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Inflation Targeting: Holding the Line

FINANCE & DEVELOPMENT

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Central banks use interest rates to steer price increases toward a publicly announced goal

Central banks' bullseyes (photo: Eddie Keogh/Reuters)

Inflation, a rise in the overall level of prices, is often bad news. It erodes savings, discourages investment, stimulates capital flight (as domestic investors put their funds into foreign assets, precious metals, or unproductive real estate), inhibits growth, makes economic planning a nightmare, and, in its extreme form, provokes social and political unrest. Governments consequently have tried to squelch inflation by adopting conservative and sustainable fiscal and monetary policies.

In recent years, many central banks, the makers of monetary policy, have adopted a technique called ***inflation targeting*** to control the general rise in the price level. In this framework, a central bank estimates and makes public a projected, or "target," inflation rate and then attempts to steer actual inflation toward that target, using such tools as interest rate changes. Because interest rates and inflation rates tend to move in opposite directions, the likely actions a central bank will take to raise or lower interest rates become more transparent under an inflation targeting policy. Advocates of inflation targeting think this leads to increased economic stability.

Why inflation targeting?

Many central banks adopted inflation targeting as a pragmatic response to the failure of other monetary policy regimes, such as those that targeted the money supply or the value of the currency in relation to another, presumably stable, currency. In general, a monetary policy framework provides a *nominal anchor* to the economy. A nominal anchor is a variable policymakers can use to tie down the price level. One nominal anchor central banks used in the past was a currency peg—which linked the value of the domestic currency to the value of the currency of a low-inflation country. But this approach meant that the country's monetary policy was essentially that of the country to which it pegged, and it constrained the central bank's ability to respond to such shocks as changes in the terms of trade (the value of a country's exports relative to that of its imports) or changes in the real interest rate. As a result, many countries began to adopt flexible exchange rates, which forced them to find a new anchor.

Many central banks then began targeting the growth of money supply to control inflation. This approach works if the central bank can control the money supply reasonably well and if money growth is stably related to inflation over time. Ultimately, monetary targeting had limited success because the demand for money became unstable—often because of innovations in the financial markets. As a result, many countries with flexible exchange rates began to target inflation more directly, based on their understanding of the links or "transmission mechanism" from the central bank's policy instruments (such as interest rates) to inflation.

How does inflation targeting work?

Inflation targeting is straightforward, at least in theory. The central bank forecasts the future path of inflation and compares it with the target inflation rate (the rate the government believes is appropriate for the economy). The difference between the forecast and the target determines how much monetary policy has to be adjusted. Some countries have chosen inflation targets with symmetrical ranges around a midpoint, while others have identified only a target rate or an upper limit to inflation. All countries have set their inflation targets in the low single digits. An inflation target of zero is not recommended because it would not allow real interest rates to fall sufficiently to stimulate overall demand when a central bank is trying to boost the economy.

A major advantage of inflation targeting is that it combines elements of both "rules" and "discretion" in monetary policy. This "constrained discretion" framework combines two distinct elements: a precise numerical target for inflation in the medium term and a response to economic shocks in the short term.

Rather than focusing on achieving the target at all times, the approach has emphasized achieving the target over the medium term—typically over a two- to three-year horizon. This allows policy to address other objectives—such as smoothing output—over the short term. Thus, inflation targeting provides a rule-like framework within which the central bank has the discretion to react to shocks. Because of inflation targeting's medium-term focus, policymakers need not feel compelled to do "whatever it takes" to meet targets on a period-by-period basis.

What is required?

Inflation targeting requires two things. The first is *a central bank able to conduct monetary policy with some degree of independence*. No central bank can be entirely independent of government influence, but it must be free in choosing the instruments to achieve the rate of inflation that the government deems appropriate. Fiscal policy considerations cannot dictate monetary policy. The second requirement is *the willingness and ability of the monetary authorities not to target other indicators*, such as wages, the level of employment, or the exchange rate.

Having satisfied these two basic requirements, a country can, in theory, conduct a monetary policy centered on inflation targeting. In practice, the authorities may also take certain preliminary steps:

● Establish explicit *quantitative targets* for inflation for a specific number of periods ahead.

● Indicate clearly and unambiguously to the public that hitting the inflation target takes precedence over all other objectives of monetary policy.

● Set up a model or methodology for *inflation forecasting* that uses a number of indicators containing information about future inflation.

● Devise a *forward-looking operating procedure* through which monetary policy instruments are adjusted (in line with the assessment of future inflation) to hit the chosen target.

Target practitioners?

Central banks from advanced, emerging, and developing economies and from every continent have adopted inflation targeting (see table). Full-fledged inflation targeters are countries that make an explicit commitment to meet a specified inflation rate or range within a specified time frame, regularly announce their targets to the public, and have institutional arrangements to ensure that the central bank is accountable for meeting the target.

Targeting inflation

There are 28 countries that use inflation targeting, fixing the consumer price index as their monetary policy goal. Three other countries—Finland, the Slovak Republic, and Spain—adopted inflation targeting but abandoned it when they began to use the euro as their currency.

