

What is “Inflation Targeting”?

Mark A. Wynne
Vice President & Senior Economist

Federal Reserve Bank of Dallas
Presentation to Economic Summit 2007
Money Makes the World Go Round: The Role of the Federal Reserve
June 7-8, 2007

The theoretical background

- Central banks have no effect on real activity in the long run
 - Friedman, Phelps
- Central banks with unlimited discretion may deliver poor outcomes
 - Simon, Friedman, Kydland & Prescott

History

- Pioneered by New Zealand
 - Part of general reform process
 - RBNZ Act 1989 established IT framework
 - First PTA: March 1990:
 - Price stability defined as 0-2 % CPI inflation
 - To be attained by December 1992
- Subsequently adopted by some 20+ countries

Current practitioners

- New Zealand (1990)
- Chile (1990)
- Canada (1991)
- UK (1992)
- Sweden (1993)
- Australia (1993)
- Mexico (1995)
- Czech Republic (1997)
- Thailand (2000)
-

What it is

- “A framework, not a rule”
 - Ben Bernanke and Frederic Mishkin
- “A way of thinking about policy...not an automatic answer to all the difficult policy questions”
 - Mervyn King

Essential features

- Price stability a primary objective
- Pre-announced target for inflation
 - Usually stated in terms of headline consumer price inflation
 - ~2%
 - Some cases set by government, some cases set by central bank, some cases agreed by central bank and government
- Delegation of monetary policy to an independent central bank
- Inflation Report
 - Usually quarterly
 - Often includes inflation forecasts

Why CPI inflation?

- Measure that best captures the costs of inflation
- Most familiar to households and business
- Available at high frequency (monthly)
- Measures of “core” continue to play a role in policy making and communication

Why positive rather zero inflation?

- Measurement bias
 - Quality improvements may cause CPI to overstate true rate of increase in the cost of living
- Nominal wage stickiness
 - Positive inflation facilitates real wage adjustment
- Fear of deflation / zero bound on nominal interest rates

Point or range?

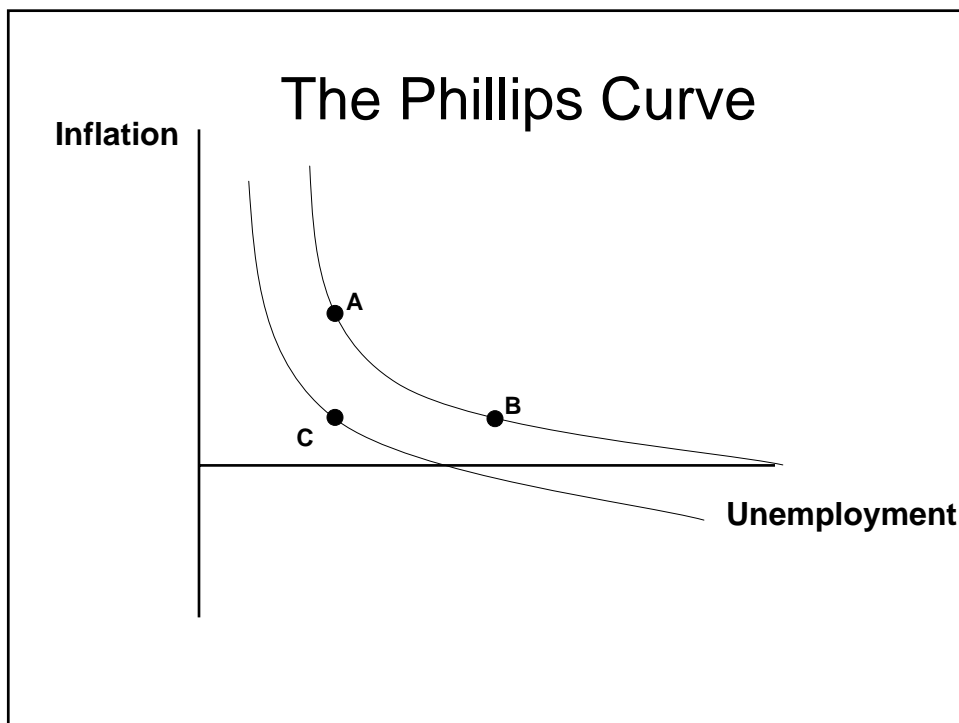
- Point
 - Advantage: clarity; anchors inflation expectations
 - Disadvantage: false sense of precision; too much attention on minor deviations
- Range
 - Advantage: allows for inevitable misses to errors & shocks;
 - Disadvantage: uncertainty about what rate of inflation the central bank seeks to achieve in the long run

