

INFLATION TARGETING WITH REFERENCE TO THE CURRENT ECONOMIC DOWNTURN

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Monetary policy is one of the most fundamental aspects of economic planning. For many years now, it has been the practice of central banks to set inflation targets to enhance stability in the economy. Here, Shane Murphy evaluates this practice, paying particular attention to the US Federal Reserve and the Bank of England. He argues that the policy of inflation targeting may be redundant today as many countries face the opposite challenge: deflation. However, he believes that this is only a temporary deviation, and that inflation targeting will remain an important monetary policy objective into the future.

Introduction

'Inflation targeting is a framework for monetary policy characterised by the public announcement of official quantitative targets (or target ranges) for the inflation rate over one or more time horizons, and by explicit acknowledgement that low, stable inflation is monetary policy's primary long-term goal. Among other important features of inflation targeting are vigorous efforts to communicate with the public about the plans and objectives of monetary authorities, and in many cases mechanisms that strengthen the central bank's accountability for attaining those objectives' (Bernanke et al., 1999: 4).

What is inflation targeting?

Inflation targeting is the process of announcing a target level of inflation and using monetary policy to adjust the economy to that level. When inflation is too high, the central bank attempts to cool the economy to this rate of price level growth (Bernanke and Woodford, 2005). It has been credited with achieving low, stable inflation and reforming monetary policy in countries such as New Zealand (ibid.). There are different types of inflation targeting regimes: those which are bound by law to a target; those which have an implicit price stability target; and those which have a target but do not have the credibility to hit the target (Carare and Stone, 2006).

Recent and future events

Recent economic troubles have meant that inflation targeting countries have departed from standard practice and this could be a reason to believe inflation targeting will not persevere. In the USA the target nominal interest rate has been completely missed, with the effective rate differing by as much as eighty-five basis points. Also the 'vigorous attempts to communicate to the public' mentioned by Bernanke et al. above have been damaged as, for example, the Bank of England surprised the market with cuts in interest rates late last year.

There is a real danger in many countries of deflation, therefore completely undershooting the target. Near-zero inflation rates bring about a number of problems, including downward pressure on nominal wages and upward pressure on the real cost of borrowing.

Why is inflation targeting so popular and will it survive the current economic downturn? This essay will consider the advantages of inflation targeting. It will examine recent events in the context of inflation targeting, the risks of very low inflation and what can be done to keep deflation at bay.

Why Inflation Target?

Role of inflation targeting:

Inflation targeting as defined above is a framework used in monetary policy to control the economy. The role of an inflation target can be summarised as follows:

‘(1) to provide an anchor for monetary policy and inflation and hence serve as a coordination device for those involved in the price and wage setting process in financial markets; and (2) to provide a transparent guide to monetary policy, whose commitment, discipline and accountability would be judged on the basis of whether policy actions were taken to ensure achievement of the target’ (Leiderman and Svensson, 1995: 2).

Most countries have adopted inflation targeting for two reasons - either monetary aggregates became less effective in controlling inflation, or an existing monetary anchor was removed (Fisher, 1995). Financial innovation in Canada meant that M1, which had been used as a monetary target, became less linked to nominal spending, and subsequently the Bank of Canada searched for an alternative (Freedman, 1995). Britain adopted inflation targeting after a rather disastrous attempt with a previous monetary anchor, the Exchange Rate Mechanism. Norman Lamont is quoted as proposing inflation targeting ‘to replace that hitherto provided by the ERM’ (Bowen, 1995: 53).

What has been achieved:

Inflation targeting has achieved considerable results in a number of areas. Mervin King (2005) points out that inflation has been consistently below 4% since the establishment of inflation targeting in the Britain, compared with the preceding two decades of high inflation. One of the main successes that economists point to is that public inflation expectations have been brought down to the target rate (ibid.).

One of the most lauded aspects of inflation targeting is that it is transparent and thus more predictable. When changes in interest rates were announced, by a determined policy of more openness, ‘they would already be incorporated in private sector decisions’ (Bain and Howells, 2003: 344).¹

The move to inflation targeting is credited with the economic turnaround experienced in New Zealand (Fisher, 1995). King (2005) compares inflation targeting and monetary stability to a sustainable way of living healthily; the ‘boom and bust’ cycles of before are akin to crash dieting. Better and more consistent monetary policy has been attributed to the movement toward inflation targeting. Charles Freedman (2005: 19) puts it clearly: ‘By fostering confidence in the value of money, monetary policy makes its contribution to the ultimate objective of public policy – a well functioning economy’.

¹ One example of this determination occurs when inflation targets are missed: the head of the Monetary Policy Committee must write to the Chancellor of the Exchequer outlining when inflation will be brought back into the target range.

