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Adopting Inflation Targeting: Overview of Economic Preconditions and Institutional Requirements

Summary

Since the beginning of the 1990s, an increasing number of developed and developing countries have introduced inflation targeting as their monetary policy framework, making low inflation the primary objective of monetary policy. This is based on the consensus view in economics that price stability is an important prerequisite for sustainable real economic growth, and central banks should thus direct their policies at achieving this goal, subordinating other, potentially conflicting objectives.

Inflation targeting utilizes an explicitly announced, clearly defined and numerically specified inflation target as nominal anchor of monetary policy. Taking the transition country context into account, this target should be jointly established and announced by the central bank and the government, as this ensures crucial government backing of the strategy and thus enhanced credibility.

However, further institutional requirements need to be established in support of this strategy. In this regard, the central bank needs to be granted operational independence, directing their instruments solely at the achievement of the target. This also implies that monetary considerations must not be dominated by fiscal considerations – on the contrary, a prudent fiscal policy stance is needed to boast public confidence in the framework. At the same time, the central bank is accountable for meeting the inflation target set. This makes it necessary that the public has enough information for monitoring the actions of the central bank, i.e. the framework needs to be highly transparent and involves a high degree of communication. All these measures help to ensure the credibility of the central bank in achieving its target, which is critical for success.

Furthermore, a number of macroeconomic and financial preconditions need to be established before the start of inflation targeting. These include external and financial sector stability, ensuring that the central bank can focus on inflation control without potentially conflicting objectives which might arise from external or banking sector vulnerabilities. Similarly, the rate of inflation at the time of introduction should not be too high, in order not to risk reputational damage to central bank credibility.

In case these requirements and preconditions are in place or in the process of being established – most of them beneficial in their own right and not necessarily related only to inflation targeting- the successful introduction of inflation targeting can make a key contribution towards higher macroeconomic and financial stability.

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1. Introduction

Monetary policy can be considered a very powerful tool for policymakers in guaranteeing a stable macroeconomic environment. Therefore, adopting the right monetary policy framework is a key decision to be taken by the authorities. More and more advanced countries[1] decided over the 1990s to make low inflation the main objective of their monetary policy, and tried to reach this objective with a strategy of inflation targeting (IT). This was partly a response to various difficulties encountered with alternative strategies like exchange rate or monetary targeting. The overall success of these countries in bringing down and stabilizing inflation at low levels caused many emerging and transition countries all over the world to consider the adoption of IT[2]. In Eastern Europe, advanced transition countries like Poland, Hungary, and the Czech Republic are currently pursuing such a monetary policy framework rather successfully.

This international experience has also sparked an active discussion in Belarus about a change in the monetary policy strategy of the NBB and a shift to a future direct IT framework. The legislative basis for the future introduction of IT in Belarus is the "Program of Banking Sector Development in the Belarusian Economy for 2006-2010"[3]. In this document, a future move to direct IT is mentioned, aimed at the second half of this period, and to be introduced in a gradual fashion.

However - independent from a specific country context -, there are a number of necessary preconditions and institutional requirements for such a regime shift in several fields. A premature shift to such a new monetary policy framework, without these conditions in place, could entail certain risks with potentially huge economic costs. Therefore, due to their importance for the overall success of the new monetary policy framework, these preconditions and institutional requirements are the topic of this paper. We will not provide a detailed assessment of the pros and cons of IT, as this

[1] The first country to adopt inflation targeting was New Zealand in 1990, followed by Canada, the UK and Sweden.
[2] A second reason were the wide-spread financial crises connected with fixed exchange rate regimes of the 1990s, which made a shift to an alternative nominal anchor necessary.
[3] Presidential Edict No 27 from 15 January 2007, downloadable under: http://www.nbrb.by/publications/banksectordev06-10.pdf.

has been extensively discussed in the literature[4]. In a companion paper (PP/07/07) titled "Adopting Inflation Targeting: Operational Framework for Belarus" we deal specifically with operational issues involved in a move towards targeting inflation directly by the monetary authorities in Belarus.

The paper is structured as follows: Part 2 analyses the determination of goals and objectives under IT. After that, part 3 discusses key institutional features related to the conduct of monetary policy under an IT regime. This concerns in detail the operational independence, transparency and accountability of the central bank and the absence of fiscal dominance. The following part 4 deals with the macroeconomic and financial preconditions necessary to be in place for a successful shift to IT. In Part 5 we conclude.

2. Objective of Inflation Targeting

In an IT framework, an explicitly announced, clearly defined and numerically specified inflation target serves as long-run goal of monetary policy. The commitment of the monetary authorities to achieve such a target provides the nominal anchor of the system, tying private sector expectations of inflation to this level if the framework is perceived to be credible. Insofar as private agents base their actions on these inflation expectations, uncertainty is reduced and the central bank can more easily achieve their target.

