INFLATION TARGETING: LESSONS FROM THE INTERNATIONAL EXPERIENCE

Frederic S. Mishkin

Graduate School of Business, Columbia University and National Bureau of Economic Research
OUTLINE

! The Role of a Nominal Anchor

! Inflation Targeting: Theory

! Inflation Targeting: Experience and Lessons
  - Industrialized Countries
  - Emerging Market Countries

! Inflation Targeting: Operational Design
Discussion of IMF Conditionality
THE ROLE OF A NOMINAL ANCHOR

! Ties Down $\pi$ Expectations

! Helps Avoid Time-Inconsistency Problem

- Time-Inconsistency Resides More in Political Process

- Nominal Anchor Limits Political Pressure for Time-Inconsistency
BASIC MODEL
(Svensson, 1997)

\[ \pi_t = \pi_{t-1} + \alpha_1 y_{t-1} + \varepsilon_t \]  \hspace{1cm} (1)

\[ y_t = \beta_1 y_{t-1} - \beta_2 (i_{t-1} - \pi_{t-1}) + \eta_t \] \hspace{1cm} (2)

Central Bank Minimizes Loss Function

\[ E_t \in \delta^{t-t} L_t \] \hspace{1cm} (3)

\[ L_t = (\pi_t - \pi^*)/2 + \lambda y/2 \] \hspace{1cm} (4)

Yields "Taylor Rule"
\[ i_t = \pi_t + b_1(\pi_t - \pi^*) + b_2y_t \] (5)
INFLATION TARGETING

5 Elements

1. Public Announcement of Medium-Term \( \pi \)-target
2. Institutional Commitment to Price Stability
3. Information Inclusive Strategy
4. Increased Transparency through Public Communication
5. Increased Accountability

Inflation Targeting is *Much More* than 1.
INFLATION TARGETING
ADVANTAGES

! Allows Focus on Domestic Concerns and Mitigate Shocks

! Uses All Available Information, Not Dependent on Stable M-PY Relationship

- If \( \lambda = 0 \) in (4), then \( i \) set so that

\[
E_t \pi_{t+2} = \pi^*.
\]

i.e, "Inflation Forecast Targeting" \( (7) \)

- If \( \lambda > 0 \), then \( i \) set according to Taylor Rule in (5) and

\[
E_t \pi_{t+2} - \pi^* = c(E_t \pi_{t+1} - \pi^*)
\]

\( (8) \)
"Flexible Inflation Forecast Targeting": What is Done
INFLATION TARGETING
ADVANTAGES

! Easily Understood and Transparent

- Better than M-target if M-PY Relationship Unstable
INFLATION TARGETING
ADVANTAGES

! Increases Accountability

- Focus Debate to Reduce Political Pressures to Inflate
- Reduces Time-Inconsistency Problem
- But Need Institutional Commitment to Price Stability
  1. Insulation of Central Bank from Politicians
  2. Central Bank Instrument Independence
- Requires Regular Communication with Public, e.g., π-Report, Testify to Congress, etc.
INFLATION TARGETING
DISADVANTAGES:
Non-Serious

! Rigid Rule

! Too Much Discretion

- No for Both: Is "Constrained Discretion"

! May Increase Output Fluctuations with Sole Focus on $\pi$

- Not way it is practiced

! Produces Low Growth
- Opposite after Disinflation
INFLATION TARGETING 
DISADVANTAGES: 
Serious

! Weak Accountability at "High" \( \pi \): \( \pi \) hard to control

- Phase in Slowly

- Controlled Prices require coordination on timing and magnitude of changes

! Does Not Prevent Fiscal Dominance

- Helps if Govt Helps Set Target
INFLATION TARGETING
DISADVANTAGES:
Serious

! Partial Dollarization with Flex Rates a Potential Problem

- Depreciation => $ Debt Burden 8 => Financial Crisis
- "Benign Neglect" toward Exchange Rate Problematic
- Increased Concern with Prudential Supervision
INFLATION TARGETING
DISADVANTAGES:
Serious