Who inflation targets:

Carare and Stone (2006:1298) classify countries with a floating exchange regime into three categories of inflation targeting. The first are *full-fledged inflation targeting* (FFIT) countries, which are a mix of industrialised and emerging market countries with some sort of legally binding inflation target. New Zealand and the Britain are examples of this group. *Implicit price stability anchor* (IPSA) countries are countries with 'so much credibility that they maintain low and stable inflation' without an inflation target *per se*. The European Central Bank and the Federal Reserve are examples of central banks that are in the IPSA category. The last category is *inflation targeting light* (ITL). These are countries with a 'broad inflation objective' but have low credibility and thus are unable to maintain inflation as the foremost policy objective.

While the US Federal Reserve is not traditionally seen as an inflation-targeting bank, it nonetheless strongly resembles one. Since 1979 the US has had a disinflationary policy, starting with a switch to non-borrowed reserve targeting; and Federal Reserve officials have consistently reiterated their commitment to low inflation (Goodfriend, 1995). In fact, the Federal Reserve has been consistent in keeping inflation at 3- 4% for many years now (ibid.). The Federal Open Market Committee (FOMC) publishes a statement, usually including the Committee's assessment of the risks to the attainment of its long-run goals of price stability; and the current governor is a proponent of inflation targeting, having written a book on the subject. However it does not have an implicit inflation target set out in law. It can thus be argued the Federal Reserve 'inflation targets' (Goodfriend, 2005:321).

The ECB can also be defined as an inflation-targeting regime. The Maastricht Treaty mandated price stability as the primary objective of the European Central Bank (Bernanke et al., 1999). Inflation targeting banks can have other objectives, and in fact 'flexible' inflation targeting regimes are the norm in practice (Bernanke and Woodford, 2005: 1).

In assessing the future inflation target it is important to look at the IPSA category to see what they do, as they are not mandated to follow a policy of inflation targeting in the same way as the other FFIT countries are, and are thus most likely to move away from it. If the ECB or the Fed abandon their inflation-targeting regimes it is likely that the FFIT group will follow. Many of the actions by central banks recently in the IPSA and FFIT categories show a movement away from the standard practice of inflation targeting.

Recent pressures on Inflation Targeting

Target rate deviations:

When considering inflation targeting with reference to the current economic climate it is important to look at what inflation-targeting countries have been doing in the last year, under increased pressure. Central banks only control short-run rates indirectly. They do not set rates but, for example, do manipulate the federal funds market in the USA. By buying and selling reserves in the market, they move the interest rate to the target. But recently in the US, which is in the IPSA category, the announced interest rate and the effective rate diverged by a considerable amount. On the 5th of December 2008 the announced rate stood at 1% but the effective rate was 0.12% (Federal Reserve Bank of New York, 2008). Either one of two things had happened: the Fed had lost the ability to manage rates, or it purposely undershot the target.

If the Fed loses the ability to manage short-run rates, then the concept of inflation targeting must be abandoned. The Federal funds rate was lowered to a range of 0.00% - 0.25% on the 16th of December 2008. This movement could be seen as just the Fed moving to keep the pretence of controlling rates. There is no reason to believe that the central bank could target inflation if it could not manage interest rates in the future. Therefore, under this assumption inflation targeting will not last long. However, if the Fed was undershooting the target on purpose, the credibility of the Bank is damaged. Investors will soon lose faith in the bank's aim of inflation targeting. Inflation targeting requires that the central bank takes a disciplined stance and a marked deviation from the target rate is not in keeping with this. But the fact that the subsequent rate change occurred so quickly could be seen as the bank being unwilling to allow long periods where the target rate and effective rate were out of sync. After all, there is a tradition of not changing the rates outside of FOMC meetings (Meyer, 2004). If this is the case inflation targeting may still be used in the future.

A return to locked room monetary policy:

As previously stated, transparency is important to inflation targeting. The ability of investors to factor in changes in interest rates before they occur is critical. Recently, this ability has been curtailed. The Bank of England's 1.5% cut in its interest rate on the 6th of November 2008 was largely unexpected by markets and economists (Cohen, 2008a). This cut brought the rate to its lowest level in over fifty years. Bain and Howells (2003) explain that the private sector learns how the Monetary Policy Committee of the Bank of England make interest decisions based on current and future economic conditions, and are thus able to predict them. If markets cannot make rational forecasts due to uncertainty over the interest rate, investment decisions will be affected. But why did the private sector fail to predict what would happen?

Was it a case of the Bank changing its normally hawkish practice in relation to inflation? This movement was predicated on the fact that 'in recent weeks [before the cut], the risks to inflation have shifted decisively to the downside' (Bank of England, 2008). It can be argued that financial markets did not have time to react to this news and thus did not price it in. But it must be asked why financial markets could not move as fast.

