INFLATION TARGETING IN THE CONTEXT OF THE CURRENT FINANCIAL CRISIS

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1. Introduction

Over the last twenty years, several central banks found that the traditional monetary policy strategy (based on intermediate variables such as monetary aggregates and exchange rate) has lost its efficiency. Therefore, the credibility of these central banks has became vulnerable. As the answer to this problem, some developed countries – New Zealand (1990), Canada (1991), the United Kingdom (1992), and Sweden (1993) – found the solution to implement the monetary policy strategy that targets inflation directly.

Since then, more than 25 recently industrialized and emerging and former socialist economies from Central and East Europe, Latin America and East Asia have switched to inflation targeting as the framework for their monetary policy, All inflation targeters managed to reduce the inflation rate after the implementation of this new strategy. The experince showed that, untill now, no one of the adopters of inflation targeting has gave up to this regime.

2. Inflation targeting – a succeessful strategy

Inflation targeting represents a superior step taken for controlling inflation, while being one of the most recent and popular monetary policy strategy.

2.1. Concept of inflation targeting

Inflation targeting represents that approach of monetary policy characterized by the announcement of numerical inflation target for one or more horizons and an explicit recognition that the low and stable inflation is the primary goal of monetary policy (Bernanke and Mishkin, 1997).

Inflation targeting is characterized by five key elements (Mishkin, 2000):

1) the public announcement of inflation targets in terms of a medium-term numerical targets;

2) an institutional commitment to make price stability the primary goal of monetary policy;

3) a strategy that takes into account not just monetary aggregates or the exchange rate, but also many variables used for establishing the policy instruments;

4) an increased transparency of the monetary policy strategy due to the communication with the public and the markets about the objectives, and decisions of the central bank;

5) an increased accountability of the central bank for attaining the inflation targets.

Although many monetary authorities announce publicly the numerical target for inflation, that does not imply that they practice inflation targeting, because inflation targeting requires the fulfilment of the other four elements for this strategy to be sustainable over the medium-term.

Thus, we can make a distinction between a country which targets inflation and the other which only makes a public announcement concerning the anticipated level of inflation for the next period. In the second situation, the central bank is not forced to implement

the monetary policy towards the attainment of the set inflation target, because this might compromise other proposed macroeconomic objectives (Brash, 1999).

2.2. Stict versus flexible inflation targeting

In practice, we can distinguish two types of inflation targeting (Walsh, 2009):

- Strict inflation targeting is a framework of monetary policy exclusively focused on the control of inflation. Since it is not preoccupied by the short-term tradeoff between inflation control and real economic stability, strict inflation targeting is too costly to be desirable.
- Flexible inflation targeting is a framework of monetary policy aimed at attainment low and stable inflation while, in the same time, minimizing fluctuations in the real economy. The words "inflation targeting" reflect the primacy of inflation as the final objective of monetary policy. The word "flexible" reveal the short-term tradeoff between inflation control and real economic stability. Since there exist a time lag between the monetary policy decisions and their effect on inflation and real economy, an effective strategy of flexible inflation targeting depends on forecasts of inflation and real economy, being illustrated as "forecast targeting" (Svensson, 2009).

2.3. Conditions for adopting inflation targeting

The initial conditions that sustain an inflation targeting framework can be grouped into four major categories (Carare, Schaechter, Stone, Zelmer, 2002).

The first and most important condition is that central bank to pursue an inflation objective and to be accountable for meeting this objective:

- The central bank should have a mandate to pursue inflation target and enjoy a sufficient degree of instrument independence. Furthermore, other objectives must be subordinated to the inflation objective. The central bank should have a high degree of independence when setting the monetary instrument as needed to pursue the targets.
- The accountability of the central bank is important as policy transmission lags obstruct the supervision of monetary policy performance by the public. Accountability motivates the central bank to meet its targets and to communicate its decisions to the public.

The second group of conditions refers to the fact that the inflation target should not be subordinated to other objectives:

- It must not show any signals of "fiscal dominance". Thus, the conduct of monetary policy should not be ruled or constrained by considerations that are purely fiscal. The borrowings from the central bank should be as low as possible or nonexistent.
- A country should have strong external stability to enable monetary policy to focus on achieving the inflation target without being affected by developments in the foreign exchange market. The policy measures used for reducing the conflicts between inflation target and external stability are represented mainly by the prudential supervision.
- The inflation rate should be low enough to ensure a reasonable degree of monetary control. The majority of the industrial countries decided to adopt the new regime in times when inflation was declining, but there were also some countries which started with high rates of inflation.

