

Inflation Targeting

BY JENNIFER WANG

The debate over best-practice monetary policy is escalating: Will it be rule-based or discretionary?

In January of 1995, the Federal Open Market Committee (FOMC) held a debate on inflation targeting. Al Broaddus, then-president of the Richmond Fed, presented arguments in favor of inflation targeting, while Governor Janet Yellen (now president of the Federal Reserve Bank of San Francisco) provided the counterarguments. The debate ended with Chairman Alan Greenspan declaring the Committee “as split down the middle as we could possibly get.”

A decade later, the issue of inflation targeting continues to spark discussion within the Federal Reserve System. The topic remains as controversial as ever, and as Greenspan’s current and final term draws nearer to its February 2006 end date, the topic will no doubt receive additional attention.

Since 1979, the Fed has vigorously pursued a policy of price stability, first under Chairman Paul Volcker, and now under Chairman Greenspan. But uncertainty over Greenspan’s successor causes some to fear that discretionary power in the wrong hands may reverse the work done in the last 25 years.

The proposed solution? An inflation targeting framework for monetary policy.

While inflation levels are stable, advocates of an inflation targeting framework want to set a few guidelines

to institutionalize monetary policy. They believe implementing a formal inflation target will cement the hard-won gains of price stability throughout leadership transitions. On the other hand, opponents of inflation targeting deem it unwise to tamper with a discretionary policy that has thus far proven so successful.

So the question the Fed appears to be asking itself is: Which will better stand the test of time — rules or discretion?

The What, How, and Why of Inflation Targeting

What does the term “inflation targeting” mean? Marvin Goodfriend, senior vice president and policy advisor at the Richmond Fed, defines inflation targeting as “a framework for monetary policy characterized by the announcement of an official target for the inflation rate and by an acknowledgement that low inflation is a priority for monetary policy.”

To implement an inflation targeting framework, the Fed must first declare a specific numerical target (or range) for inflation, which is measured by a price index such as the CPI or the PCE. The Fed would then pledge to achieve and maintain inflation within these bounds over a stated time horizon.

Theoretically, through improved communication with the markets, and repeated success in attaining target objectives, an inflation targeting framework would lead to increased transparency and credibility for the central bank, fostering an environment conducive to sustained price stability and economic growth.

Looking briefly at monetary policy abroad over the past 15 years, it is not difficult to see why a proposal to put inflation targeting in practice is so compelling. In December of 1989, the New Zealand Parliament codified inflation targeting as the country’s

Bank of England Governor Mervyn King (left) talks with U.S. Federal Reserve Chairman Alan Greenspan (center) and the President of the European Central Bank, Jean Claude Trichet (right), at the 2004 G20 conference in Berlin. The Bank of England has adopted an inflation targeting framework, while the Fed and the ECB remain undecided.



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framework for conducting monetary policy. Since then, 20 other countries — including industrial, transitional, and even developing economies — have adopted similar legislation with some degree of success (see table).

In the United States, during the period known as the Volcker disinflation (1979 to '87), the Fed brought down core inflation from 10 percent to 4 percent. Subsequently, inflation has remained low and relatively stable. Pursuing “hawkish” inflation policies also led the Volcker-Greenspan Fed to more elusive, unquantifiable accomplishments like the reestablishment of central bank credibility and a restored faith in the Fed’s commitment to low inflation.

Indeed, Goodfriend and others have argued that although the Fed has never explicitly employed inflation targeting, it has long done so implicitly. Goodfriend, a strong supporter of inflation targeting within the Federal Reserve System, summarizes his case: “When one considers the Greenspan era as a whole, it would appear that the Greenspan Fed adopted, gradually and implicitly, an approach to monetary policy that can be characterized as inflation targeting.” The question becomes: Should the Fed take the next step and declare an explicit inflation target?

Yes ...

Supporters of inflation targeting say it would generate two significant advantages over the status quo. Mickey Levy, chief economist at Bank of America, identifies one of the main benefits: more clarity regarding policy decisions. “I think a lot of the difficulty or confusion the Fed has had over its announcements about monetary policy would evaporate if the Fed had a properly stated monetary policy or inflation guideline,” Levy says. With inflation targeting, “I think the issue of transparency becomes much more straightforward, which would help the Fed avoid some of the problems it’s run into in the last few years.”

Frederic Mishkin, a professor of banking and financial institutions at Columbia University’s Business School,

was an early champion of inflation targeting. Mishkin articulates the second advantage: Policymaking would become less dependent on a chairman’s personal philosophy. “We have as strong a nominal anchor as any country that has announced inflation targeting. The problem is that nominal anchor is embodied in Chairman Greenspan.” Left alone, this strategy could prove dangerous.

“Putting in an inflation targeting regime is, in a sense, trying to provide a succession plan for Greenspan,” Mishkin suggests. “We’d like to clone Greenspan. We can’t. But what we would like to do is imbibe a future policy framework with the basic principles [of price stability] in which he has operated.”

Results from countries that practice inflation targeting have been generally positive. Across the board, average inflation has dropped significantly after an inflation-targeting policy was adopted. In the United Kingdom, for example, inflation fluctuated wildly until the adoption of inflation targeting in 1992. Since then, inflation has been brought down to manageable levels for the first time in many decades.

