Pros and cons of inflation targeting

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Outline

• What is inflation targeting?
• Alternative monetary policy regimes
• Benefits of Inflation Targeting
• Challenges to Inflation Targeting
• Conclusions
Inflation targeting

- Public announcement of quantitative target
- Price stability main goal of monetary policy
- Policy based on wide set of information, including inflation forecast
- Increased transparency
- Increased accountability
Inflation targeting in practice
Inflation targeters; start dates and initial inflation

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Alternative monetary policy regimes

1. Exchange rate target
2. Monetary aggregates target (with floating exchange rate)
3. Inflation target (with floating exchange rate)
4. Discretionary regime
Advantages and disadvantages of exchange rate targeting

1. Provide a nominal anchor
2. Reduce currency risk component
3. Prevents discretionary policy
4. Simple, clear, transparent: understood by agents thus leading to lower inflation expectations
5. May lead to economic climate where price stability takes important role
6. Useful when markets and instruments not developed
7. No scope for domestic policy
8. Shocks to anchor country propagated to domestic economy
9. Domestic economy must be flexible and similar to anchor country
10. Rate may be sub-optimal
11. CB loses ability to be lender of last resort
12. Can lead to fin. stability problems
13. Exit strategy
14. Subject to attacks if not credible
Advantages and disadvantages of monetary targeting

- Allows independent domestic policy
- Monetary data timely
- Does not depend on availability of forecast/models/good demand side data
- Needs reliable relationship between inflation and money aggregate
- Relationship undermined by financial market liberalisation and structural change

3. Difficult to explain to public
Advantages of IT

1. Policy linked to medium/long term goals, but with some short term flexibility (Bernanke 1999)
2. Target informs and anchors expectations (Orphanides and Williams 2003, Levine and co, 2004)
3. Systematic approach to policy makes it predictable \(\Rightarrow\) more influence over expectations
Advantages of IT

4. Institutional continuity (Bernanke)

5. Easy to explain to public
What is the empirical evidence?

• Ball and Sheridan (2003)
  – “Once one controls for regression to the mean, there is no evidence that inflation targeting improves performance”
• Other studies disagree
  – e.g. Vega and Winkelried (2005), Hyvonen (2004)
• Levin et al (2004) find evidence that persistence is lower, and expectations more anchored in IT countries.
Inflation targeting has been successful in emerging markets, “IT appears to have been associated with lower inflation, lower inflation expectations and lower inflation volatility relative to countries that have not adopted it”

*IMF WEO Aug 2005*
IT a relatively new framework

IT framework corresponded to time of Great stability/ NICE decade; When the going gets tough, will central bankers be blamed? Will IT frameworks survive?
Challenges

1. Challenges to the framework and concept
2. Asset prices
3. Changes in pricing dynamics
4. Communication challenges
5. Forecasting issues
1 Challenges to the framework

1. IT puts too much weight on inflation relative to other goals

2. ITers should say more about the weight they put on output gap stabilisation (Svensson, Woodford)

3. Inflation target reduces “flexibility”
   “Placing any number on an inflation objective - however much it would be surrounded with caveats - has the potential to constrain policy in some circumstances in which it would not be desirable to do so.” Don Kohn (2003)

4. IT ignores money
2 Asset prices and inflation targets

IT does not take sufficient account of asset prices?

• How should policy react to asset price booms?
  – Concern is financial instability, credit crunch that may accompany an asset price correction
  – Entirely consistent with inflation targeting, but need to look beyond the usual medium-term horizon
Asset prices and inflation targeting

• practical difficulties in implementation
  – Need to identify cause of asset price boom
  – Transmission lags imply only narrow window for pre-emptive policy
  – Small rate increases unlikely to be effective, but large increases imply large short-term costs
3 Changes in pricing dynamics

• Anchoring of inflation expectations and globalisation have:
  – Reduced response of inflation to demand shocks
  – Reduced inflation persistence; expectations do the work

• Pass-through of cost shocks also reduced
Response to lower profit margins

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4 Communication

“A central bank’s effectiveness is largely determined by its credibility. But what that now requires is not just an ability to make the right decisions at the right time. In order to manage expectations of interest rates and inflation, those decisions need to be put into context and explained in a way that is rational and consistent”

(Lambert 2004)
Techniques of communicating

• How precisely to define target?
• Press Conference?
• Minutes?
• Votes/Differences in view?
Communication strategy depends on decision making structure

Blinder and Wyplosz;
1. Governor takes decision; no votes no minutes
2. Autocratically-collegiate committee; pre-prepared statement for press conference
3. Consensus committee; no votes, no minutes, press conference important
4. Individualistic committee; no press conference; votes and minutes are key
5 Forecast issues

1. Energy prices; supply shocks
2. How much to say about the future; especially the future path of interest rates
Feb 2007 CPI inflation projection based on market interest rate expectations

Charts 5.3 and 5.4. The fan chart depict the probability of various outcomes for CPI inflation in the future. If economic circumstances identical to today’s were to prevail on 100 occasions, the MPC’s best collective judgement is that inflation over the subsequent three years would lie within the darkest central band on only 10 of those occasions. The chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 10 occasions. Consequently, inflation is expected to lie somewhere within the entire fan chart on around 90 occasions. The bands width widens over the extended time horizon, indicating the increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 Inflation Report for a fuller description of the fan chart and what it represents. The dashed line is drawn at the two-year point.
5 Interest rates in the inflation forecast

Conditioned on:

• Constant interest rates

• Interest rates expected in the market

• CB’s own forecast of interest rates
Feb 07 CPI inflation projection based on constant nominal interest rates at 5.25%
Feb 2007 CPI inflation projection based on market interest rate expectations

Charts 5.3 and 5.4 The fan chart depict the probability of various outcomes for CPI inflation in the future. If economic circumstances identical to today’s were to prevail on 100 occasions, the MPC’s best collective judgement is that inflation over the subsequent three years would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 10 occasions. Consequently, inflation is expected to lie somewhere within the entire fan chart on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 Inflation Report for a fuller description of the fan chart and what it represents. The dashed line is drawn at the two-year point.
Reserve Bank of New Zealand: 90 day interest rate projection

- Conditional projection includes upside and downside scenarios

Source: RBNZ Monetary Policy Statement December 2005

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Figure 2

Successive projections of 90 day interest rates

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Chart 1.11 Sight deposit rate in the baseline scenario and market expectations concerning the sight deposit rate.\(^1\) Per cent. Quarterly figures. 06 Q1 – 09 Q4

\(^1\) Derived from estimated forward rates. The sight deposit rate was reduced by a credit risk premium and a technical difference of 0.20 percentage point. The grey, shaded interval shows the highest and lowest interest rates in the market’s sight deposit rate path in the period 27 Feb – 10 Mar 2006.

Source: Norges Bank
Figure 1: Repo Rate with uncertainty bands

Source: The Riksbank
Should the central bank publish its projections for interest rates?

- Recent academic literature on CBs publishing interest rate paths (papers by Svensson, Goodhart and Woodford)
- Internal inconsistencies in forecast?
- Is it practical for a Committee to agree on a path?
- Does this information help the audiences we are targeting?
- Will the audiences understand the conditional nature of the projections?
Conclusions

Inflation targeting proved successful in those industrialised countries that adopted it.

Frameworks have been flexible.

But IT still relatively new.

Challenges to:
- concept
- Technical forecast issues
- Communications strategy