Country	Inflation targeting adoption date	Inflation rate at adoption date (percent)	2010 end-of-year inflation (percent)	Target inflation rate (percent)
New Zealand	1990	3.30	4.03	1 - 3
Canada	1991	6.90	2.23	2 +/- 1
United Kingdom	1992	4.00	3.39	2
Australia	1993	2.00	2.65	2 - 3
Sweden	1993	1.80	2.10	2
Czech Republic	1997	6.80	2.00	3 +/- 1
Israel	1997	8.10	2.62	2 +/- 1
Poland	1998	10.60	3.10	2.5 +/- 1
Brazil	1999	3.30	5.91	4.5 +/- 1
Chile	1999	3.20	2.97	3 +/- 1
Colombia	1999	9.30	3.17	2 - 4
South Africa	2000	2.60	3.50	3 - 6
Thailand	2000	0.80	3.05	0.5 - 3
Hungary	2001	10.80	4.20	3 +/- 1
Mexico	2001	9.00	4.40	3 +/- 1
Iceland	2001	4.10	2.37	2.5 +/- 1.5
Korea, Republic of	2001	2.90	3.51	3 +/- 1
Norway	2001	3.60	2.76	2.5 +/- 1
Peru	2002	−0.10	2.08	2 +/- 1
Philippines	2002	4.50	3.00	4 +/- 1
Guatemala	2005	9.20	5.39	5 +/- 1
Indonesia	2005	7.40	6.96	5 +/- 1
Romania	2005	9.30	8.00	3 +/- 1
Serbia	2006	10.80	10.29	4 - 8

Turkey	2006	7.70	6.40	5.5 +/- 2
Armenia	2006	5.20	9.35	4.5 +/- 1.5
Ghana	2007	10.50	8.58	8.5 +/- 2
Albania	2009	3.70	3.40	3 +/- 1

Sources: Hammond, 2011; Roger, 2010; and IMF staff calculations.

The first country to adopt inflation targeting was New Zealand, in December 1989. The only central banks to have stopped inflation targeting once they started it are Finland, Spain, and the Slovak Republic in each case after they adopted the euro as their domestic currency. Armenia, the Czech Republic, Hungary, and Poland adopted inflation targeting while they were making the transition from centrally planned to market economies. Several emerging market economies adopted inflation targeting after the 1997 crisis, which forced a number of countries to abandon fixed exchange rate pegs.

Many economies use an inflation target to define their monetary policy framework but are unable to maintain the inflation target as the foremost policy objective. This monetary policy regime is often referred to as "inflation targeting light" (ITL). The ITL countries choose not to adopt a fixed exchange rate because it would leave them vulnerable to a speculative attack, but a monetary target is not practical due to the instability in money demand. Yet they do not become full-fledged inflation targeters because of constraints, such as the absence of a sufficiently strong fiscal position. Often, ITL is used as a transitional approach—aiming at maintaining monetary stability until the implementation of structural reforms in support of a single nominal anchor. Poland, for example, switched from monetary targeting to ITL before making the full transition to inflation targeting.

There are also a number of central banks in more advanced economies—including the European Central Bank, the U.S. Federal Reserve, the Bank of Japan, and the Swiss National Bank—that have adopted many of the main elements of inflation targeting, and several others are moving toward it. Although these central banks are committed to achieving low inflation, they do not announce explicit numerical targets or have other objectives, such as promoting maximum employment and moderate long-term interest rates, in addition to stable prices.

On target?

It is difficult to distinguish between the specific impact of inflation targeting and the general impact of more far-reaching concurrent economic reforms. Nonetheless empirical evidence on the performance of inflation targeting is broadly, though not totally, supportive of the effectiveness of the framework in delivering low inflation, anchoring inflation expectations, and lowering inflation volatility. Moreover, these gains in inflation performance were achieved with no adverse effects on output and interest volatility.

Inflation targeters also seem to have been more resilient in turbulent environments. Recent studies have found that in emerging economies, inflation targeting seems to have been more effective than alternative monetary policy frameworks in anchoring public inflation expectations. Furthermore, the monetary policy of inflation targeters appeared to be more suited to dealing with the recent financial crisis.

In some countries, notably in Latin America, the adoption of inflation targeting was accompanied by better fiscal policies. Often, it has also been accompanied by the enhancement of technical capacity in the central bank and improvement of macroeconomic data. Because inflation targeting also depends to a large extent on the interest rate channel to transmit monetary policy, some emerging economies also took steps to strengthen and develop the financial sector. Thus, the monetary policy outcomes after the adoption of inflation targeting may reflect improved broader economic, not just monetary, policymaking.

Not a panacea

Inflation targeting has been successfully practiced in a growing number of countries over the past 20 years, and many more countries are moving toward this framework. Over time, inflation targeting has proven to be a flexible framework that has been resilient in changing circumstances, including during the recent global financial crisis. Individual countries, however, must assess their economies to determine whether inflation targeting is appropriate for them or if it can be tailored to suit their needs. For example, in many open economies, the exchange rate plays a pivotal role in stabilizing output and inflation. In such countries, policymakers must debate the appropriate role of the exchange rate and whether it should be subordinated to the inflation objective.

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