But inflation targeting is certainly no magic wand, and supporters stress that it should be viewed as a framework or set of guidelines — not a rigid rule. Mervyn King of the Bank of England has been careful to point out that inflation targeting is “a way of thinking about policy. It isn’t an automatic answer to all the difficult policy questions.”

Supporters of inflation targeting believe a policy change will be easiest to implement while inflation is already low, and the public and markets are familiar with the approach. Even Congress is thinking about it.

Robert Keleher, chief macroeconomist of the Joint Economic Committee of the U.S. Congress, has argued that inflation targeting would have the effect of “institutionalizing and depersonalizing the goal of price stability.” This, he says, “will help ensure that Federal Reserve performance depends more on a transparent

system of rules rather than upon the vagaries of individuals, and is less prone to political manipulation or pressure.”

... Or No?

On the other side of the fence, skeptics of inflation targeting, including many economists within the Fed, believe there would be a number of disadvantages associated with the adoption of an inflation targeting framework.

The first and most frequently discussed issue pertains to the advantage of having policymaking flexibility within a discretionary framework. Federal Reserve Board Governor Donald Kohn agrees the Fed has conducted policy with an eye on long-run price stability, but is not convinced that recent success is due to implicit inflation targeting. Rather, it is derived in large part from the Fed’s “ability to adapt to changing conditions — a flexibility that likely has benefited from the absence of an inflation target.”

Thomas Schlesinger, executive director of the Financial Markets Center and a vocal critic of inflation targeting, says that the evidence from abroad is not as clear as supporters of inflation targeting might suggest. Schlesinger cites a paper by Laurence Ball and Niamh Sheridan that concludes that after factoring in regressions to the mean, there is “no evidence that inflation targeting improves performance as measured by the behavior of inflation, output or interest rates.”

Schlesinger identifies another reason why an inflation targeting model might prove inadequate: “It ignores obvious and important questions about financial stability problems that can occur in a low inflation regime,” he says. “The evidence indicates ... that managing the economy in periods of sustained low inflation can be just as tricky, if not trickier, than achieving the goal of price stability. We’ve seen that asset bubbles and busts can and have occurred in periods of sustained low inflation.”

Finally, skeptics of inflation targeting argue that adopting an inflation target is simply unnecessary. The United

States has done well without inflation targeting, they say, and it is hard to justify a policy change when there is little evidence to suggest the economy would profit more under a different regime — particularly since credibility could erode if the Fed fails to achieve its target range. Moreover, there are less drastic alternatives available to increase policy transparency, such as earlier releases of records and forecasts.

Rules vs. Discretion in a Post-Greenspan Fed

Mark Gertler, chairman and professor of the economics department at NYU, believes that inflation targeting is

“useful for central banks in transition to price stability. But in the United States, I don’t know why we would be worse off one way or the other.”

The ambiguity inherent in Gertler’s statement echoes the sentiments of economists in the banking and financial services industries who think that it is still too early to tell.

Stuart Hoffman, chief economist at PNC Financial Services Group, thinks an explicit inflation targeting framework won’t happen for a while. The most basic details have yet to be worked out — down to which inflation measure to use, and what the appropriate ranges would be for a target. Hoffman also alludes to the trouble of

establishing a time period for an inflation target, and the need to define a coping strategy should the inflation rate move toward the ends of a target range.

Although Hoffman acknowledges that such a change will be difficult to implement, he remains hopeful. “I think the market would benefit from some explicit inflation target framework from the Fed,” he says. “It would be a learning process for the Fed. It would be a learning process for the markets. But I think it would be a good discipline, and I do think it might help to anchor public and market inflation expectations.”

When asked to speculate about the future look of a post-Greenspan Fed, Bank of America’s Mickey Levy replies with optimism. “Anything can happen, but the Federal Reserve and the whole of the financial community recognize the economic benefits of stable low inflation, and so even under a new Fed regime with a new chair, the impetus is toward continuity, and the policy thrust toward stable low inflation.”

Ultimately, the decision of implementing inflation targeting can be thought of as a choice between stability or flexibility, rules or discretion.

“You don’t want to adopt a policy or not adopt a policy because of current circumstances. You want to adopt a policy that works under all sorts of circumstances — not just in times of economic depression or economic prosperity,” cautions Joel Naroff, chief economist for Commerce Bank. “My view is that either the policy is correct to be implemented under all sets of circumstances, or it shouldn’t be implemented at all.” **RF**

Does Inflation Targeting Work?

Average inflation rates have fallen more rapidly in countries with inflation targeting (IT) regimes, but they have also had more room for improvement.

Sample IT Countries	Year IT Began	1980 to 1989	1990 to 1999	1998 to 2001
Australia	1994	8.4	2.5	2.8
Canada	1991	6.5	2.2	2.0
Chile	1991	21.2	11.5	4.0
Israel	1992	104.7	11.2	3.2
South Korea	1998	8.1	5.7	3.6
New Zealand	1990	11.8	2.1	1.6
Poland	1998	43.0	52.0	8.6
Sweden	1993	7.9	3.2	0.9
United Kingdom	1992	7.4	3.7	2.4
Sample Non-IT Countries				
Japan	-	2.5	1.2	-0.3
United States	-	5.5	3.0	2.5
Euro area	-	6.6	2.8	1.8

SOURCE: Bank for International Settlements

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