

Inflation Targeting

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What is Inflation Targeting (IT)?

1. An announced numerical inflation target
 - Point v.s. range targets (with soft edges)
 - Typically more “flexible” rather than “strict” to allow for dual mandate (or more)
2. Forecast targeting
 - Almost always, target forecast because monetary policy operates with a lag.
3. High degree of transparency and accountability
 - Monetary policy is about “managing expectations,” hence credibility is important. The more credibility, the more flexibility.
 - Accountability: NZ requires achieving inflation target as KPI. In UK, if inflation deviate from range more than 1 percent, a public letter from the Central Bank is required.

Required Institutions: i) mandate for price stability, ii) independence, iii) accountability

Conceptual Thinking Behind IT

- Simple calculus, minimize this loss function:

$$L_{t+\tau,t} = (\pi_{t+\tau,t} - \pi^*)^2 + \lambda(y_{t+\tau,t} - \bar{y}_{t+\tau,t})^2,$$

- Just pick inflation (π) and output (y) that minimize this.
- Unfortunately, life (monetary policy) is not that simple... why?

New Zealand, where it all began

- Started from developed nations and quickly spread to EMEs after Asian crisis
- US, Euro and Japan only adopted a weak form in recent years (after Subprime)

Table 2.1: Approximate adoption dates of inflation targeting

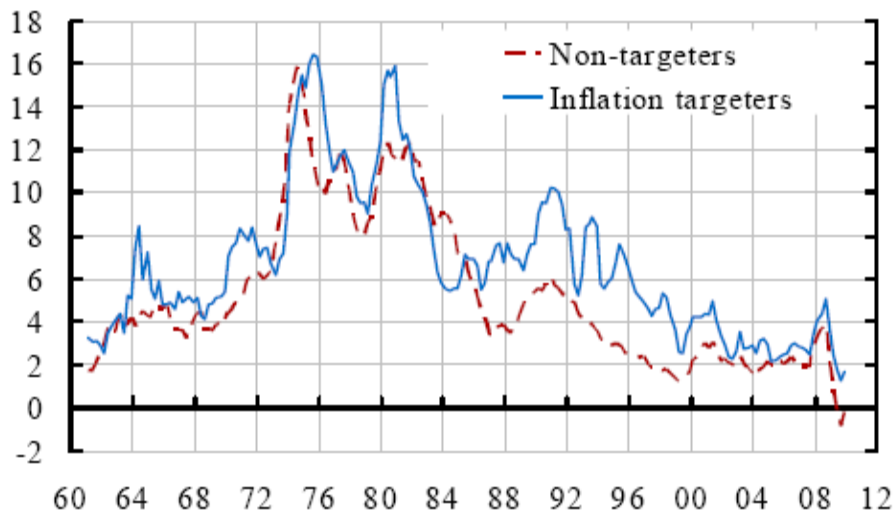
Country	Date	Country	Date
New Zealand	1990 q1	Korea	2001 m1
Canada	1991 m2	Mexico	2001 m1
United Kingdom	1992 m10	Iceland	2001 m3
Sweden	1993 m1	Norway	2001 m3
Finland	1993 m2	Hungary	2001 m6
Australia	1993 m4	Peru	2002 m1
Spain	1995 m1	Philippines	2002 m1
Israel	1997 m6	Guatemala	2005 m1
Czech Republic	1997 m12	Slovakia	2005 m1
Poland	1998 m10	Indonesia	2005 m7
Brazil	1999 m6	Romania	2005 m8
Chile	1999 m9	Turkey	2006 m1
Colombia	1999 m9	Serbia	2006 m9
South Africa	2000 m2	Ghana	2007 m5
Thailand	2000 m5		

Source: Roger (2009)

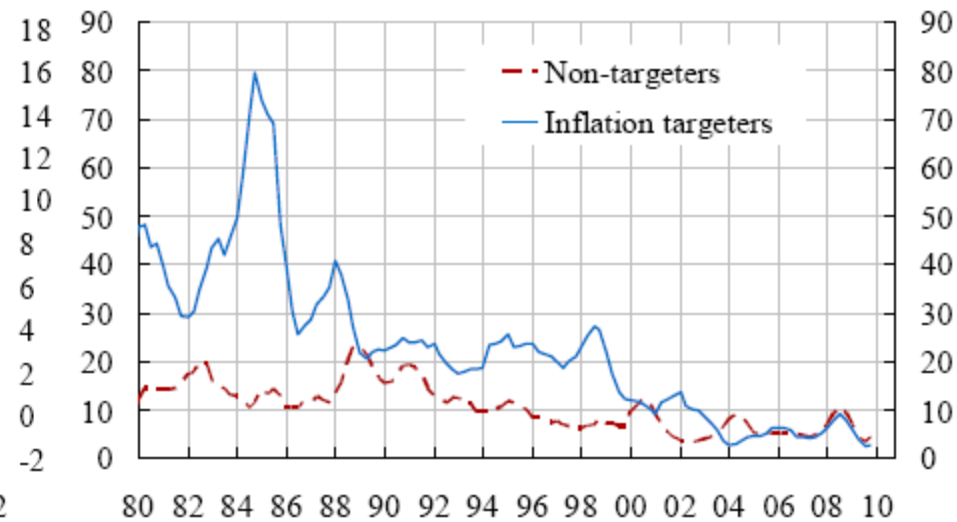
Has IT worked?