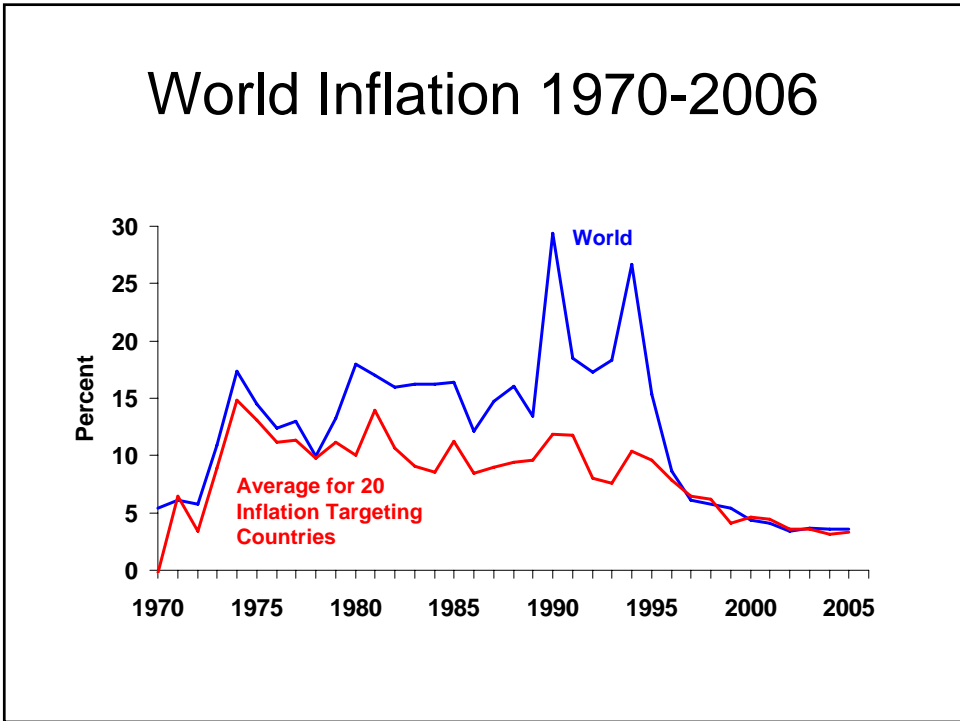
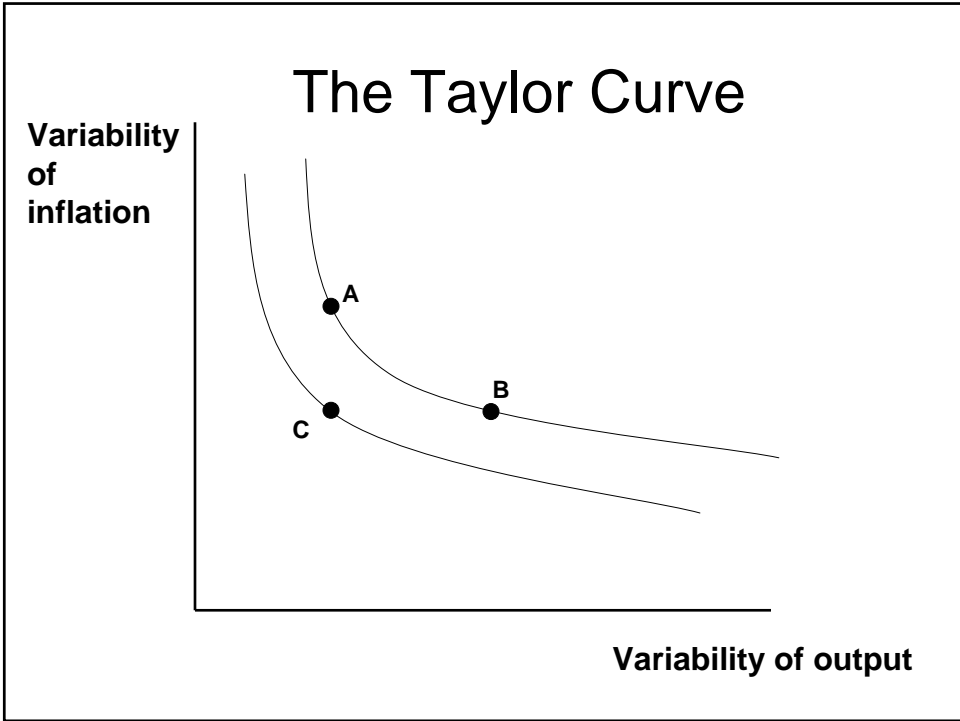
Types of inflation targeters

