratory focus on institution bottlenecks. The qualitative approach is suited for capturing complex interactions between policy credibility, governance structures, and socio-economic outcomes that are not easily quantifiable.

Case Study Justification

Nigeria is selected as a critical case due to its hybrid monetary policy framework, persistent inflationary pressures, and observable tensions between fiscal and monetary authorities. As one of the largest economies in Africa with significant macroeconomic volatility, Nigeria provides a representative yet analytically rich context for examining the constraints of inflation targeting in developing economies.

Sources of Data

The study relies on secondary data drawn from Central Bank of Nigeria (CBN) reports and monetary policy statements, publications from international financial institutions (IMF, World Bank), Peer-reviewed academic literature, Policy analyses and working papers. Sources were selected based on relevance, credibility with emphasis on materials published between 2000 and 2025 to capture both pre and post-inflation targeting dynamics.

Analytical Framework

The study employs thematic content analysis guided by three core analytical categories:

1. Institutional credibility (policy consistency, independence, communication)
2. Fiscal dominance (deficits, debt financing, policy interference)
3. Distributional outcomes (income inequality, welfare effects, sectorial impacts)

Data were systematically coded according to these themes, allowing for identification of patterns and cross source comparison. The analysis integrates theoretical insights with empirical observations to generate a coherent political economy explanation of inflation targeting outcomes.

Analysis and Discussion

Theme One: Institutional Credibility

Table 1

Analytical category	Codes/indicators	Evidence from documents	Emerging theme
Institutional credibility	Policy consistency	CBN has frequently missed inflation targets despite repeated monetary tightening measures.	Weak policy consistency undermines credibility.
Institutional credibility	Central Bank Independence	Monetary policy decisions are often influenced by fiscal considerations and government borrowing needs.	Limited autonomy weakens inflation-targeting effectiveness.
Institutional credibility	Central Bank Independence	Inflation objectives are communicated, but public confidence remains low due to persistent inflationary pressures.	Credibility depends on both communication and policy outcomes.

Discussion

The findings indicate that institutional credibility remains a major challenge to the effectiveness of inflation targeting in Nigeria. Although the Central Bank of Nigeria publicly communicates inflation objectives, persistent deviations from inflation targets weaken public confidence in monetary policy. According to Time Inconsistency Theory, repeated departures from announced policy goals reduce the credibility of future commitments. Inflation targeting functions less as a credible commitment mechanism and more as a constrained policy framework. Limited central bank autonomy reduces the effectiveness of inflation-targeting strategies. The interaction between monetary and fiscal authorities often creates uncertainty regarding the central bank's ability to pursue long-term price stability objectives independently.

Theme Two: Fiscal Dominance

Table 2

Analytical category	Codes/indicators	Evidence from documents	Emerging theme
Fiscal dominance	Fiscal deficits	Persistent government deficits continue to create inflationary pressures.	Fiscal imbalances constrain monetary policy effectiveness.
Fiscal dominance	Central bank financing	Government reliance on central bank financing affects monetary policy decisions.	Fiscal needs often override inflation-control objectives.
Fiscal dominance	Public debt pressures	Rising debt obligations increase pressure on monetary authorities to accommodate fiscal policy.	Fiscal dominance weakens inflation-targeting credibility.

Discussion

The analysis reveals that fiscal dominance remains one of the most significant barriers to successful inflation targeting in Nigeria. Government financing requirements frequently influence monetary policy decisions, reducing the independence of the central bank. This finding supports the Fiscal Theory of the Price Level, which argues that price stability cannot be achieved solely through monetary policy when fiscal policy remains unsustainable. The evidence suggests that inflation targeting is unlikely to achieve its objectives unless fiscal discipline is strengthened. Persistent fiscal deficits and growing public debt create structural constraints that limit the effectiveness of anti-inflationary measures.

Theme Three: Distributional Outcomes

Table 3

Analytical category	Codes/indicators	Evidence from documents	Emerging theme
Distributional outcomes	Income inequality	Inflation and monetary tightening disproportionately affect low-income households	Inflation-targeting policies have unequal social effects.
Distributional outcomes	Access to credit	Higher interest rates increase borrowing costs for SMEs and vulnerable groups.	Monetary tightening reduces financial access.

Distributional outcomes	Welfare effects	Food inflation significantly reduces the purchasing power of poor households.	Inflation control measures may generate short-term welfare costs.

Discussion

The findings demonstrate that inflation targeting is not neutral. While price stability remains an important macroeconomic objective, the policies used to achieve it often impose significant costs on vulnerable groups. Higher interest rates increase borrowing costs and restrict access to credit, particularly for small and medium enterprises and low-income households. At the same time, persistent inflation erodes purchasing power and reduces household welfare. This creates a policy dilemma in which both inflation and anti-inflation measures impose costs on vulnerable populations. Therefore, the effectiveness of inflation targeting should be assessed not only in terms of inflation outcomes but also with respect to its broader social and economic consequences.

Conclusion

This study has examined inflation targeting in developing economies through a political economy lens, focusing on institutional credibility, fiscal dominance, and distributional outcomes. The analysis demonstrates that while inflation targeting has the potential to enhance macroeconomic stability, its effectiveness is significantly constrained by weak institutions and persistent fiscal pressures. In many cases, the framework fails to achieve its intended objectives due to limited credibility and government interference in monetary policy.

The study highlights that inflation targeting is not distribution neutral. The policies used to control inflation can impose disproportionate costs on vulnerable groups, raising important questions about equity and social welfare. As such, inflation targeting should not be evaluated solely on the basis of inflation outcomes but also in terms of its broader economic and social impacts.

Recommendations

The following recommendations have been suggested for this study:

1. Governments should enhance the independence and transparency of central banks to build public trust and improve policy effectiveness.
2. Reducing fiscal deficits and limiting reliance on central bank financing are essential for minimizing fiscal dominance and supporting inflation targeting.
3. Greater coordination between fiscal and monetary authorities can help align policy objectives and reduce conflicts.
4. Policymakers should complement inflation targeting with social policies that protect vulnerable groups from the adverse effects of contractionary measures.
5. Allowing for some flexibility in response to external shocks can improve policy outcomes in volatile economic environments.

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