! See this by modifying model to allow for exchange rate effects

\[ \Pi_t = \Pi_{t-1} + \alpha_1 y_{t-1} + \alpha_2 e_{t-1} + \varepsilon \]  \hspace{1cm} (1')

\[ y_t = \beta_1 y_{t-1} - \beta_2 (i_{t-1} - \Pi_{t-1}) + \beta_3 (e_{t-1} - e_{t-2}) + \eta \]  \hspace{1cm} (2')

\[ e_t = \varphi i_t + u_t \]  \hspace{1cm} (9)
Optimal Policy sets $i$ with Modified Taylor Rule

$$i_t = \pi_t + b_1(\pi_t - \pi^*) + b_2 y_t + b_3 e_t \quad (5')$$

- If $\lambda > 0$, then $i$ set according to Taylor Rule in (5) and

$$E_t \pi_{t+2} - \pi^* = c(E_t \pi_{t+1} - \pi^*) \quad (8)$$

- Continue to get "Flexible Inflation Forecast Targeting"

- Same Result if Worry About Financial Stability
INFLATION TARGETING:
EXPERIENCE AND LESSONS
INDUSTRIALIZED COUNTRIES

HAS INFLATION TARGETING BEEN A SUCCESS?

YES

Inflation Targeting Has Been Successful in Controlling Inflation.

\( \pi \) Reduced

Lower than Forecast with Pre-Regime VARs
HAS INFLATION TARGETING BEEN A SUCCESS?

Inflation Targeting Weaken the Effects of Inflationary Shocks.

- No Ratcheting Up of $\pi$
  - After GST (VAT) Tax Increase in Canada in 1991
  - After Sept. 1992 Devaluation in UK and Sweden
HAS INFLATION TARGETING BEEN A SUCCESS?

Inflation Targeting Can Promote Growth and Does Not Lead to Increased Output Fluctuations.

Once Disinflation Achieved, Growth is High

Output fluctuations no higher
HAS INFLATION TARGETING BEEN A SUCCESS?

! Inflation Targets Do Not Necessarily Reduce the Cost of Reducing Inflation.

! \( \pi \) Expectations Don't Immediately Fall After Adoption

! Sacrifice Ratios No Lower in Industrialized Countries

! Tentative Evidence that Cost of Reducing \( \pi \) is Lowered in Transition from Moderate to Low \( \pi \) in EM Countries
INFLATION TARGETING: EXPERIENCE

TRANSPARENCY AND ACCOUNTABILITY

The Key to Success of Inflation Targeting is Its Stress on Transparency and Communication with the Public.

Stress on Transparency and Communication

- Inflation Reports
  1. Goals and Limitations of Monetary Policy
  2. How Targets to Be Achieved
  3. Reasons for Deviations from Targets

- Speeches
- Testimony to National Parliaments
- Glossy Brochures
TRANSPARENCY AND ACCOUNTABILITY

! Inflation Targeting Increases Accountability Which Helps Ameliorate the Time-Inconsistency Problem.

! Focus Public Debate on Appropriate Long-Run Issues

! Lowers Political Pressure for Time-Inconstant M-policy
TRANSPARENCY AND ACCOUNTABILITY

Increased Transparency and Accountability Under Inflation Targeting Helps Promote Central Bank Independence.

- Provides Benchmark to Evaluate Monetary Policy
- Led to Independence of Bank of England
- 1996 Debate Increased Support for Bank of Canada
TRANSPARENCY AND ACCOUNTABILITY

! Accountability to the General Public Seems to Work as Well as Direct Accountability to the Government.

! Direct Accountability to Government in New Zealand Doesn't Work Better than Less Formalized Approaches
TRANSPARENCY AND ACCOUNTABILITY

! Inflation Targeting is Consistent with Democratic Principles.

