

Inflation targeting: dead or alive?

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Abstract

The present paper investigates how the global financial crisis has prompted the need to revise monetary policy in general and inflation targeting in particular, with the final purpose of establishing whether the crisis has rendered inflation targeting obsolete or has only strengthened its position as the central banking orthodoxy of our days. Departing from an outline of inflation targeting fundamentals and a brief history of monetary policy, the paper explores the merits of and criticism on inflation targeting from a theoretical as well as practical perspective. Finally, conclusions are drawn upon the analysis and prospects for the future, including proposed successors of inflation targeting, are briefly explored.

Keywords: inflation targeting, monetary policy, central banks.

JEL Classification: E3, E31, E4, E5

Introduction

Amidst the world economic turmoil that began in mid 2007 and continues to claim its victims ever since, the death announcement of inflation targeting came in May 2012. The obituary of inflation targeting was written by Jeffrey Frankel, professor at Harvard University and former economic advisor to the Clinton administration, who argued that the monetary policy regime born in New Zealand in March 1990, passed away in September 2008, when the subprime mortgage crisis reached its critical stage. Oddly enough, the death announcement was made almost five years after the unfortunate event itself, which is said to be partly due to the difficulty of finding a suitable successor. But as this problem seems to have been finally figured out, Frankel (2012) decided to take a stance and made the traditional proclamation: “Inflation targeting is dead: long live nominal GDP targeting”.

Since its first formal adoption in 1990, the monetary policy strategy centered on meeting publicly announced medium-term numerical targets for inflation gained great popularity and was adhered to by an increasing number of central banks around the world. As of today, there are approximately 39 countries all over the world that have either fully adopted, are in the process of adopting inflation targeting or are implicit inflation targeters (Warburton & Davies, 2012). No country has so far abandoned inflation targeting after adopting it, except for joining the euro area (Svensson, 2010), which suggests that its performance has been quite satisfactory.

A key advantage of inflation targeting is the fact that it is easily understood by the public and is highly transparent. A great importance is placed on transparency and regular communications with the public, which contributes significantly to reducing uncertainty about monetary policy, interest rates and inflation, and promotes public debate on monetary policy. Add to this superior level of information and understanding the fact that inflation targeting is based on an explicit numerical target for inflation, and you obtain a great tool for holding central banks accountable. Furthermore, inflation targeting diminishes the potential for central banks to fall into the time-inconsistency trap, which consists in increasing short-run economic growth and employment at the expense of increased long-run inflation (Mishkin, 2000).

Nevertheless, the recent financial crisis has revealed some disturbing failures of inflation targeting and has brought the future of the monetary policy under severe scrutiny. The lively debate about what caused the crisis questioned severely the soundness of monetary policy and blamed it for laying the foundations for the crisis. The opinions are, however, split on whether the crisis has rendered inflation targeting obsolete or has only strengthened its position as the best-practice monetary policy regime. The debate continues but one thing is certain: inflation targeting is a reality of our days. The purpose of the present paper is to assess the merits and failures of inflation targeting, and hopefully to provide a clear answer to the question of whether inflation targeting is dead or alive.

A historical pattern

There aren't few the ones who view the wide acceptance of inflation targeting merely as a pragmatic response to the failure of other monetary policy regimes rather than the result of new economic thinking (Jahan, 2012). Indeed, a brief glance at the recent history of monetary policy reveals a pattern of the kind. In the early 1980's money-supply targeting was the monetary policy of choice (Frankel, 2012). It consisted in targeting the growth of a nation's money supply with the purpose of controlling inflation, strategy which could have went fairly well provided that central banks were actually able to control the money supply and there existed a stable relation over time between money supply and inflation. But as innovations in the financial markets began

to spread and gain magnitude, the demand for money became highly unstable and the reign of money-supply targeting was abruptly terminated in favor of exchange-rate targeting.