- Flexible inflation targeting
 - Inflation targeting as constrained discretion
 - Assign some weight to stabilizing the real economy and financial stability
 - Flexibility in getting inflation back to target
- Inflation “nutters”
 - Price stability isn’t everything, it’s the only thing

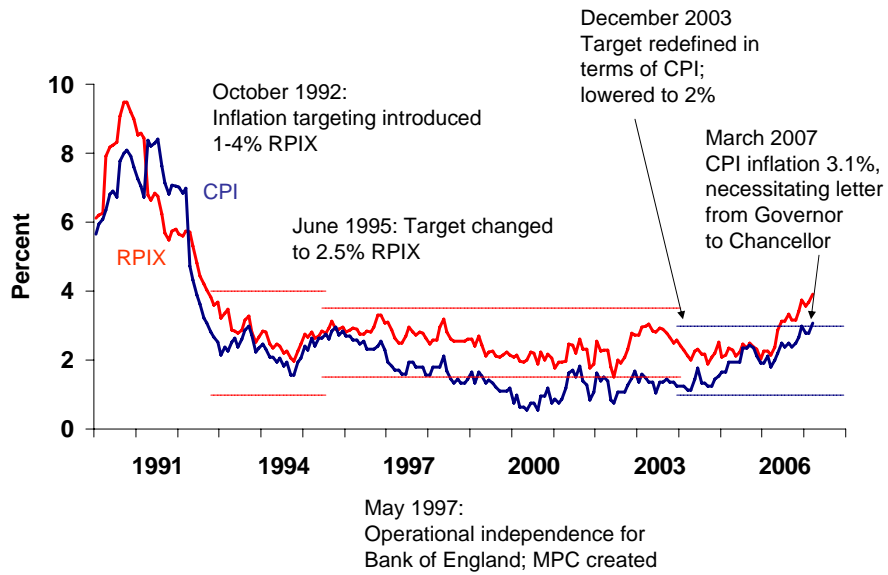
Does inflation targeting deliver better inflation outcomes?

- Effects on level, persistence & variability of inflation
- Hard to tell
 - Short sample
 - Disentangling the effects of IT from e.g. effects of globalization
- Effects on inflation expectations





