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Open-economy inflation targeting

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Abstract

The paper examines inflation targeting in a small open economy with forward-looking aggregate supply and demand with microfoundations, and with stylized realistic lags in the different monetary-policy transmission channels. The paper compares strict and flexible targeting of CPI and domestic inflation, and inflation-targeting reaction functions and the Taylor rule. Flexible CPI-inflation targeting does not limit the variability of CPI inflation but also the variability of the output gap and the real exchange rate. Negative productivity supply shocks and positive demand shocks have similar effects on inflation and the output gap, and induce similar monetary policy responses. © 2000 Elsevier Science B.V. All rights reserved.

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> Why does the Bank make things so complicated? Why doesn't it just follow the Taylor rule? [Interruption by a distinguished macro economist at an American university, when the author was presenting Bank of Sweden's approach to inflation targeting]

1. Introduction

During the 1990s, several countries (New Zealand, Canada, UK, Sweden, Finland, Australia and Spain) have shifted to a new monetary policy regime,

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inflation targeting. This regime is characterized by (1) an explicit quantitative inflation target, either an interval or a point target, where the center of the interval or the point target currently varies across countries from 1.5 to 2.5 percent per year, (2) an operating procedure that can be described as 'inflation-forecast targeting', namely the use of an internal conditional inflation forecast as an intermediate target variable, and (3) a high degree of transparency and accountability.[1]

The operating procedure can be described as inflation-forecast targeting in the following sense: The central bank's internal conditional inflation forecast (conditional upon current information, a specific instrument path, the bank's structural model(s), and judgemental adjustments of model forecasts with the use of extra-model information) is used as an intermediate target variable. An instrument path is selected which results in a conditional inflation forecast in line with a(n explicit or implicit) target for the inflation forecast (for instance, at a particular horizon, the forecast for inflation equals, or is sufficiently close to, the quantitative inflation target). This instrument path then constitutes the basis for the current instrument setting.

Inflation-targeting regimes are also characterized by a high degree of transparency and accountability. Inflation-targeting central banks regularly issue 'Inflation Reports', explaining and motivating their policy to the general public. In New Zealand, the Reserve Bank Governor's performance is being evaluated, and his job is potentially at risk, if inflation exceeds 3 percent per year or falls below 0. In the UK, the Chancellor of Exchequer recently announced that, if inflation deviates more than 1 percentage point from the inflation target of 2.5 percent, the Governor of the Bank of England shall explain in an open letter why the divergence has occurred and what steps the Bank will take to deal with it.

As argued in Svensson (1998a), inflation targeting can be interpreted as the announcement and assignment of a relatively specific loss function to be minimized by the central bank. The operating procedure, inflation-forecast targeting, can be interpreted as a way of ensuring that first-order conditions for a minimum of the loss function are approximately fulfilled. The high degree of transparency and accountability, especially the published Inflation Reports, can be interpreted as a way for outside observers of verifying that the first-order conditions are fulfilled. As shown in Faust and Svensson (1997), more transparency makes the central bank's reputation more sensitive to the bank's actions and increases the cost of deviation from the announced policy. Thus, the high degree of transparency increases the incentives for the central bank to minimize the assigned loss function. This means that inflation targeting is a strong

[1] See, for instance, Leiderman and Svensson (1995), Haldane (1995), Haldane (1997), Mayes and Riches (1996), McCallum (1997), Svensson (1997a), Freedman (1996), and Bernanke and Mishkin (1997).