The third category of conditions refers to the stability and development of financial system:

- The financial stability enables monetary policy to persue the inflation targets and not be preocuppied about the healt of financial sector. Financial stability refers in this case to a minimal

vulnerability to crises. By having a stable financial system, the central bank's credibility is enhanced and the inflation expectations can be easily anchored to the inflation target.

- A well-developed and deep financial market contribute to a better implementation of inflation targeting because it ensures that movements in asset prices communicate information to the central bank on economic basics and market expectations about prospect monetary actions.

The last set of conditions refers to choosing the appropriate monetary instruments to pursue the inflation target:

- A central bank should be able to influence inflation through its monetary policy tools and have a resonable understanding of the links between the stance of monetary policy and inflation. All central bank that practice inflation targeting use exclusively market-based instruments of monetary policy.
- The transmission mechanism of monetary policy is represented by the connection between changes in the monetary stance and their effect on the operating target, and finally, inflation. The changes will be more effective as the transmission links will be stronger and better understood.
- Exchange rate objective must be clearly subordinated to the inflation target. The central bank should clarify the fact that foreign market exchange interventions and changes in the policy interest rate are aimed only at smoothing the effects of temporary shocks.
- Inflation forecasting has an essential role in an inflation targeting regime. The inflation forecasts made by central bank should take into consideration all available information on the outlook for inflation.
- Fiscal policy and public debt management should be coordinated in order to support inflation targeting.

Besides the already mentioned conditions, the monetary authorities should also consider the following four essential elements (Masson, Savastano, Sharma, 1997):

✓ explicit inflation targets for some periods ahead;

✓ clear and unambiguous indications that pursuing those inflation targets is the primary objective of monetary policy;

✓ a model for forecasting inflation that uses relevant variables and information indicators;

✓ a forward-looking operating procedure in which the setting of policy instruments depends on assessing inflationary preasures and where inflation forecasts are employed as the major intermediate target of monetary policy.

To design this framework, the monetary authorities must possess the technical and institutional ability to shape and forecast domestic inflation and to assess the efficiency of the instrument changes. Moreover, they must also have a view on the way in which monetary impulses affect the main macroeconomic variables.

The requirements mentions beyond do not are strict prerequisites, so that the miss of one would not impede the adoption of inflation targeting regime. The practice has revealed that despite the problems in achievment of some conditions, inflation targeting has worked well (Carare, Schaechter, Stone, Zelmer, 2002).

Therefore, the adoption of inflation targeting has been associated with rapid improvements in anchoring both inflation and inflation expectations without any unfavourable effects on output. Still, though the fulfilment of initial requirements may not be decisive before adopting the strategy, their improvement will be necessary for the success of this approach. The evidence from the emerging market countries suggests that the viability and the success of the inflation targeting seems to depend more on the authorities' commitment and ability to plan and implement institutional

changes after adopting it (Batini and Laxton, 2006).

3. Strong points and weak points of inflation targeting

Promoters of inflation targeting consider that it has several strong points in comparison with other operating strategies.

Contrasting with exchange rate targeting, inflation targeting regime allows monetary policy to focus upon national economic problems, thus better managing the possible shocks. Unlike monetary targeting, inflation targeting has the advantage that it does not depend on a stable relation between money and inflation for its success. But it employs all data for finding the best instruments of the policy. Moreover, because the public can easily understand it, this strategy is highly transparent (Mishkin, 2000).

This regime increases the accountability of central bank due to an explicit numerical target for inflation and, thus, can reduce the probability that the central bank will fall into the time-inconsistency trap, which is frequently caused by political pressures on the central bank to promote expansionary monetary policy.

Inflation targeting requires the existence of a strong institutional commitment for price stability as the primary goal of monetary policy (Mishkin, 2000).

Another strong point of inflation targeting consists in stating the target in terms of the rate of inflation rather than in terms of the price level and on defining the target in terms of a price index that is very familiar and broadly used by the public, such as consumer price index (Masson, Savastano, Sharma, 1997).