! Instrument but Not Goal Independent

- Greater Oversight =>
  Policies Consistent with Society's Interests
INFLATION TARGETING
EMERGING MARKET EXPERIENCE

! Chilean Experience with Gradual Hardening quite Successful

- Inflation from above 20% in 1991 to 3% now

- Growth very High until Target Undershot Recently

  M-policy too tight in response to 1998 shocks
  Too Much Focus on Exchange Rate,
  Eased in 1999 and Decreased Exchange Rate Focus

- Adopt Full $\pi$-Targeting Regime Only in May 2000
INFLATION TARGETING
EMERGING MARKET EXPERIENCE

! Brazil has all "Bells and Whistles"

- Shows that this can be implemented quickly - 4 months

- Jury is not out:

  Has worked better than expected

  Fiscal policy and independence of central bank unclear

! Mexico and Peru moving toward Inflation Targeting

! Colombia: No demonstrated commitment to
Inflation Control
- Inflation Targeting Has to Be Done Right
INFLATION TARGETING  
LATIN AMERICAN EXPERIENCE

! Sound Financial System Key to Success

- Rigorous Prudential Supervision Key to Success for Chile
- Mexico ? and Peru

! Fiscal Discipline Key to Success

- Problem for Brazil and Colombia
- Multi-year $\pi$ Targets with Govt help, but not enough
INFLATION TARGETING:
OPERATIONAL DESIGN

Inflation Targeting is Far From a Rigid Rule.

- No Mechanical Instructions
- Flexible, Targets Modified
- "Constrained Discretion"
OPERATIONAL DESIGN

Inflation Targets Have Always Been Above Zero With No Loss of Credibility.

- Midpoints of Target Ranges Between 1 and 3%
- No loss of Credibility
- Optimal Level of $\pi$ Still Controversial
OPERATIONAL DESIGN

Inflation Targeting Does Not Ignore Traditional Stabilization Goals.

- Targeters Not "Inflation Nutters"
  - Do Express Concerns About Output
  - Gradual Convergence to Long-Run $\pi$-Goal => Weight on Output Fluctuations (Svensson, 1997)
  - Stabilization Goals in Appropriate Long-Run Context
OPERATIONAL DESIGN

Undershoots of the Inflation Target are as Important as Overshoots.

- π-Targeters (Canada) emphasize Floor of Target as much as Ceiling

  - Avoids Characterization as "Inflation Nutter"

- π-Target Helps Stabilize Economy because it makes it Easier for Central Bank to Respond to Negative Demand Shocks Without π_e Rising

  - Helped Australia React Quickly to East Asian Crisis
ECB Needs Clearer Communication that Floor is 0%
OPERATIONAL DESIGN

! When Inflation is Initially High, Inflation Targeting May Have to be Phased in After Disinflation.

! $\pi$-Targeting Phased in After Successful Disinflation

- Both in Industrialized and EM Countries (see Chile later)

! Reason:

- Credibility at High $\pi$ Low

- Harder to Control $\pi$ at High $\pi$
OPERATIONAL DESIGN

! Edges of Target Range Can Take on a Life of Their Own.

! New Zealand Focus on Narrow Misses, 1995

! UK Chancellor of Exchequer Resists Tightening in 1995
Because \( \pi \) still below 4% Ceiling

! Focus on Edges, Not Midpoint => Bizarre Objective

! Argues for Point Target (with report to Parliament when Miss is Big)
OPERATIONAL DESIGN

Too Short a Horizon and a Narrow Range Can Lead to Controllability and Instrument Instability Problems.

Monetary Policy Has Long Lags (2-3 Years for $\pi$)

Controllability Problem: Too Frequent Misses

1995 RBNZ Overshoot

Output Fluctuations Higher

New Zealand too Tight at End of 1996
Instrument Instability Problem:

- Interest Rates, Exchange Rates Fluctuate Too Much
- Focus on Exchange Rate Because Works Faster
- Both Problems in New Zealand

Solutions

1. Longer Horizons (2 Years)
2. Wider Range (But Problem of Possible Loss of Credibility)
3. Escape Clauses (but hard to design)
4. Core $\Pi$ Measures
5. Multi-Year Targets or Additional Long-Run Target
New Zealand Now Uses 1st 3
OPERATIONAL DESIGN

Targeting Asset Prices Like the Exchange Rate Worsens Performance.

