



Inflation Targeting; challenges facing industrialised countries

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Outline

- What is Inflation Targeting?
- Benefits of IT
- Challenges
 - Framework/concept
 - Communication
 - Forecast



Inflation targeting

- Public announcement of quantitative target
- Price stability main goal of monetary policy
- Policy based on wide set of information, including inflation forecast
- Increased transparency
- Increased accountability



Benefits of IT

1. Policy linked to medium/long term goals, but with some short term flexibility (Bernanke 1999)
2. Target informs and anchors expectations (Orphanides and Williams 2003, Levine and co, 2004)
3. Systematic approach to policy makes it predictable → more influence over expectations



Benefits of IT

4. Institutional continuity
(Bernanke)

5. Easy to explain to public



What is the empirical evidence?

- Ball and Sheridan (2003)
 - “Once one controls for regression to the mean, there is no evidence that inflation targeting improves performance”
- Other studies disagree
 - e.g. Vega and Winkelried (2005), Hyvonen (2004)
- Levin et al (2004) find evidence that persistence is lower, and expectations more anchored in IT countries.



Challenges

- Challenges to all central banks
 - Asset prices
 - Higher energy prices
- Challenges to inflation targeters
 - Challenges to the framework and concept
 - Communication challenges
 - Forecasting issues



Challenges to the framework

1. IT puts too much weight on inflation relative to other goals
2. Inflation target reduces “flexibility”
“Placing any number on an inflation objective - however much it would be surrounded with caveats - has the potential to constrain policy in some circumstances in which it would not be desirable to do so.” Don Kohn (2003)
3. IT ignores money
4. IT ignores asset prices



IT a relatively new framework

IT framework corresponded to time of Great stability/ NICE decade; When the going gets tough, will central bankers be blamed?

Will IT frameworks survive?



Communication

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“A central bank’s effectiveness is largely determined by its credibility. But what that now requires is not just an ability to make the right decisions at the right time. In order to manage expectations of interest rates and inflation, those decisions need to be put into context and explained in a way that is rational and consistent” (Lambert 2004)



Techniques of communicating

- How precisely to define target?
- Press Conference?
- Minutes?
- Votes/Differences in view?
- Information overload?



Communication strategy depends on decision making structure

Blinder and Wyplosz;

1. Governor takes decision; no votes no minutes
2. Autocratically-collegiate committee; pre-prepared statement for press conference
3. Consensus committee; no votes, no minutes, press conference important
4. Individualistic committee; no press conference; votes and minutes are key



Should the CB communicate a path for interest rates?

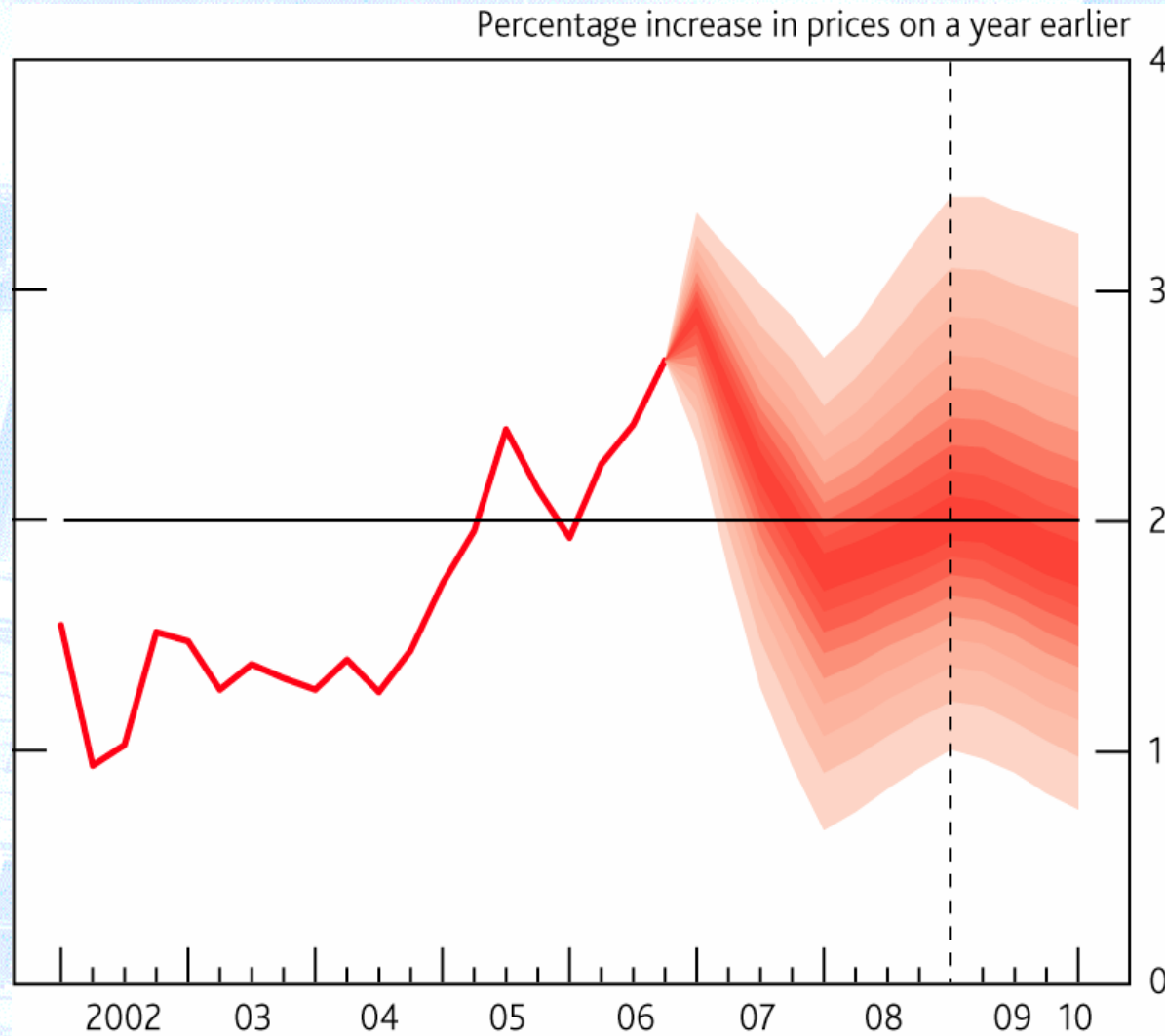
Inflation forecasts are conditioned on :