Monetary policy is more transparent in comparison with other strategies due to the communication with the public about de monetary policy decisions. So, transparency plays a key role in communicating to market participants the fact that central bank is accountable for its performance (Mishkin, 2000).

Inflation targeting causes lower economic costs in the case of monetary policy failures in comparison with other strategies. Under exchange rate pegs, for example, the costs of policy failure can be very large and can lead to high inflation, financial and banking crises and massive foreign currency reserves losses. With inflation targeting the output costs of failure will be significantly reduce, being limited to a higher inflation rate than targeted and slower economic growth (Batini and Laxton, 2006).

Critics of inflation targeting highlight the weak points of this strategy.

A first weak point is that monetary policy is too rigid, beeing focused towards the atainment of the set infaltion target and, so that, the other objective of monetary policy would be neglected. Thus, monetary policy suffers of some constrains and central bank does not employ discretionary decisions. This is the reason for what the inflation targeting is called as „constrained discretion", beeing an „intermediate monetary arrangement in the rules-versus-discretion tradeoff" (Schmidt-Hebbel and Tapia, 2002).

Inflation targeting has been criticised for focusing only to inflation evolution and, therefore, for ignoring output and employment. However, this strategy enjoys enough flexibility to permit for the short run tradeoff between output and inflation (Debelle, 1999).

Contrary to other alternative monetary policy strategy, such as exchange rates and monetary aggregates, the inflation rate cannot be easily controlled by the central bank and its results include the effects of instruments changes, which occur only after a considerable lag. This problem is critical in emerging countries, where inflation rate is reduced from quite high levels, due to the difficulty in the controll of inflation. In this situation, inflation forecast errors can be relatively large,

inflation targets could be missed, and it would be very complicate for central bank to get credibility from this regime, and for public to understand the causes of the deviations. This is the reason for what, inflation targeting is recommended to be adopted after a successful disinflation process (Mishkin, 2000).

High exchange rate volatility represents another shortcoming of inflation targeting. Because this strategy promotes price stability as the primary goal of central bank, it could ignore the exchange rate, with unfavourable effects on exchange rate volatility and economic growth (Batini and Laxton, 2006).

Another disadvantage of this approach is that it may not be able to guarantee fiscal discipline or avoid fiscal dominance. On the long-run, high fiscal deficit can generate the collapse of inflation targeting since they will be probably monetized or public debt eroded by a great devaluation, which will cause a high inflation. The success of this strategy depends on the absence of fiscal dominance and on the establishment of an institution responsible for monitoring fiscal policy. (Mishkin, 2000).

4. The impact of the current financial crisis on the inflation targeting

In reply to financial crisis, main central banks, no matter what monetary policy strategies they apply, have considerably reduced their monetary policy interest rates aiming to lower real interest rates and boost aggregate spending. In some countries, such as United States, Japan, England, but also Euro area, the interest rates were lowered towards zero. Once the policy rate reaches zero, traditional open market operations used for the expansion of reserves cannot lower interest rate more. These evolutions lead to serious debates about the fact that zero lower bound policy rates constrains the capacity of monetary policy to encourage the real economy (Walsh, 2009).

In spite of the significant decline in the interest rates in United States, the cost of credit has generally risen. The tightening of credit conditions and the maintenance of the cost of credit at relatively high level, although the central banks lowered the monetary policy rate, have led to contradicted opinions. Some specialists belive that monetary policy has been ineffective throughout the current financial crisis. This point of view was criticized by the other authors, who consider that contrary monetary policy has been even more effective than throughout usual periods because it not only reduced the interest rates on default-free securities, but also helped lower credit spread. Tighter monetary policy would cause economic activity to contract further, which would create more uncertainty, making the financial crisis worst, causing economic activity to contract further and so on. If interest rates fall to close to the zero lower bound, monetary policy can use nonconventional tools (Mishkin, 2009).

The zero lower bound policy rates became a serious problem even in the case of inflation targeters, since they all use the short-term interest rates as the main operating instruments of monetary policy (Masson, Savastano, Sharma, 1997). Before the current financial crisis, the inflation targeting was broadly considered as the best practice monetary policy. Although this strategy has managed to maintain low and stable inflation without causing the greater output volatility, its opponents have foreseen and the current crisis has raised new questions on the future of inflation targeting (Walsh, 2009).