UK inflation



UK GDP Growth

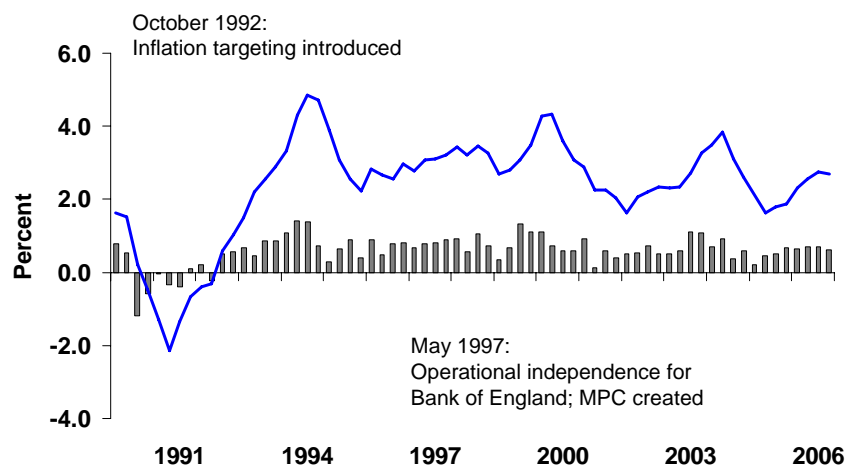


Chart 5.1 Current GDP projection based on market interest rate expectations

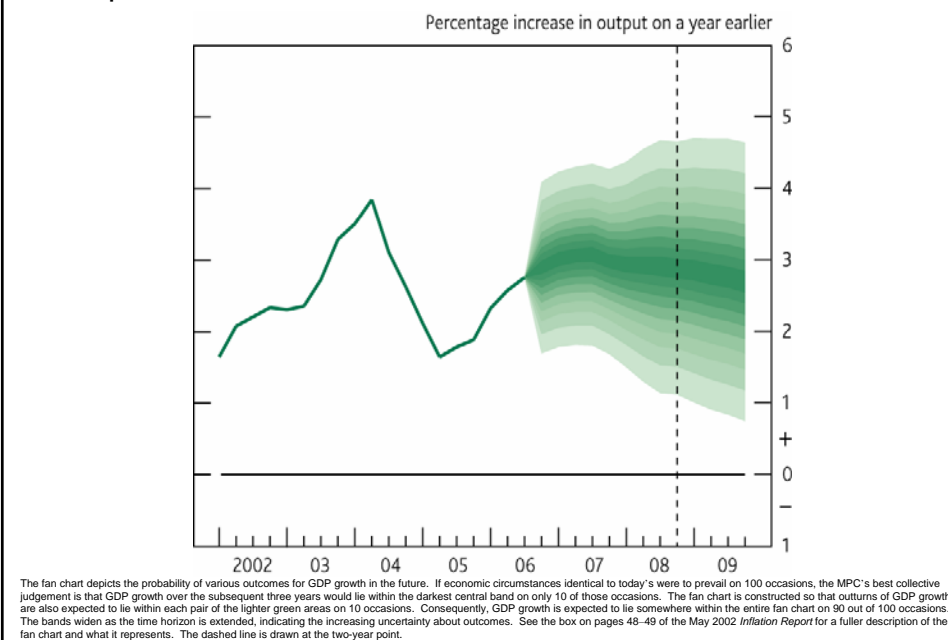


Chart 5.3 Current CPI inflation projection based on market interest rate expectations

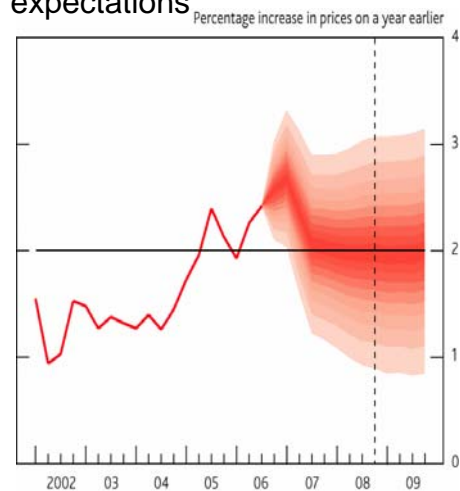
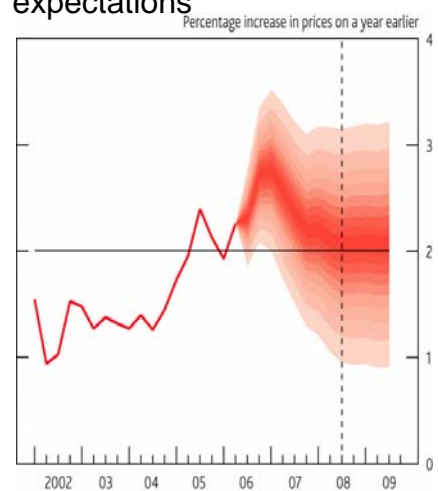
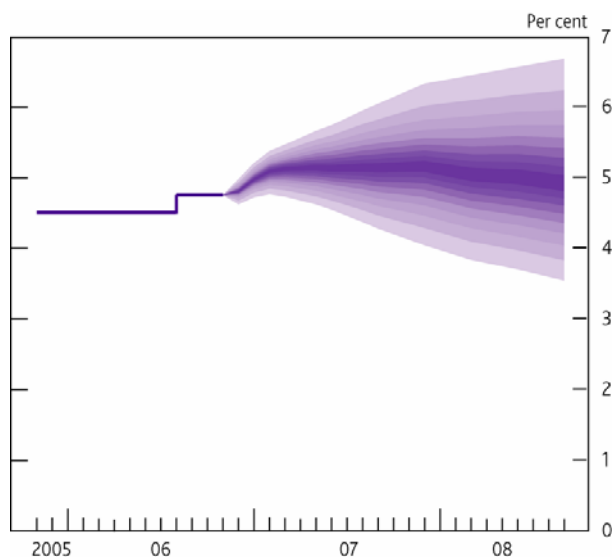


Chart 5.4 CPI inflation projection in August based on market interest rate expectations



Charts 5.3 and 5.4 The fan charts depict the probability of various outcomes for CPI inflation in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation over the subsequent three years would lie within the darkest central band on only 10 of those occasions. The fan charts are constructed so that outcomes of inflation are also expected to lie within each pair of the lighter red areas on 10 occasions. Consequently, inflation is expected to lie somewhere within the entire fan charts on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. See the box on pages 48-49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents. The dashed lines are drawn at the respective two-year points.