Intuitively enough, exchange-rate targeting involved linking the value of a country's domestic currency to that of a presumably stable, low-inflation country called anchor country. This implied that the targeting country was forced to pursue essentially the same monetary policy as the anchor country and so it lost the ability to respond to domestic shocks that were independent of those hitting the anchor country (Mishkin, 2004). However, it was the exposure of countries to speculative attacks on their currencies that represented the biggest problem inherent to exchange-rate targeting and it was the very problem that brought the regime to an end. It happened during the currency crises of the 1990's, when many speculators attacked the foreign exchange value of various targeting countries' currencies by making massive bets on their depreciation against the anchor country's currency. The result was a sharp depreciation of the attacked currencies and the ultimate demise of exchange-rate targeting.

In this context where authorities truly needed to anchor public expectations regarding monetary policy, inflation targeting was, as Jeffrey Frankel simply puts it, "in the right place at the right time". Unlike money-supply targeting, its success was independent from the existence of a stable relationship between money and inflation. Unlike exchange-rate targeting, it allowed focusing on domestic considerations and respond to domestic shocks. Add to these the advantages of increased transparency and accountability as well as the fact that inflation targeting employs all available information, and not just monetary aggregates, in the process of monetary policy setting and it becomes clear why, by the end of the 1990's, inflation targeting had become the new central banking orthodoxy (Warburton & Davies, 2012).

The privileged position held by inflation targeting as the best-practice monetary policy was, however, shaken by the 2008 financial crisis and the resulting deep recession, just as it happened with the currency crisis that hit exchange-rate targeting in the 1990's. The future of monetary policy is yet to be decided but if we go by the old saying "history repeats itself", we might as well acknowledge that the glory days of inflation targeting might have passed and a new "star" is to be found. One leading candidate for this position, proposed by Frankel, is nominal GDP targeting, a variation on inflation targeting which targets the growth rate of nominal GDP (real GDP times the price level) rather than inflation (Mishkin, 2004). It remains, however, to be seen whether nominal GDP targeting will occupy a place in the history of monetary policy as the successor of inflation targeting.

A theoretical perspective

Needless to stress out, the flawless monetary policy is yet to be discovered and inflation targeting makes no exception, as a regime with inherent disadvantages. One common concern about inflation targeting is that it leads to low growth in output and employment. This concern is rooted in a theory dating back to 1958, known as the Phillips curve tradeoff, according to which there is a long-run tradeoff between inflation and unemployment, and monetary authorities can achieve a permanently lower rate of unemployment by accepting a rise in inflation (Bernanke, Laubach, Mishkin & Posen, 2001). Ten years later, this theory was declared wrong by Friedman and Phelps, who argued that higher inflation can indeed stimulate the economy and lower employment for short periods, but in the long-run output and unemployment will return to their normal levels and only inflation will have been permanently affected (Bernanke et al., 2001). A conservative conclusion is that although inflation reduction adversely affects economic growth and employment in the short-run, once the low inflation target is achieved output and employment will bounce back to levels as high as before (Mishkin, 2004).

The apparently exclusive focus of inflation targeting on price stability to the detriment of other macroeconomic goals represents another topic that has raised major concerns regarding inflation targeting. The rationale for which the primary-goal of monetary policy should be price stability has been long documented and explained by Bernanke et al. (2001) who rest their case on the following three arguments. First of all, three decades of monetary policy history have led most macroeconomists to recognize that, in the long run, inflation is the only variable that can be affected by monetary policy. Secondly, there is a macroeconomic consensus that the maintenance of a low and stable rate of inflation is not only important, but perhaps necessary, for the achievement of other macroeconomic goals. Thirdly, an inflation target serves as an anchor for the expectations of financial markets and the public in general, and imposes discipline and accountability in conducting monetary policy by serving as a reference point against which to judge the desirability of short-run policies against the long-run inflation goals.

These strong arguments in favor of centering monetary policy on price stability should not, however, lead to the deceitful impression that inflation targets are so important that they must be pursued at all costs. This point is emphasized by Svensson (2010), who makes a distinction between strict inflation targeting, which aims at stabilizing only inflation with no regard to the stability of the real economy, and flexible inflation targeting, which aims at stabilizing both inflation and real economic developments. In practice inflation targeting is always flexible, with the monetary authorities addressing not only price stability but also the stabilization of resource utilization around a normal level (Svensson, 2010).