These questions are about how monetary policy should be conducted, the role played by monetary policy in the crisis, and the changes in the way of which inflation targeting should be conducted. As for the first question, under the impact of crisis, the monetary policy had to be temporarily adjusted in a more expansionary way in order to

support financial stability, more precisely, for the improvement of the fragile situation of the financial sector and gaining some time for a the reform and recovery of the financial sector Thus, the financial crisis and the severe recession that has followed it have motivated the central banks to operate large cuts in the monetary policy interest rate. But, we should take into account the fact that trying to use interest rates to attain financial stability would cause significant collateral harm to inflation and the real economy (Svensson, 2009).

About the second question, the most important conditions causing the current crisis had very little connection with monetary policy, being principally linked to insufficient regulatory framework and, to some extent, to some particular circumstances, including the United States' housing policy (Svensson, 2009).

So, we cannot make inflation targeting responsible for a crisis, which emerged in a country – United States – whose central bank does not practice this strategy. If we consider the crisis as a negative aggregate demand shock causing both the decline of output and inflation, then even a strict inflation targeter would react with expansionary monetary policy to avoid the collapse of aggregate spending (Walsh, 2009).

Under inflation targeting the central bank is committed to ensure price stability. Thus, recessionary pressures on the real economy require expansionary monetary policy responses. The general agreement that monetary policy should only be preoccupied with price stability may have contributed, somewhat, to the financial crisis by ignoring financial distortions. But this failure was not limited to inflation targeters. The presence of financial distortions calls for central

Price level targeting would be a viable alternative to inflation targeting, being superior in terms of the way in which it can change expectations so they serve as an automatic stabilizer. The advantages of price level targeting

banks to trade-off some stability of inflation and real economic activity to ensure financial stability (Walsh, 2009).

The assurance of financial stability, as well as a well-functioning payment system, represents, explicitly or implicitly, a main objective for central banks, which can be compatible with a flexible inflation targeting framework. In normal situations financial stability does not impose any constraints on monetary policy. The best instruments to achieve financial stability are supervision and regulation. But, in a lot of countries responsible for these instruments are other institutions than the central bank (Svensson, 2009).

There is a wide consensus that price stability is not sufficient to ensure financial stability, which requires a robust regulation, including new macroprudential tools. However, the financial stability is generally not a monetary policy concern. The improvement of regulatory framework and the new macroprudential tools will change the transmission mechanism of monetary policy and, thus, the implementation of monetary policy (Carney, 2009).

Prior to the crisis, the most financial stability mandates were quite ambiguous and the supposition that price stability was consistent with financial stability led to few conflicts. While the crisis, financial stability mandate should strengthen and the compromise between price stability and financial stability has occurred. The question is if the central bank can jointly optimize the both objectives. As an answer to this dilemma, some inflation targeters take into consideration the solution to adjust the price stability objective and to move to the price-level targeting (Carney, 2009).

depends seriously on its credibility and the experience with inflation targeting show that credibility takes time gain. But the adoption of price level targeting is not recommended during the crisis (Walsh, 2009).

In spite of these new debates, a flexible inflation targeting, applied in the proper way and taking into account all the information regarding the relevant financial factors for the inflation forecast and resource utilization at any horizon, can be considered as the best-practice monetary policy before, during, and after the financial crisis. However it immediately calls for an improved theoretical, empirical and operational understanding of the role of financial factors in the transmission mechanism of monetary policy (Svensson, 2009).

5. Conclusion

The current financial crisis was produced by causes which had very little connection with monetary policy, and, consequently, we cannot make it responsible for crisis. Moreover, the origins of the crisis are located in a country which is not an inflation targeter.

In the context of the current crisis, the monetary policy became more expansionist, many central banks operating large cuts in the monetary policy interest rate. But, the interest-rate policy is not enough to achieve financial stability. Trying to use interest rates to attain financial stability would cause significant collateral harm to inflation and the real economy.

Furthermore, price stability is not sufficient to attain financial stability. Excellent flexible inflation targeting by itself does not support financial stability. This requires specific policies and instruments, being generally not a monetary policy objective.

In spite of the new debates about the possibility to move towards price level targeting, the strategy of inflation targeting can be considered as the best-practice monetary policy before, during, and after the financial crisis.

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