

Inflation targeting with NAIRU uncertainty and endogenous policy credibility[☆]

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Abstract

Stochastic simulations are employed to compare performances of monetary policy rules in linear and nonlinear variants of a small macro model with NAIRU uncertainty under different assumptions about the way inflation expectations are formed. Cases in which policy credibility is ignored or treated as exogenous are distinguished from cases in which credibility and inflation expectations respond endogenously to the monetary authorities' track record in delivering low inflation. It is shown that endogenous policy credibility strengthens the case for forward-looking inflation forecast based rules relative to backward-looking Taylor rules. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Inflation targeting has become a popular monetary policy strategy for industrial countries. Quantitative targets or target ranges for inflation have been announced by New Zealand (in 1990), Canada (1991), Israel (1991), the United Kingdom (1992), Australia (1993), and Sweden (1993),¹ while a number of other countries have implemented strategies that emphasize informal objectives for inflation. In describing the attractiveness of such strategies, proponents have emphasized that an inflation targeting framework can make the objectives of monetary policy more transparent and, over time, may result in an increase in policy credibility that in turn has desirable implications for macroeconomic performance.²

The increasing popularity of inflation targeting has been accompanied by significant strides in the use of simple macro models to advance the conceptual framework for formulating such strategies.³ The formal literature has adopted a broad interpretation of inflation targeting, defining it to imply that policy is characterized by a reaction function in which the monetary policy instrument is adjusted in response to, but not necessarily only in response to, deviations of the inflation rate from an explicit target.⁴ Research by economists at central banks and elsewhere has demonstrated, within the context of linear models, that relatively attractive macroeconomic performances can be delivered by adopting policy rules in which the monetary authorities adjust short-term interest rates in response to both deviations of a recently observed inflation rate from target and deviations of a recently observed level of output from potential.⁵ Such strategies are often referred to as Taylor rules, based on a formulation advanced by Taylor (1993). Under some model specifications, analysis has suggested that Taylor

¹ Finland and Spain also operated with quantitative inflation targets for several years prior to relinquishing monetary policymaking to the European Central Bank.

² See, for example, Fischer (1996), Freedman (1996), Svensson (1997), Bernanke and Mishkin (1997) and Debelle (1997).

³ A number of recent examples of such papers were included in the programs of the NBER Conference on Monetary Policy Rules (January 15–17, 1998), the Federal Reserve Bank of San Francisco Conference on Central Bank Inflation Targeting (March 6–7, 1998), the Bank of Sweden Conference on Monetary Policy Rules (June 12–13, 1998), the 1998 Symposium on Computational Economics at Cambridge University (June 29–July 1, 1998), and the Reserve Bank of New Zealand Conference on Monetary Policy Under Uncertainty (June 29–July 3, 1998). Earlier contributions to the inflation targeting literature include the conference volumes Leiderman and Svensson (1995), Haldane (1995), Federal Reserve Bank of Kansas City (1996), and Lowe (1997).

⁴ Rudebush and Svensson (1999) and Svensson (1999) distinguish between reaction functions that are essentially derived as first-order conditions for minimizing policy loss functions and reaction functions that are simply postulated, suggest that the term ‘targeting rule’ should only be applied to the former class of reaction functions.

⁵ See, for example, Levin et al. (1999) and Taylor (1999).

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