Nevertheless, an important criticism of inflation targeting is that an exclusive focus on inflation would lead to very poor economic outcomes and would destabilize the economy in the event of large supply side shocks (Bernanke et al., 2001). Simply put, rigid adherence to inflation targets alone has the potential of increasing output instability. To convey a picture in this sense, imagine the case of a negative supply shock that raises the inflation rate and lowers output; if the only concern of the monetary authority is price stability, this will trigger a tightening of monetary policy to meet the target inflation rate which will cause the output to decline even further. The fact that all inflation targeting countries have set their inflation targets above zero is, however, a clear proof that monetary authorities do display concern about output fluctuations and acknowledge the fact that a particularly low level of inflation can have substantial negative effects on real economic activity.

Furthermore, there aren't few the critics that interpret inflation targeting as a rigid rule on monetary policy, which prescribes simple and mechanical instructions on how monetary policy should be conducted and thus limits the discretion of monetary authorities to respond to unforeseen circumstances (Mishkin, 2004). Advocates of inflation targeting could not disagree more with this view, as they argue that inflation targeting is far from being rigid and would be better described as a "constrained discretion" policy in which central banks are left with considerable scope to respond to short-run phenomena while keeping in mind the constraints imposed by the long-term inflation targets (Bernanke et al., 2001; Mishkin, 2004; Kuttner & Posen, 2012). Elements of flexibility in inflation-targeting regimes consist in allowing inflation to deviate from the target or modifying the target, as well as modifying the price index on which the inflation targets are based in order to exclude or moderate the effect of supply shocks. Furthermore, research has revealed that the monetary policy frameworks that formally target inflation are by no means less flexible than those that do not have formal inflation targets (Kuttner & Posen, 2012).

A practical perspective

Besides these textbook pros and cons of inflation targeting, the current financial crisis has revealed some practical shortcomings of the regime, which might prove to be the only ones that matter in deciding the future of inflation targeting. One of the first economists to highlight the failure of inflation targeting was Joseph Stiglitz, Nobel laureate in economics, in an article dating back to 2008, the year of the alleged death. He argued that the crude recipe laying at the core of inflation targeting of raising interest rates whenever price growth exceeds a target level, not only that is based on little economic theory or empirical evidence but it completely disregards the source of inflation by applying a single best “treatment” to all types of inflation. His article made the case of developing countries facing imported inflation due to high international prices of food and fuel, for which domestic measures of raising interest rates to bring down inflation would have little or even negative effects, causing marked economic slowdowns and high unemployment. He argued that only action from the world economic powers could meaningfully influence international prices and concluded that in the context of rising food and energy prices, the economic slowdowns and higher unemployment brought by inflation targeting would only make survival more difficult for developing as well as developed countries.

The inappropriate response of inflation targeting to supply shocks¹ and terms-of-trade shocks² was also cited by Frankel in his 2012 article. The specific way in which inflation targeting fell short of appropriately addressing these aspects consists in its anomalous response to terms of trade fluctuations, which is due to the choice of the consumer price index (CPI) as the operational target used to measure inflation. The appropriate response to an increase in the world price of *imported* commodities is the loosening of monetary policy, but the response commanded by CPI inflation targeting is to tighten money enough to appreciate the currency (Frankel, 2012). Conversely, the appropriate response to an increase in the world price of *exported* commodities is the tightening of monetary policy, but a CPI inflation target prevents the monetary authorities from tightening money (Frankel, 2012). Simply stated, strict adherence to a CPI target delivers exactly the wrong outcome. Unfortunately, this is not a theoretical example of what can go wrong with inflation targeting. The puzzling decision of the European Central Bank to raise interest rates in July 2008, when the economy was facing the toughest moment since the 1930’s, is widely suspected to have been an attempt to stabilize the CPI as oil prices were reaching record high levels (Frankel, 2012). It may seem therefore that rigid adherence to inflation targets can preclude, after all, other considerations.

All things considered, the strongest argument against inflation targeting, also brought by Frankel, is its lack of response to asset-price bubbles. The burst of the subprime mortgage crisis made it clear that asset bubble had not been paid sufficient attention and one important factor which led to the aforementioned situation is said to have been inflation targeting and its sole focus on the operational target used to measure inflation, meaning the CPI. Needless to stress out, the CPI captures only the price level of consumer goods and services, and does not account for investment items such as real estate, insurance and financial instruments in general. Central

¹ Supply shocks are events that cause sudden changes in the relative prices of certain commodities or services, such as technology and raw materials, which influence production costs and therefore the aggregate supply of an economy (Ball & Mankiw, 1995; Mishkin, 2004).