Exchange Rate Should Be a Concern

- Direct Effects on $\Pi$ (Pass-Through)
- Affects Competitiveness and National Pride
- Effects Balance Sheets and Financial Stability
  (in Emerging Market Countries Only)
Danger of Too Much Focus on Exchange Rate

- Risks Transforming Exchange Rate to Nominal Anchor (Israel and Chile)

Effects of Depreciation Different Depending on Shocks

- Portfolio Shock is Inflationary $\Rightarrow i_8$
- Terms of Trade Shock, Exports $9 \Rightarrow i_9$
- Likely to Get Wrong Response to Real Shocks

E.g.: New Zealand, Chile Versus Australia, 1997-99
Response to Exchange Rates or Other Asset Prices Can't Be Mechanical

- Different Response Depends on Assessment of Shocks

- MCI is a Bad Idea

- Asset Prices Hard to Control, CB Looks Foolish When Miss Targets, Yet

- If CB Targets Asset Prices, Public Fears CB Too Powerful
- Govt Not Better than Market at Knowing Appropriate Prices
OPERATIONAL DESIGN

Who Should Set π Target?

- Common View: Central Bank Should Be Instrument Independent (e.g. CB sets i)
  CB Should be Goal Dependent
  (Govt Sets Long-Run π Goal with CB)

- Problem: Horizon for Medium Term Target Involves Goal and Technical Decisions
  1. Weight on Output Fluctuations Affects Horizon
  2. Length of Policy Lags Affect Horizon

- Less of Dilemma if Near Long-Run Goal
  Big Dilemma During Transition from high to low
π

! May Want CB to Set Medium-Term Target
INFLATION TARGETING
SPECIAL ISSUES FOR EM COUNTRIES

! EM Countries Need Pay Special Attention to Exchange Rate

- Probably have gone too far

- Run risk of moving to exchange rate anchor

-Passthrough is Regime Dependent
   May Improve over Time

- Rigorous Prudential Supervision Helps
INFLATION TARGETING
SPECIAL ISSUES FOR EM COUNTRIES

! How to Deal with Exchange Rate

- Smooth as is done with interest rates:

  1. Should Have Exchange Rate Affect \( i \) as in Modified Taylor Rule in 9'

  2. Determined by Market over longer horizon

  3. Avoid FX Intervention
INFLATION TARGETING
SPECIAL ISSUES FOR EM COUNTRIES

TRANSITION FROM MODERATE TO LOW $\pi$

! Basic Problem at Initially High $\pi$

1. Low Credibility of Central Bank
2. Hard to Control $\pi$

! Gradual Hardening of Targets

! Shorter Horizon (1 Year)

- Multi-Year Targets (but deviations likely)
- Annual Target Only
TRANSITION FROM MODERATE TO LOW $\pi$

! Point Target

- Range Can Weaken Credibility

! Asymmetric Inflation Targeting

- Low $\pi$: Stress Undershoots as Much as Overshoots:
  Symmetric Approach

- High $\pi$: Lose Credibility if Overshoot
  More Aggressive on Preventing Overshoots
  Danger: Output Loss Too Great and Lose Support
CONCLUSIONS
FOR EMERGING MARKET COUNTRIES

! Issue:

- Not Fix vs Flex

- Whether Have Institutions so Can Constrain Discretion

- Issue is relevant Now because $\pi$ is low(er)

! No Regime is Panacea

- Must Prevent Fiscal Dominance

- Need Rigorous Prudential Supervision for
Sound Financial System
CONCLUSIONS
FOR EMERGING MARKET COUNTRIES

