Inflation Targeting Assumes Growing Importance in Monetary Policymaking

In recent years, inflation targets have been increasingly adopted as the primary focus for the conduct of monetary policy, according to an analysis in the October 1996 edition of the *World Economic Outlook*. Countries that have adopted official inflation targets in the 1990s include Australia, Canada, Finland, New Zealand, Spain, Sweden, and the United Kingdom. By focusing on the ultimate goal of monetary policy—reasonable price stability, that is, inflation at rates low enough not to affect economic decisions—inflation targets may provide a more transparent framework for policy than alternative frameworks based on monetary targets or pegged exchange rates. Indeed, inflation targets have typically been adopted after unsuccessful experiences with either monetary targeting or pegged exchange rates, or both. Inflation targeting may not be the most appropriate monetary policy framework for all countries, however, according to the *World Economic Outlook*. It has been most useful in cases where policymakers have needed to establish a credible commitment to low-inflation policies. A number of countries that have been relatively successful at achieving and maintaining low inflation—including Germany, Japan, and the United States—have continued to eschew formal inflation targets.

Explicit inflation targets play two key roles in the effort to reduce and control inflation:

• By communicating to the public the objective that monetary policy seeks to accomplish, they serve as a coordination device in wage- and price-setting processes and in forming the public's inflation expectations.

• They provide a transparent guide to the conduct of monetary policy, whose commitment and credibility can then be assessed on the basis of whether policy actions are taken to ensure that the targets are achieved.

Accordingly, in those countries that have adopted them, inflation targets have become a key nominal anchor. Usually, inflation targets have not been supplemented by explicit intermediate targets for other nominal variables, such as monetary aggregates, although in principle it would not be inconsistent to do so.

Once an explicit inflation target is adopted, the authorities need to specify the price index to be used in calculating the inflation rate, the target inflation rate or range, the horizon over which the target applies, and the situations under which the target may be modified or even disregarded. In practice, countries have set targets for the rate of inflation rather than the price level, which implies that overshooting the inflation rate target need not be followed by undershooting, as would be the case if the objective were absolute stability of the price level. A variety of theoretical and statistical arguments have been advanced in favor of targeting a low, but non-zero, inflation rate. Most inflation targets have been specified as inflation bands with widths of up to 3 percentage points. While a single target rate might most effectively serve as a focal point for inflation expectations, a relatively narrow band may be more credible in view of the authorities' necessarily imperfect control over inflation. As to the appropriate price index, some countries target an inflation index that excludes particularly volatile items such as food and energy prices, indirect taxes and subsidies, and interest cost components; others directly target the broadly defined consumer price index.

The legal and institutional support for inflation targets differs across countries. In New Zealand, the targets were established as part of a thorough institutional reform, including a legislated goal of price stability and an independent and accountable central bank. In other cases, targets have been established by the central bank without an explicit commitment by the government to achieve them. In addition, accountability by the monetary authorities for their actions can vary considerably. For example, in the United Kingdom, although the Bank of England was given greater operational independence in determining the timing of monetary policy actions following the introduction of inflation targets in 1992, the Chancellor of the Exchequer (who is accountable to Parliament) retains control of monetary policy; but many other central banks are directly accountable to the legislature.

In practice, since monetary policy affects economic activity and inflation with long lags, and since knowledge of the monetary transmission mechanism is imperfect, policy must be forward looking and policymakers must rely on multiple indicators to evaluate the economy's inflation outlook. These indicators include monetary aggregates, the yield curve, movements in asset prices, market- or survey-based expectations of inflation, forecasts of the output gap, indicators of the fiscal stance, and exchange rate forecasts. Based on their evaluation of the inflation outlook, the authorities can choose a time path for the monetary policy instruments that results in a conditional probability distribution of future inflation consistent with achieving the inflation target. Instead of setting policy instruments on the basis of point estimates of future inflation, a more fruitful procedure has been to assess the risks and uncertainties associated with the inflation outlook and to set policy instruments according to probable inflation outcomes.

Since monetary policy decision making requires assessing current and future inflationary trends and comparing these trends with the announced inflation target, the process leaves room for discretion, the use of which will affect policy credibility. These considerations point to the importance of transparency and openness in the conduct of policy in relation to the operating framework. Thus, some aspects of the monetary policy process in the United Kingdom since 1992, such as the Bank of England's *Inflation Report* with its inflation forecast and the publication of the minutes of meetings between the Governor and the Chancellor, have increased both the transparency of policymaking and the accountability of the treasury and the central bank to the public.