The long-term commitment to price level stability as a legal mandate for the central bank has a number of advantages, which are nowadays among economists undisputed. First, there is wide scientific consensus that in the long-run money is neutral to real economic activity (employment and output), and only impacts prices. However, in the short-run, such an impact on activity is given, and monetary policy can have real effects. Second, high and volatile inflation is costly in economic terms, and should be therefore avoided. Low and stable inflation is conducive to sustainable economic growth and socio-economic development. Therefore, clear priority has to be given to price stability over other, competing objectives for monetary policy. It is not possible to target at the same time another nominal variable, like the nominal exchange rate, in a consistent way. In case the central bank tries to target multiple goals without a clear hierarchy, conflicts of interest will arise in relation to other possible objectives, and credibility and effectiveness of the central bank will be undermined. Therefore, in order to avoid confusion, other policy objectives need to be subordinated to the primary goal of price stability. However, this implies also that *as long as price stability is not jeopardized*, the central bank is also flexible to follow other, secondary objectives like general support for state economic policy.

An important issue in this regard is which authority sets the inflation target. International practice is mixed about this, and the concrete setting is done in different ways. While some countries determine the target jointly between the central bank and the government (New Zealand, Canada, Czech Republic, Hungary), other countries allow either the government (UK) or the central bank (Sweden, Poland) to establish the target on their own. Given the complex roots of past (hyper-) inflations in transition countries, predominantly in fiscal issues, it seems a good opportunity to improve the overall credibility of the IT framework by coordinating the activities of the central bank and the government (represented through the ministry of finance) through a joint adoption of the target. Such an explicitly government backing of the target would make the policy objective more clear and credible and thus support the actions of the central bank. Overall confidence in macroeconomic policies would be strengthened.

[4] See Truman, E.M. (2003). *Inflation Targeting in the World Economy*, Institute for International Economics, for a further discussion.

3. Institutional Requirements in the Conduct of Monetary Policy

As has been demonstrated in the last chapter, the firm anchoring of inflation expectations is a key contribution to stabilizing the actual rate of inflation. The central bank needs to operate with a high degree of credibility in its policy conduct; otherwise the fulfilment of its final objective is endangered. The importance of credibility can best be illustrated by describing a negative scenario where the public does not trust the central bank to reach its stated target, i.e. where policy lacks credibility. In this case, inflation expectations are high and not anchored by the target. This in turn influences actual inflation, at least in the short run, which will increase. Then the central bank is confronted with the dilemma to either tighten monetary policy drastically, risking a negative impact on output and employment, or to accommodate high inflation, which will further damage its credibility. Therefore, credibility is a key feature for a successful conduct of monetary policy. In order to acquire the necessary credibility quickly, a number of institutional requirements and arrangements need to be established as support for the IT framework.

3.1 Operational Independence

The key institutional arrangement in the framework of IT is without doubt the delegation of operational independence[5] to the central bank. The monetary authorities need to be free in setting monetary policy instruments to pursue the inflation target which has been previously established[6]. This operational independence is absolutely necessary for the regime to be credible, as it demonstrates that the central bank has both the authority and the capability to use all its instruments to influence the operating target[7] to achieve the inflation target. While the context of general central bank independence is much broader, and includes other aspects as well, this is for the introduction of inflation targeting not essential at this stage of the process[8].

3.2 Absence of Fiscal Dominance

To support operational independence and to give further credibility to an IT framework, especially at an early stage, many countries have introduced budgetary reforms to limit the incentive of budget financing through direct central bank credit. The monetary expansion implied by such a fiscal deficit financing would endanger credibility, private sector expectations, and lead to negative policy outcomes. However, also quasi-fiscal activities like directed lending to certain sectors at the request of the government, either through the central bank or via other, state-owned banks can endanger policy credibility and thus need to be eliminated. At the same time, the commercial orientation of the banking system has to be strengthened and credit allocated in an efficient way. Overall, prudence in fiscal and quasi-fiscal activities is required in such a way that fiscal considerations don't constrain monetary policy.

3.3 Transparency

Enhanced transparency in all aspects of the conduct of monetary policy is a key requirement for central banks targeting inflation, as this enables the private sector to constantly monitor the performance of the authorities[9]. This refers to a clarification of policy objectives, the decision making mechanism and policy implementation issues.

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[5] This form of independence is often also called "instrument independence" in the literature.

[6] The question who sets the target (the government, the central bank, or jointly) is not of importance in this respect.

[7] In developed countries that have adopted an IT framework, this is usually a short-term interest rate.

[8] In the longer term, however, the advantages of a more comprehensive approach to central bank independence should be considered.

[9] Obviously, in case an exchange rate target serves as nominal anchor, the monitoring is much easier for the public than in the case of inflation targeting, where long and variable lags exist between instrument use and impact on inflation.

In this respect, regular and extensive communication is an important tool to achieve credibility. Regular reviews and assessments of the past development of inflation and the explanation of policy measures taken are essential elements of such a communication strategy, as well as forward-looking information like the possible development of inflation in the future[10] and guidance of possible policy responses.

The central bank should use in principle a combination of different tools to communicate with the public: periodic inflation reports, press releases and conferences explaining policy decisions[11] and special research publications that help to better understand the link between policy actions and inflation results. In doing so, it can signal its intentions to the private sector and prevent possible policy surprises.