! Be Skeptical of "Original Sin"

- Recent Successes suggest Countries can Grow Up
- Inflation Targeting an Option for Several of Them
UNRESOLVED ISSUE: PRICE LEVEL VS $\pi$ TARGET

! Price Level Target Better More Forward Looking is Price Setting

- Evidence Unclear

! Problem of More Likely Deflations with Price Target
UNRESOLVED ISSUE: PRICE LEVEL VS \( \pi \) TARGET HYBRID POLICIES

! \( \pi \) Target with Small Amount of Error Correction

- Additional Long-Run Average Target

! \( \pi \) Target with Deflation Escape Clause

- Price Level Target Only if Deflation Sets In
IMF CONDITIONALITY
AND INFLATION TARGETING

! Conditionality based on Financial Programming Framework

- Net Domestic Assets
- Net International Reserves

! Do NDA Ceiling and NIR Floor Make Sense Under \( \pi \) Targets?
IMF CONDITIONALITY
AND INFLATION TARGETING

Alternative Approaches to Monitoring

1. Monetary Policy Institutions
   - Central Bank Independence
   - Central Bank Mandate
   - Central Bank Transparency and Accountability
2. Bands Around $\pi$ Target
3. Taylor Rules
4. Assessment of CB Procedures
   - Forecasting
   - Explanation of Actions
     Similar to issue for Supervision of Risk Management
EXCHANGE RATE TARGET
ADVANTAGES

! Fixes \( \pi \) for Internationally Traded Goods

! Provide Nominal Anchor and Ties down \( \pi \) expectations

! Transparent: Simple and Clear

! Automatic Adjustment Mechanism (Rule)

- Prevents Time-Inconsistency?
  M-policy and F-policy
EXCHANGE RATE TARGETING
DISADVANTAGES

! Loss of Independent Monetary Policy

- Illustrated by following simple model (Svensson, 1997)

\[ \Pi_t = \Pi_{t-1} + \alpha_1 y_{t-1} + \varepsilon_t \]  
\[ y_t = \beta_1 y_{t-1} - \beta_2 (i_{t-1} - \Pi_{t-1}) + \eta_t \]

Central Bank Minimizes Loss Function

\[ E_t \delta^{t-T} L_t \]

\[ L_t = (\Pi_t - \Pi^*)/2 + \lambda y/2 \]
Yields "Taylor Rule"

\[ i_t = \pi_t + b_1(\pi_t - \pi^{*}) + b_2y_t \]  \hspace{1cm} (5)

- Loss from Exchange Rate Target Small Only If Pegging Country is Highly Integrated with Anchor Country

- Then inflation and output gaps are highly correlated so anchor country Taylor rule OK for domestic country

- Bottom Line:

"Good" M-policy Better than None for larger Countries
SOFT PEG
DISADVANTAGES

! Open to Speculative Attacks


! Weakened Accountability: Lose Exchange-Rate Signal
SOFT PEG:
DISADVANTAGES
EMERGING MARKET COUNTRIES

! Makes Financial Crisis More Likely

Financial Crisis = Nonlinear Disruption to Information =>
Can't Channel Funds to those with most productive
investment opportunities

! Institutional Features in Emerging Market Countries

1. Short duration debt
2. Debt denominated in foreign currencies
HOW A DEVALUATION CAN TRIGGER A FINANCIAL CRISIS

! E 9, Debt burden 8, Assets same => Net Worth 9
  => moral hazard 8, adverse selection 8 => lending 9

! E 9, Banks debt burden 8, Assets 9 because firms default
  => Bank capital 9 => Bank's restrict lending

! i 8, Bank capital 9 => central bank reluctant to raise i
  => speculative attack more likely => E 9

! E 9, πe 8, i 8 => interest payments 8, cash flow 9
  => balance sheets 9 => lending 9
WHY EXCHANGE-RATE TARGETING MAKES FINANCIAL CRISES MORE LIKELY IN EMERGING MARKET COUNTRIES

! Devaluation => Nonlinear 9 Balance Sheets
   Banks and Nonfinancial Firms

! Devaluation => π Surge => i 8 => Balance Sheets 9

! Encourages Capital inflows =>
   Lending Boom, Bad Loans =>
   Deterioration in Bank Balance Sheets =>
   Currency Crisis

! Story in Chile 1982, Mexico 1994-95, East Asia 1997-98
SOFT PEG: DISADVANTAGES EMERGING MARKET COUNTRIES

! Loss of Lender of Last Resort?