- Constant interest rates
- Interest rates expected in the market
- CB's own forecast of interest rates



- Bank of England
 - Forecast conditioned on market path.
- New Zealand
 - publishes “recommended” path (since 1997)
- Norway (since 2005)
- Sweden (Feb 2007)

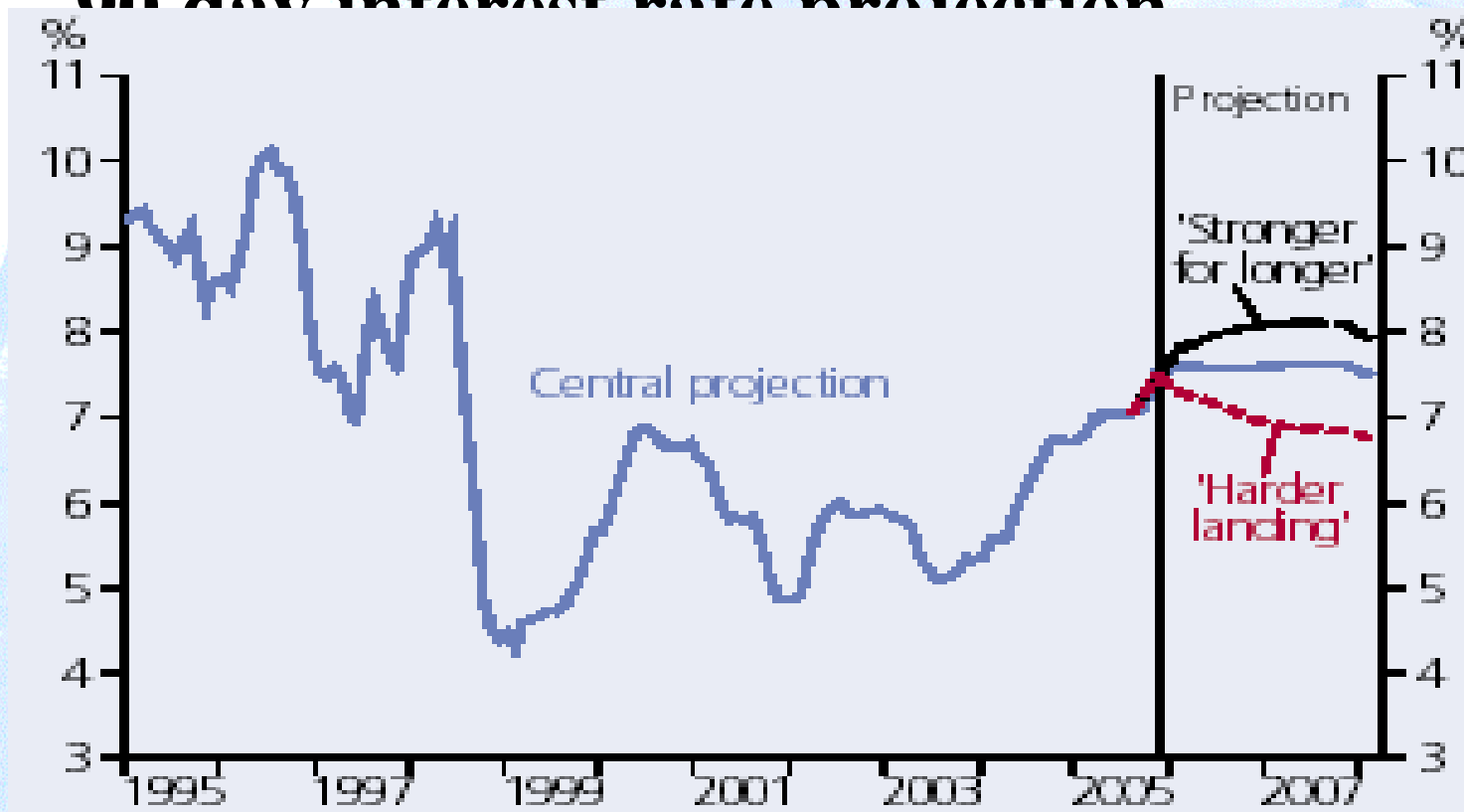
Chart 2 Current CPI inflation projection based on market interest rate expectations