Chart A Market beliefs about future interest rates

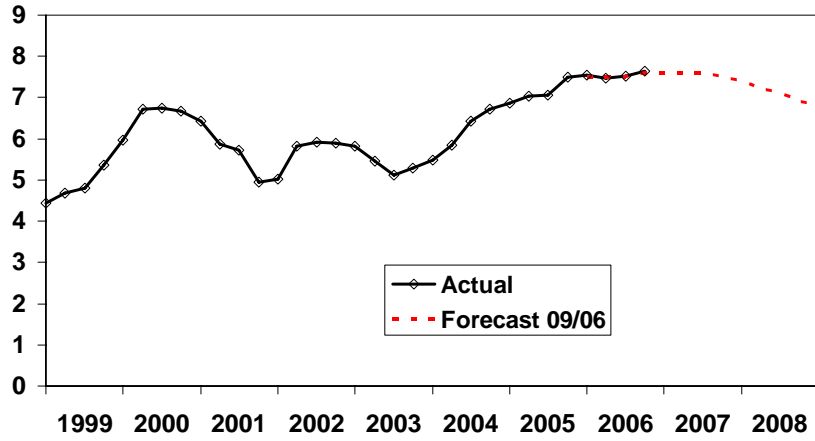


The mean of the fan chart is the market rate profile for the fifteen-day average ending 8 November, consistent with the measure of interest rates shown in Table 1. The distribution is derived using the prices of options on three-month Libor futures contracts traded on Euronext.liffe. It is constructed by averaging the daily distributions around a common mean for each of the fifteen days. The average is calculated for each probability band at each quarter. The fan chart depicts the probability of outcomes for interest rates in the future. It has a similar interpretation to the fan charts in the Overview and in this section of the *Report*. The chart is only indicative of market expectations of future policy rates as it is based on Libor instruments, and is estimated on the assumption that investors are risk-neutral.

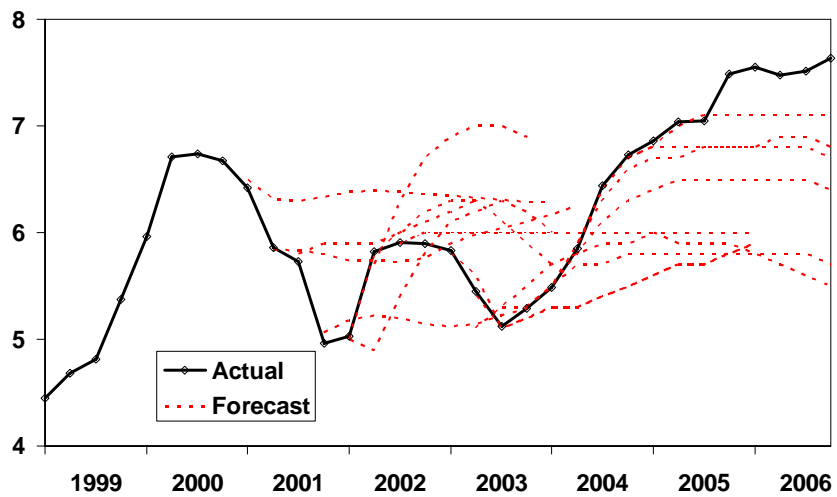
What's next?

- Ever more transparency
 - Release of interest rate projections
 - New Zealand (1998)
 - Norway (November, 2005)
 - Sweden (January, 2007)
- Move from inflation targeting to price level targeting

RBNZ policy rate & projection



RBNZ interest rate projections



Issues for the Fed

- Theory is compelling
 - What is the evidence?
 - Ambiguous
- How to deal with the dual mandate
 - Promote “...maximum employment, stable prices, and moderate long-term interest rates”

Issues for the Fed

- What measure?
 - CPI? PCE? Headline? Core?
- What number?
 - 0%? 2%?
- Point or range?
 - Hard or soft bounds?
- Time period?
 - Explicit (e.g. 1-3 years) or vague (“medium term”)

Resources

- Ben Bernanke, Thomas Laubach, Frederic Mishkin & Adam Posen *Inflation Targeting* PUP 1999
- Edwin Truman *Inflation Targeting in the World Economy* IIE 2003
- Claes Berg “Experience of Inflation Targeting in 20 Countries” *Sveriges Riksbank Economic Review* 2005
- Laurence Ball & Niamh Sheridan “Does Inflation Targeting Matter?” NBER WP 9577
- Ben Bernanke & Michael Woodford *The Inflation Targeting Debate* PUP 2005