In most countries, performance with inflation targets thus far has been satisfactory in some important respects. Despite the less-than-full credibility of the targets, which may be inferred from discrepancies between measures of the public's inflation expectations and the targets, inflation objectives have in most cases been achieved or surpassed. While this may seem impressive, a more complete judgment awaits the passage of at least a full business cycle. In most countries, the targets were introduced in periods of considerable economic slack, making it difficult to judge their performance since countries without explicit targets have also experienced low inflation in recent years. The advent of greater inflationary pressures in the future may show more decisively the effectiveness of inflation targeting relative to other monetary policy frameworks. These pressures, if and when they arise, may create divisions about the goals of monetary policy, which in turn may constitute a substantial test of the credibility and functioning of inflation targets. Finally, formal inflation targets are only one aspect of macroeconomic policy. As such they are likely to function best when fiscal policy and wage behavior are compatible with the inflation targets, and when the institutional arrangements concerning the status and policies of the central bank are supportive.

Inflation Targeting: Some Theoretical Considerations

To achieve price stability, central banks in several industrial countries have geared their monetary policy toward ensuring that inflation stays within an agreed-upon target range. An IMF Working Paper by John H. Green of the IMF's Monetary and Exchange Affairs Department assesses the theoretical effectiveness of inflation targeting in helping achieve greater price stability.

The major question guiding the working paper is: can inflation targeting in fact deliver long-run price stability, or does it suffer from the drawbacks associated with other kinds of discretionary policies that in theory can lead to an inflation bias? The study concludes that inflation targeting can deliver long-run price stability if either price stability is made the single policy objective or consistent targets for both inflation and output are set.

Who Has Adopted Targeting?

As a monetary policy framework, inflation targeting has been adopted in several industrial countries. New Zealand first announced an inflation target in 1990 as part of its economic reform and restructuring program, and Canada followed in early 1991. In the wake of the European exchange rate mechanism (ERM) crisis in September 1992, the United Kingdom announced an inflation target to replace the exchange rate anchor that had been in place for two years. Under similar circumstances, Sweden and Finland set up inflation targets during the same period. Australia and Spain have also announced inflation targets.

How Do Targets Work?

In an inflation-targeting regime, the government announces a target or, more typically, a target range for future inflation. A change in the current policy stance is indicated if projected inflation over a one- to two-year time horizon falls outside of the announced range. Operationally, then, inflation targeting can be viewed as a two-step process whereby the monetary authority must first make an inflation forecast to assess whether, under current policies, inflation is likely to remain within the announced target range. The second step is *(Continued on next page)*

(Continued on from page 2) taken in the event future inflation is judged likely to move outside the target; in this instance, necessary policy measures are taken to help ensure that the projected inflation rate is kept within the target range.

Increased transparency can be an important part of inflation targeting. Measures to increase transparency—regular publication of central bank and treasury assessments of inflation and inflation prospects, for example—can be used to strengthen public support for a given inflation targeting strategy. It can also serve as a means of conveying, implicitly or explicitly, an output target.

How Are Targets Best Implemented?

Inflation targeting alone may not resolve the underlying potential problem of inflationary bias that arises when a central bank can trade off inflation for higher output in the short run. The problem can be overcome, however, if one of two alternative courses of action is followed:

- Price stability is made to be the single objective of policy. By focusing solely on price stability, the monetary authority commits to refrain from surprise inflation—that is, it will not lower interest rates to stimulate the economy in a way that could trigger inflation. This approach, however, may require certain institutional arrangements that hold the monetary authority to the single inflation objective.
- A dual policy objective is adopted. By announcing an output objective consistent with price stability over the long run—attempting to keep output growth in line with the economy's potential but not above it—the monetary authority can enhance its credibility. Transparency measures, such as those adopted in the inflation-targeting countries, implicitly contribute to credibility in this way.

Copies of Working Paper 96/65 *Inflation Targeting: Theory and Policy Implications*, by John H. Green, are available for $7.00 from Publication Services, Box XS600, International Monetary Fund, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org