- Overstated for Emerging Market Countries Currently

Debt Structure Makes LLR Ineffective Anyway

! Bottom Line

Soft Peg Bad Idea in EM Countries, Except for Initial Stabilization When $\pi$ is Very High

- Issue of Exit Strategy
HARD PEGS
CURRENCY BOARDS VS FULL DOLLARIZATION

CURRENCY BOARDS

! Subject to Speculative Attacks

! High Interest Rates From Currency Risk?

FULL DOLLARIZATION

! Reduce Interest Rates to International Levels?

- Country Risk Problem (e.g. Confiscation of $-Assets)

Fiscal insolvency => confiscation of $-deposits => Banking Crisis
HARD PEGS
BOTTOM LINE

! Two Necessary Conditions:

1. Sound Financial System
2. Sound Fiscal Policy

! Hard Peg Does not ensure 2 conditions will be met
EXCHANGE RATE TARGETING: EXPERIENCE AND LESSONS

! Successful in Reducing $\pi$

- France:
  1987: $\pi = 3\%$, 2\% above Germany
  1997: $\pi = 2\%$, = Germany

- U.K.:
  1990: $\pi = 10\%$
  1992: $\pi = 3\%$

- Argentina: Currency Board
  1989-90: $\pi > 1000\%$
  1994: $\pi = 5\%$
EXCHANGE RATE TARGETING: EXPERIENCE AND LESSONS

! Output Variability & Because Lose Independent M-Policy

- Problems after German Reunification
  U.K., French Monetary Policy too Tight:
  Clarida, Gali and Gertler (1997)

- Argentina: 2 Serious Recessions in 1990s
EXCHANGE RATE TARGETING: EXPERIENCE AND LESSONS

! Still Subject to Speculative Attacks and Bank Runs

- Argentina in Tequila Crisis had Deposits 17%
- Bank Panic in Panama in 1988-89

! Hard to Exit

- Feasible if Currency Appreciating, but Political Will Weak
- Worse for Dollarized Economy:
  New Money and M-authorities lack credibility
EXCHANGE RATE TARGETING: EXPERIENCE AND LESSONS

! Two Necessary Conditions for Exchange Rate Peg to Work:
   1. Sound Financial System
   2. Sound Fiscal Policy

! Even Hard Peg Does not ensure 2 conditions will be met

- Weakness of Argentina's Banking System almost brought down Currency Board in 1995
- Soundness of Panama Banks Result of Foreign Ownership

-Panama's Fiscal Policy No Better
   Request for 13 IMF Programs - Most in Latin America
- Argentina Still Has Fiscal Problems
EXCHANGE RATE TARGETING:
BOTTOM LINE

! Soft Pegs Highly Dangerous

- May be Useful for Stabilization, but Not for Long Run Strategy

! Hard Pegs only Feasible Strategy in Some EM Countries

If political and economic institutions cannot support independent central bank focused on price stability
MONETARY TARGETING

3 Elements

1. Use of M-aggregate to guide conduct of M-policy
2. Announcement of M-target
3. Accountability to Meet Target
MONETARY TARGETING:
ADVANTAGES

! Able to Cope with Domestic Considerations

! Nominal Anchor that is Fairly Understandable

! Signals are Immediate

! Immediate Accountability of Central Bank
MONETARY AGGREGATES: DISADVANTAGES

Advantages Only *IF* Strong Relationship between M and PY

- Illustrate by adding money demand function to model above

\[ m_t - p_t = \gamma y_t - \kappa i_t + \upsilon_t \quad (6) \]

- Presence of \( \upsilon_t \) and uncertainty about parameters \( \gamma \) and \( \kappa \) => Weak Relationship between M and PY, M-Targeting Deviates from Optimal Policy in (5), Higher Volatility of \( Y, \Pi \) and \( i \).
MONETARY TARGETING: EXPERIENCE AND LESSONS

! Not Successful in U.S., Canada, U.K.