In today's uncertain climate, financial markets may be unable to predict movements in interest rates, thus inflation targeting loses its effectiveness, as changes in rates can no longer be accounted for. This will bring uncertainty to the market, raising risk premia and diminishing inflation targeting's ability to work by raising long-term interest rates. However, this crisis brings another risk to inflation targeting into play: deflation.

Risks in the Future

Since inflation targeting has been established, it has been rare to see countries undershooting their target levels, but this has not been the case recently. The likelihood of deflation is very high at the moment and can be seen as central banks move their rates to zero in hopes of avoiding it. If near-zero inflation (or deflation) occurs, a number of problems may arise.

Problems with near-zero inflation:

Low interest rates work well in periods of constant growth. This was the case in Britain from 1992, the year it adopted inflation targeting, onward (King, 2005). However, current events are leading developed countries to rethink inflation targeting policies. The

aim has previously been to slow price level growth, allowing central banks to meet the inflation target. Now they must *increase* inflation so as not to undershoot the targeted inflation level. There are several risks if the rate is undershot.

When an economy undergoes negative shocks, there is downward pressure on real wages. When inflation is high, these cuts can be achieved through maintaining the nominal wage; but if inflation is very low or close to zero, then the only way of achieving a fall in real wages is by a decline in the nominal wage (Sorensen and Whitta-Jacobsen, 2005).

At extremely low inflation rates, the real cost of borrowing increases. In periods of normal inflation the principal that has to be paid back in real terms falls. But in a period when there is deflation and when the zero bound in nominal interest rates has been reached, the real interest rate will remain positive. As the real interest rate is just the nominal rate (zero) less the inflation rate (which is negative), real interest rates are positive. One of the worst consequences of deflation is that the amount borrowed will actually go up in real terms.

How could central banks stop deflation?

The first move would be to lower nominal interest rates, which is what many countries are doing today, but the zero bound may still eventually be reached. Indeed there is an expectation in the financial press that this will occur in Britain (Cohen, 2008b; Goff, 2009). The steps to be taken after the zero bound has been reached have been discussed by many economists, most notably Ben Bernanke.

Bernanke (2002) spoke about what could be done by a central bank faced with the possibility of deflation when the policy rate had already been driven down to zero. His argument focused on the fact that having a fiat currency meant that a central bank could just print money, generating 'higher spending and hence positive inflation'. He also outlined the method he would prefer to take if deflation happened. The Fed should begin by announcing explicit ceilings for yields on longer maturity Treasury debt; to make this happen the Fed must then commit to make unlimited purchases of securities up to two years from maturity. This would also make long-term yield fall, as the term structure of long-run interest rates would incorporate these falls.

If this policy were to fail, however, Bernanke still believes that lending directly to banks would work, using the discount window with commercial paper as collateral. This would reduce the risk and liquidity premia, thus lowering the cost of capital and encouraging positive inflation through greater spending.

Charles Bean (2002), Deputy Governor at the Bank of England, also spoke on the matter saying that once the zero bound had been reached, the central bank should attempt to drive down long-run rates by committing to zero short rates for a protracted period, or by purchases of longer-term government securities. Bean also recommended following Keynes' advice, i.e. increase fiscal spending.

Bernanke (2002) does note that Japan's deflation problem is partially due to massive financial problems in the banking and corporate sectors and a large overhang of government debt. Considering the current financial system and the fact that many of the world's economies will be embarking on very large public spending programs, this is a highly relevant observation.

Conclusion

'Inflation targeting' has brought advantages to the countries that have adopted it. It has encouraged more effective monetary policy in countries where previous monetary targets lost effectiveness or which had abandoned previous monetary anchors. Inflation-targeting countries are generally characterised by well-functioning economies and low, stable inflation. Flexible inflation-targeting regimes have become the norm.

Unfortunately, due to recent events, inflation-targeting regimes have not maintained a disciplined stance.. In the United States a divergence between the effective rate and target rates has damaged the credibility of inflation targeting. But quick moves to bring the target and effective rates back together can be seen as a commitment to the process. In Britain, the actions by the Bank of England could be viewed as a move to a much less transparent monetary policy. Alternatively, the speed at which the economy is deteriorating could mean that markets were unable to keep up with the Bank of England. This has problems for inflation targeting, but on the whole these are small deviations compared with other potential risks, notably deflation.

Long-run yields are also coming down (US Department of the Treasury, 2008) which is what central bankers want in order to avoid deflation. There are two components to long run yields: the sum of expectations of short-run yield and a risk premium. If investors think that inflation targeting will be abandoned then the future of monetary policy is unknown. If this were an accurate description of expectations, it would be assumed that the risk premium would go up, which does not seem to be the case in today's markets.

Will inflation targeting last after the economic difficulties being experienced now? This essay would conclude with an optimistic 'yes'. In the current climate, central bankers have to do whatever is possible to keep from falling under the target and it is believed that the current deviations from the policy are only temporary.

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