² Terms of trade shocks, on the other hand, reflect sudden, large, and enduring changes either in import or export prices which in turn affect national wealth and growth. (Funke, Granziera & Imam, 2008)

banks thought, however, that housing and equity prices implied information regarding goods inflation and therefore were paid all the attention they deserved. This proved to be awfully wrong and this is how the boom-bust cycle came without inflation (Frankel, 2012). There is no doubt that inflation targeting failed to signal the asset-price bubble and the problem seems to have been the price index it employed.

But the declaration of the Bank of Thailand's Chairman, Virabongsa Ramangkura, that "inflation targeting is no longer effective because inflation has been globalised" might just have been, if not the last, at least another nail in the coffin of inflation targeting. Virabongsa stated that in small economies with a high degree of openness to trade, such as Thailand, local commodity prices are determined by global supply and demand forces, and not by the policy of a particular country; the source of instability for emerging countries is thus foreign exchange and not inflation. A monetary policy debate has sparked after this declaration has been made, at the beginning of August 2012, and alternatives frameworks are now being proposed to replace inflation targeting in the pursuit of economic growth.

Conclusions and prospects for the future

Despite the criticism and failures of inflation targeting, the regime still has its supporters. According to Svensson (2010), flexible inflation targeting, applied in the right way and using all the relevant information for the forecast of inflation and resource utilization, remains the best-practice monetary policy before, during, and after the financial crisis. Mark Carney (2012), governor of the Bank of Canada, refers to flexible inflation targeting as being arguably the most successful monetary policy idea in history and holds the view that is not the time to risk abandoning frameworks that have proved their worth through the crisis and will probably be essential to sustain the recovery. Furthermore, it is a fact that no central bank has yet formally abandoned inflation targeting and the Federal Reserve has even released this year, for the first time in its history, an explicit inflation target.

However, the global financial crisis has revealed some serious shortcomings of inflation targeting, namely its lack of response to asset-price bubble as well as its inappropriate response to supply shocks and terms-of-trade shocks. The operational target used to measure inflation (the consumer price index) has proved to be one of the major causes of the regime's failures, and an alternative monetary policy proposed by Frankel (2012) to address this issue is product-price targeting, a monetary policy focused on stabilizing an index of producer prices rather than an index of consumer prices. The regime preferred by Frankel (2012) to succeed inflation targeting is, however, nominal GDP targeting, a monetary policy targeting a country's value of output for a given year as measured by the prices prevailing during that year. Quite obviously, it holds an advantage over inflation targeting in that it puts weight both on prices and on output, and thus it does not cause excessive tightening in response to adverse supply shocks. But most importantly, nominal GDP targeting is believed to provide a way of achieving monetary expansion, which in the context of the present economic state of affairs is unarguably its biggest advantage.

The validity of both the merits and the criticism of inflation targeting remains arguable, but inflation targeting seems indeed to be dying. I would personally not declare it dead yet, and even less so agree with the statement that it died in 2008, but its effectiveness has been seriously impaired by the so-called globalization of inflation, as the power to control inflation has been shifted from the hands of individual countries to a more international level. This phenomenon is even more exacerbated for small developing countries that are highly dependent on international trade, and which will be probably forced to demise inflation targeting. Inflation targeting may,

however, survive in developed countries that can actually exercise an influence on international prices, but this is something that only time can tell. The fact that inflation targeting has resisted the past five years of economic turmoil is by no means a negligible fact and, regardless of the final outcome, inflation targeting has proved to be a very powerful and esteemed monetary policy strategy; if, however, inflation targeting will successfully survive the biggest depression from the 1930's, then it is the greatest monetary policy framework in history. As to the question of what will be the successor of inflation targeting, I think that there will be no single regime suitable to all the countries that are currently targeting inflation, and that the choice of a new regime will be tailored to the stage of economic development and the particularities of each individual country.

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