- Not Pursued Seriously

- Instability of M-PY Relationship

"We Didn't Abandon Monetary Aggregates, They Abandoned Us."
MONETARY TARGETING: EXPERIENCE AND LESSONS

! Has Not Been Practiced in EM Countries like Latin America

- Many central banks have first element, but not others

- Peru is cited as having Monetary Anchor in 1990s, but never Announced Target Strategy is discretionary

- Instability of M-PY Relationship When $\pi < 20\%$

Mexico:

1997: $MB > MB^* \text{ by } 4.1\%, \pi = 15.7\% = \pi^*, 15\%$
1998: $MB < MB^* \text{ by } 1.5\%, \pi = 18\% > \pi^* = 12\%$
1999: MB > MB* by 21%, \( \pi = 12.3\% < \pi^* = 13\% \)
MONETARY TARGETING: EXPERIENCE AND LESSONS

Swiss and Especially German Experience More Successful

- Not Bound by Monetarist Orthodoxy

- Means to Communicate Strategy and Focus on Long-run

  Inflation Goal Explicit and Work Backwards to M-target

- Flexible:

  Target Ranges Missed 50% of time
Π-G: Goal Varies and Adjusted Slowly to Long-Run Goal
MONETARY TARGETING: EXPERIENCE AND LESSONS

! Germany: Highly Successful Even with Flexibility

- Produced Low $\pi$ => Anchor Country for ERM

- Kept $\pi$ in Check after German Reunification

- Criticism: Asymmetric Response to Target Misses => Not Concerned Enough About Undershoots, Policy Too Tight in mid 1990s?
MONETARY TARGETING: EXPERIENCE AND LESSONS

! Switzerland: Problematic Since 1988

- 1989-92: $\pi$ 8 to 5%

  New Interbank Payment System Distorts M-PY Relationship

  Exchange Rate Shocks

- Result: Move to Much More Flexible Framework
MONETARY TARGETING: EXPERIENCE AND LESSONS

! Bottom Line: Key Elements

- Flexibility
- Transparency
- Accountability

! Same Elements in π-Targeting

! Germany and Switzerland Closer to π-Targeting than to Monetarist M-Targeting
MONETARY POLICY WITH AN IMPLICIT BUT NOT AN EXPLICIT NOMINAL ANCHOR: "JUST DO IT"

! Greenspan Fed

! Implicit Commitment to Price Stability

! Forward-Looking and Preemptive to Deal With Long Lags
"JUST DO IT"
ADVANTAGES

Able to Cope with Domestic Considerations

Does Not Rely on Stable M-PY Relationship

Demonstrated Success: Worked Well in the U.S.

If It Ain't Broke Why Fix It
"JUST DO IT"
DISADVANTAGES

! Not Transparent

! Lack of Accountability

! Exposure to Inflation Scares

! Missed Opportunity to Focus Debate on Long-Run
  - Contrast of Response to 1997 M-tightening in UK and US

! Makes CB More Consistent With Democratic Principles
  - Promotes CB Independence
JUST DO IT
DISADVANTAGES

! Requires Good Monetary Policy and Political Institutions

- U.S. Has Good Institutions

But Even Fed Has Fallen Off Anti-\(\pi\) Wagon in Past

Especially Good Policymakers Recently in U.S.

Greenspan, Rubin, Summers

Unprecedented Cooperation Between Fed and Treasury

- Most Other Countries Don't, Particularly EM Countries