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Performance of inflation targeting based on constant interest rate projections

Seppo Honkapohja^{a,*}, Kaushik Mitra^b

^a*Faculty of Economics, University of Cambridge, Sidgwich Avenue, Cambridge, CB3 9DD, UK*

^b*Royal Holloway College, University of London*

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Abstract

Monetary policy is sometimes formulated in terms of a target level of inflation, a fixed time horizon and a constant interest rate that is anticipated to achieve the target at the specified horizon. These requirements lead to constant interest rate (CIR) instrument rules. Using the standard New Keynesian model, it is shown that some forms of CIR policy lead to both indeterminacy of equilibria and instability under adaptive learning. However, some other forms of CIR policy perform better. We also examine the properties of the different policy rules in the presence of inertial demand and price behaviour.

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1. Introduction

Inflation targeting has become a fairly common objective of monetary policy in the past 10–15 years; see e.g. Svensson (2003). This general objective can be implemented in a number of different ways. One possibility is to formulate an

*Corresponding author. Tel.: +44 1223 335251; fax: +44 1223 335299.

E-mail address: smsh4@cam.ac.uk (S. Honkapohja).

explicit objective function, i.e. a ‘general targeting rule’ using the terminology suggested by Lars Svensson. A different approach has been the use of a particular target level for the inflation rate. This target is usually specified at some given horizon for the future and we may speak of inflation forecast targeting in this case. Formally, the inflation target is set for some fixed forecast horizon h and policy tries to achieve that target:

$$E_t \pi_{t+h} = \bar{\pi}. \quad (1)$$

Here $E_t \pi_{t+h}$ is the forecast of the inflation for period $t+h$ and in the analysis it will be taken to be the rational expectations (RE) forecast. In other words, the central bank acts as if private agents have RE, which are computed under knowledge of the structural model of the economy.

It can be noted that if the horizon is long, there will typically be many different paths for interest rates up to the target horizon that achieve the specified inflation target. If this is the case, a fixed inflation target at the specified horizon does not yield a unique value or time path for the interest rate, which is the actual instrument of monetary policy. A further specialization for achieving the fixed target is to use inflation forecasts that are derived as constant interest rate (CIR) projections, see e.g. the discussions in [Leitemo \(2003\)](#) and [Svensson \(1999\)](#). CIR inflation targeting has been advocated as an easily understandable and hence practical approach to conducting monetary policy; for general discussions of its merits and problems see [Goodhart \(2000\)](#), [Kohn \(2000\)](#), [Svensson \(2004\)](#) and [Woodford \(2003, pp. 620–623\)](#).

In practice, there appear to be at least two different ways for computing and employing the CIR projections in setting the value for the monetary policy instrument. One approach, which is arguably close to the practice in the UK, has been described by [Goodhart \(2000, p. 177\)](#): “When I was a member of the MPC I thought that I was trying, at each forecast round, to set the level of interest rates so that, without the need for future rate changes, prospective (forecast) inflation would on average equal the target at the policy”.¹ Given a model of the macroeconomy, setting the forecast of inflation based on constant interest rates at a given target level of inflation implies a rule for the interest rate.

A second approach to CIR policy-making is in general terms described by the quote “. . . if the overall picture of inflation prospects (based on an unchanged repo rate) indicates that in twelve to twenty-four months’ time inflation will deviate from the target, then the repo rate should normally be adjusted accordingly”; see [Riksbanken \(1999\)](#). This way of conducting monetary policy seems (at least implicitly) to be the practice in Sweden.² In this approach, the CIR projection is computed at the interest rate prevailing before any policy decision and the rate of interest is then adjusted depending on the difference between the CIR projection and the inflation target.

¹Charles Goodhart has commented to us as a qualification that this practice is not to be followed if it leads to drastic policy changes. Our second interpretation of CIR policy has a more gradualist approach to changing interest rates.

²Anders Vredin pointed to us that in practice policy appears to respond to other aspects of the economy besides CIR forecasts of inflation.

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