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INFLATION TARGETING

PRO INFLATION TARGETING: YES, BUT ...

PETER BOFINGER*

Inflation targeting was born “a child of need”. In the late 1980s and early 1990s monetary policy strategies that had seemed to have worked quite well in the past, suddenly became inapplicable. The ERM crises of 1992/93 ended the strategy of exchange rate targeting for the United Kingdom, Finland and Sweden almost over night. In Canada and New Zealand policy makers were becoming increasingly dissatisfied with monetary targeting.

Confronted with the need to fill a vast conceptual vacuum, central bankers decided to focus on the obvious: a monetary policy approach that aims at a low inflation rate by pursuing an interest rate policy that is mainly guided by available inflation forecasts for two years ahead. Traditional intermediate targets like the money stock and the exchange rate are no longer given a “prominent role”, but they are still regarded important determinants of the inflation forecasts. For this policy framework the appealing name “inflation targeting” was invented.

In a very general form inflation targeting can be regarded as synonymous to what is normally (and especially in Germany) understood as a stability-oriented monetary policy. Thus, almost all major central banks could be regarded as inflation targeter. This applies even to those central banks which pretend to follow a strategy of monetary targeting. For instance, reaction functions for the Bundesbank show very clearly that money growth was not a dominant factor in the decisions of its Central Bank Council. For the ECB, the role of its “reference value” for the money stock M3 cannot yet be adequately assessed, but its first interest rate decision, a reduction on 9 April 1999 was clearly incompatible with an excessively high monetary

growth rate at that time. In the case of the Federal Reserve System, no specific intermediate target has been announced in the last decade and there is also no doubt that Alan Greenspan is following a forward-looking approach in the Fed’s interest rate decisions.

Of course, to many adherents of inflation targeting, this approach goes beyond a general commitment to price stability as the main target of monetary policy. It is above all Lars Svensson¹ who regards inflation targeting as a clearly specified policy rule (“targeting rule”) and who emphasises the need for central banks to publish their internal inflation forecasts.

The monetary policy rule of inflation targeting sounds relatively simple. A central bank compares the inflation forecast for two years ahead (which is conditional on the actual short-term interest rate) with its inflation target. If the forecast exceeds the target, the short-term rate must be raised and vice versa. Analogous to monetary and exchange rate targeting, the inflation forecast is regarded an intermediate target of monetary policy; consequently Svensson has coined the term “inflation-forecast-targeting”. Upon closer scrutiny this rule is far from being simple. While it is easy to compare target and forecast, it is by no means easy to arrive at an inflation forecast. As the proponents of inflation targeting only offer very general recommendations for this difficult task (“look at everything which is needed as an input for a good econometric model”), their “rule” provides a central bank with little help in its difficult business of setting short-term interest rates. Thus, compared with a “simple rule” like a Taylor rule or the rule of monetary targeting which both reduce the complexity of a central banker’s decision process, “rule” is simply a misnomer when applied to inflation targeting.

The second key feature of narrowly defined inflation targeting is the publication of a central bank’s inflation forecast. It is argued that this (ideally



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¹ Lars E.O. Svensson (1999), “Inflation Targeting as a Monetary Policy Rule”, *Journal of Monetary Economics*, forthcoming.

together with the minutes of a central bank's decision making body) would enhance the accountability of monetary policy. In this context it is necessary to make a distinction between two forms of accountability. Ex-post accountability means that a central bank has to justify actual deviations of the inflation rate from its target rate. Ex-ante accountability is a forward-looking concept according to which a central bank is already to be held accountable for expected deviations of the inflation rate from its target value. Because of the long lags of monetary policy decisions this forward-looking dimension of accountability is certainly very important. The main question is whether the central bank's own forecast is an ideal benchmark for that exercise. Following the literature based on the Barro-Gordon model, one must be aware of the risk that a central bank that intends a policy of surprise inflation will not be providing an honest forecast. Therefore, ex-ante accountability should be based on the external assessment of future price changes. Useful data for that purpose may be obtained from the forecasts of international institutions (IMF, OECD), from consensus forecasts of private institutions, from the forecasts that are implicit in financial market prices, and from wage agreements. Thus an efficient ex-ante accountability normally does not require a forecast by the

central bank itself. The only exception is a situation where the central bank's forecast deviates from external forecasts. By publishing its forecast and explaining how it has been derived the central bank could try to correct an inadequate external assessment of its policy.

All in all, if inflation targeting is understood in the very general sense of a "stability-oriented monetary policy" there is little one could object to such an approach. However, such a framework provides little concrete guidance for the conduct of monetary policy. This is somewhat different for the more narrowly defined inflation targeting suggested e.g. by Lars Svensson. His "targeting rule" is useful as a very broad guideline, but for concrete interest rate decisions it simply states the obvious. The most important element of this more narrow approach consists of the inflation forecasts and their very useful contribution to the ex-ante accountability of monetary policy. For that purpose, external forecasts of inflation are the key factor, while the central bank's own forecast is only needed if it differs considerably from external forecasts.

For more information on inflation targeting see my homepage: www.geldpolitik-online.de