3.4 Accountability

The explicit announcement of inflation targets and the delegation of autonomy to the central bank to met them raises automatically the question of accountability. "Accountability" refers to the fact that the central bank is responsible for fulfilling its stated objectives. While operational independence of the central bank is a prerequisite and can be considered a major pillar of the IT framework, accountability for the actions taken mirrors this increased autonomy and is therefore a natural complementing institutional mechanism. In this regard, past policy actions, but especially any deviations of actual inflation from the inflation target need to be carefully explained and the source of this deviation to be analysed. In the UK, for instance, every time inflation diverges by more than one percentage point by either side from the specified threshold, the central bank is required to write an open letter to the government, explaining the reasons behind it and stating with which measures inflation can be brought back on target in the future. It is obvious that a transparent conduct of monetary policy promotes the accountability of the central bank, both to the private sector and to other designated public authorities [i.e. the legislative (parliament) and/or the executive (government)].

4. Macroeconomic and Financial Preconditions

Generally, the adoption of IT, especially in emerging and transition countries, has taken place in a gradual way, rather than at a single point in time. This transition period, which typically started after the official announcement of a future shift to an IT regime, gave the authorities enough time to develop and install the necessary institutional requirements and capacities, but also have the right macroeconomic and financial preconditions in place. Otherwise, with macroeconomic and financial instabilities present, this might burden the central bank with conflicting goals and damage its credibility. The following macroeconomic and financial preconditions are necessary for a successful implementation of IT:

4.1 External Stability

While IT is inherently oriented towards achieving domestic policy objectives, i.e. a low and stable rate of inflation, the external position of the country has to be taken into account. If there is not sufficient stability in the external position of the country due to frequent shocks to the balance of payments, and resulting disturbances in the foreign exchange market, monetary policy might become trapped in a conflict between domestic objectives (as specified in the IT framework) and reaching external stability. Therefore, the ideal time for a shift to IT would be in a period of external stability, where such conflicts of interest will not arise.

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[10] Conditional inflation forecasts play a major role in the operational framework. This topic is covered in our companion paper.

[11] In some countries, minutes and voting results of the meetings of the policy decision body are available to the public in a timely manner.

4.2 Stability of the Financial System

The operational independence of the central bank implies that during the conduct of its monetary policy it sets its instruments in such a way as to bring the rate of inflation in line with the announced target. Fluctuations in its operating target (normally a short-term interest rate) are necessary and part of the implementation of this strategy. If the banking system is not robust enough and financial markets are shallow, the impact of interest rate increases, which can be necessary to control inflation, might lead to financial stress in the sector. Similarly, the expected increase in exchange rate movements, which normally follows the introduction of IT has to be managed by the banking system. Therefore, the establishment of a well supervised and regulated, efficient banking system, which is able to withstand such volatilities, needs to be in the focus of the authorities prior to the introduction of IT. Otherwise, the credibility of the central bank is undermined if private agents expect it to use its instruments to cushion the banking system against financial volatility rather than to direct it at achieving the inflation target.

4.3 Declining Inflation

Usually, the introduction of IT follows a period of already declining inflation rates, with annual rates not above 10% at the time of introduction[12]. In doing so, policymakers avoid the problem of having to set very high targets (which might be perceived as too high by the public) or to drastically reduce inflation over a relatively short period of time. While severe reputational costs might be associated with the former case, also including target misses, the latter case might cause disruptions to the economy.

5. Conclusions

Sound economic arguments back the view that a monetary policy regime directed primarily at domestic inflation control supports best a dynamic and sustainable socio-economic development. While very important for social reasons, low inflation is also a prerequisite for high long-run economic growth. Many countries, both developed and developing have reacted over the last two decades to this consensus view by introducing IT as a flexible monetary policy framework, which is able to achieve this objective, but is also able to stabilize short-term output and employment fluctuations along this way. The essential feature of this regime is a nominal anchor in the form of an explicitly announced, clearly defined and numerically specified inflation target.

However, in order to establish with IT a strategy that ultimately improves the performance of monetary policy, this paper identified some challenges of adoption. Certain institutional requirements need to be in place, which safeguard the success of the framework and increase its credibility. This ensures that the central bank is able to direct its monetary policy at achieving its objective without disturbances from other sides.

Furthermore, the introduction of IT following the application of other monetary policy regimes (i.e. exchange rate targeting) should be done in a gradual process, which also takes into account certain macroeconomic and financial sector preconditions. The establishment of these preconditions until the time of the introduction of IT increases the likelihood of a successful application right from the start.

To conclude, while above described preconditions and institutional features are essential building blocks of IT as a concrete monetary policy framework, they have also intrinsic benefits in their own right. Regardless of the concrete regime, be it monetary or exchange rate targeting, issues like operational independence and absence of fiscal

[12] See Masson, P., Savastano, M., and Sharma, S. (1998). Can Inflation Targeting Be a Framework for Monetary Policy in Developing Countries?, *Finance & Development*.

dominance can be considered critical to virtually any systematic monetary policy regime, and should therefore have a prominent place on policymakers' agenda.

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