- Unfortunately, mixed results (but why?...)
- Non-targeting countries with inflation target in mind?

OECD



EMEs



What about inflation expectations?

- IT seemed to work better anchoring inflation expectation
- International Monetary Fund (2008) found that “in emerging economies, inflation targeting seems to have recently been more effective than alternative 10 monetary-policy frameworks in anchoring expectations.”
- Table 2.2 reports the percentage-point response of expected headline inflation 1, 3, 5 and 6—10 years ahead to a 1 percentage-point change in actual inflation for emerging-market economies

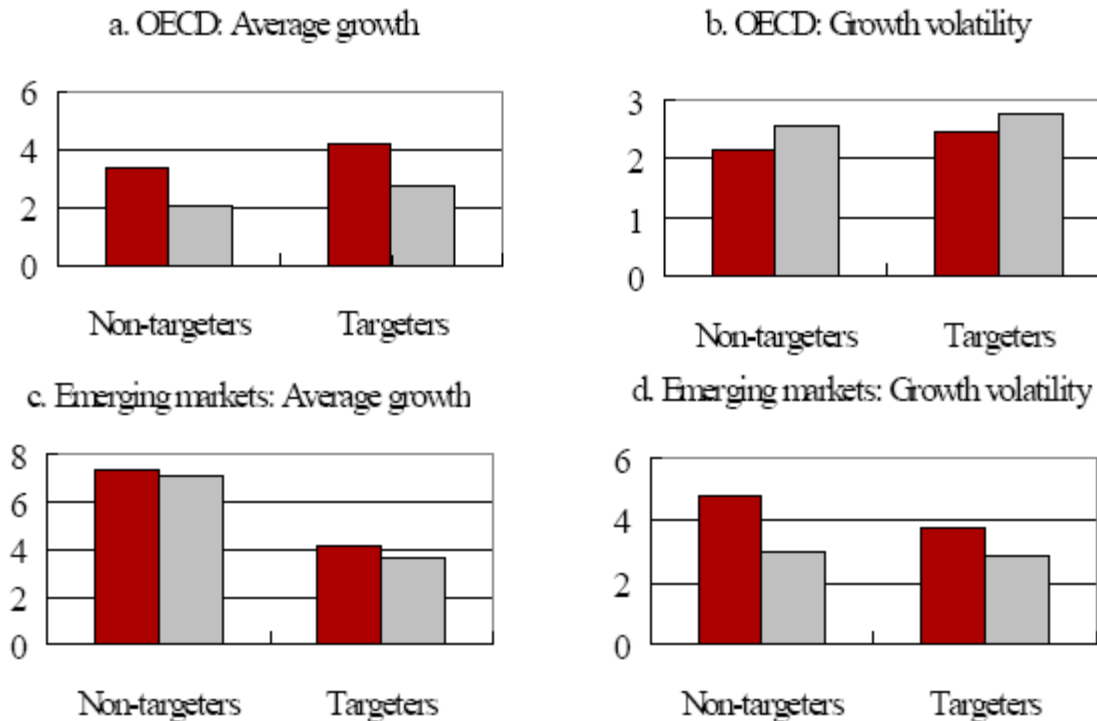
	1 year	3 years	5 years	6-10 years
Inflation targeters	0.00	0.00	0.00	0.024
Non-inflation targeters	0.23	0.12	0.07	0.00

Note: Expected inflation 1, 3, 5, and 6–10 years ahead; percentage-point responses to a 1 percentage point change in actual inflation.

Source: International Monetary Fund (2008, figure 3.12)

What else does IT do?

- Does IT put too much emphasis on inflation and kill economic growth? Not really.



For the NT countries, the threshold years are 1998 for the OECD countries and 2001 for the emerging-markets economies.

Does EMEs have what it takes?

- Pre-conditions to IT:
 - institutional independence of the central bank;
 - a well-developed technical infrastructure in terms of forecasting, modeling and data availability;
 - an economy with fully deregulated prices, not overly sensitive to commodity prices and exchange rates, and with minimal dollarization;
 - and a healthy financial system with sound banks and well-developed capital markets.
- Pre-conditions to IT:
- Batini and Laxton (2007) surveyed 21 EME central banks and found none of them have all the pre-conditions. Are they necessary before adopting?

Conclusion

- IT is by far the best form of monetary policy rule academics and practitioners have put forward.
- Anchoring expectations appear as the clear benefit from adopting IT.
- Countries don't need to full list of pre-condition to adopt, but a commitment to build credibility
- Another conclusion is that interest-rate policy is not enough to achieve financial stability. Monetary policy must be more than just interest rate setting.