Charts 5.3 and 5.4 The fan chart depict the probability of various outcomes for CPI inflation in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation over the subsequent three years would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outcomes of inflation are also expected to lie within each pair of the lighter red areas on 10 occasions. Consequently, inflation is expected to lie somewhere within the entire fan chart on 90 of 100 occasions. The Bank of England does not accept any liability for misleading or inaccurate information or omissions in the information provided. See the box on pages 18-19 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents. The dashed line is drawn at the two-year point.



Reserve Bank of New Zealand: 90 day interest rate projection



Source: RBNZ Monetary Policy Statement December 2005

- **Conditional projection includes upside and downside scenarios**

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scenarios

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Figure 2
Successive projections of 90 day interest rates

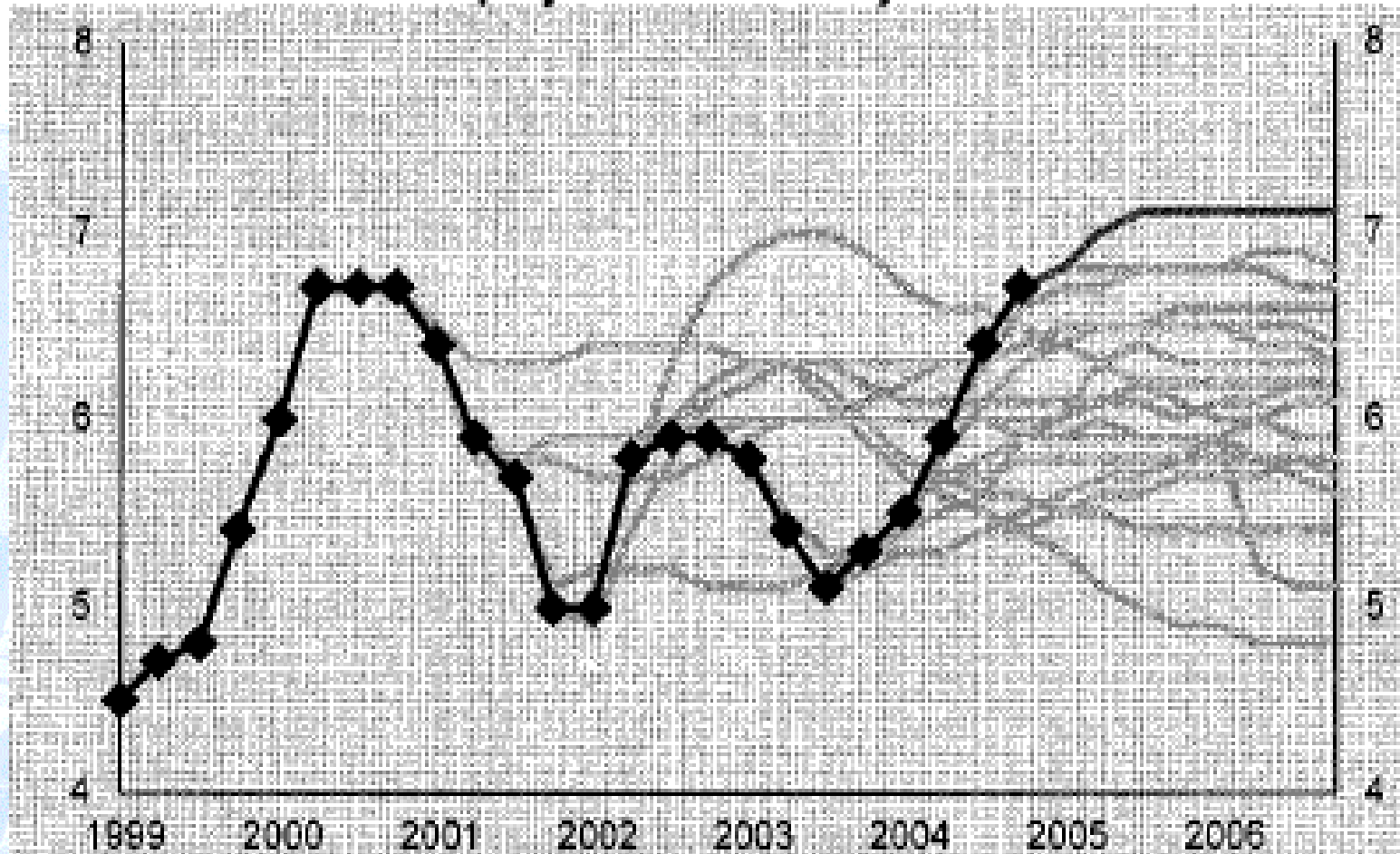
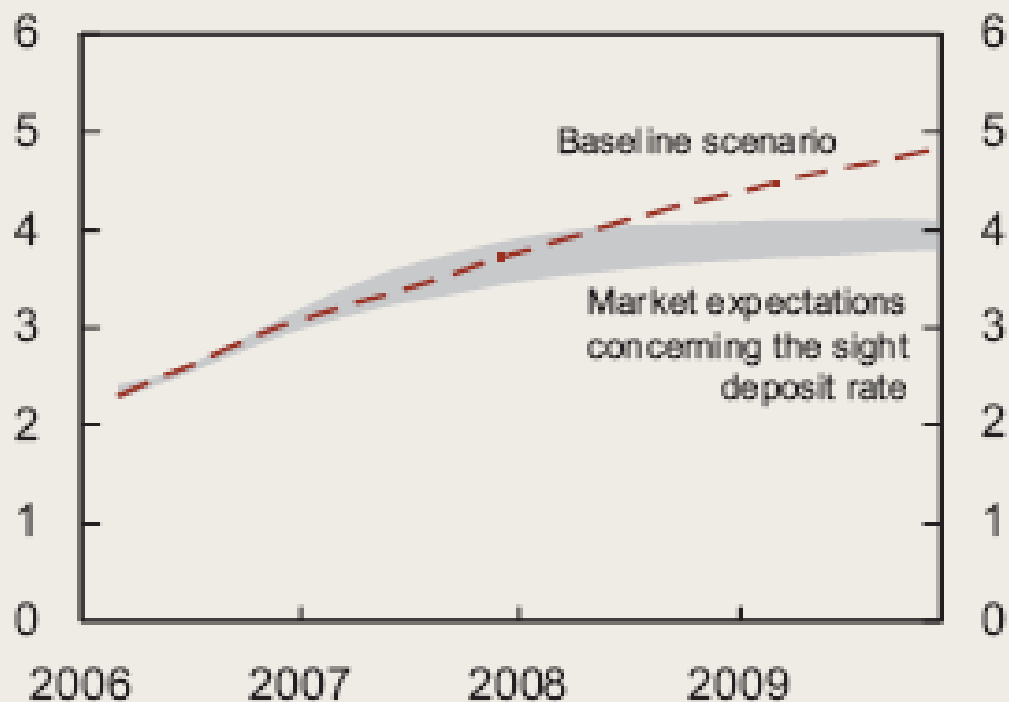




Chart 1.11 Sight deposit rate in the baseline scenario and market expectations concerning the sight deposit rate.¹⁾ Per cent. Quarterly figures. 06 Q1 – 09 Q4



¹⁾ Derived from estimated forward rates. The sight deposit rate was reduced by a credit risk premium and a technical difference of 0.20 percentage point. The grey, shaded interval shows the highest and lowest interest rates in the market's sight deposit rate path in the period 27 Feb – 10 Mar 2006.

Source: Norges Bank

Should the central bank publish its projections for interest rates



- Recent academic literature on CBs publishing interest rate paths (papers by Svensson, Goodhart and Woodford)
- Is it practical for a Committee to agree on a path
- Does this information help the audiences we are targeting ?
- Will the audiences understand the conditional nature of the projections?
- In the end- a choice between explicit and implicit communication

Conclusions



Inflation targeting proved successful in those industrialised countries that adopted it

Frameworks have been flexible

But IT still relatively new

Challenges to;

Framework

How it is implemented in practice