1997 conference

Price Stability, Inflation Targets and Monetary Policy

Proceedings of a conference - May 1997

Session 4 - General Discussion

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In response to the presentations made by the other members of the round table, Allen commented that to introduce targets there must be a certain minimum level of credibility, since there is a significant lag between the announcement of the inflation target as a goal and the attainment of the target. For this reason, targets could not have been introduced during the high inflation of the mid-1970s, since there was not adequate credibility.

Sherwin commented that in New Zealand (as in Sweden), changes in the exchange rate have caused problems in terms of the mix of monetary conditions. In particular, the exchange rate has appreciated considerably in the last few years and, given the relative performance of the tradable and non-tradable sectors, a lower exchange rate and higher interest rates would be preferable. Sherwin also commented that at times there was a large gap between inflation as measured by the consumer price index (CPI) and underlying inflation, but wage settlements and other indicators of expectations seemed to follow the underlying rate. The inclusion of mortgage interest rates in the CPI was noted as a problem by all the round-table participants.

Charles Freedman reiterated Sherwin's point that it is hard to disentangle the exact effect of adopting targets from the effects of the other policy changes being implemented. In this regard he said that at the conference on targeting inflation, hosted by the Bank of England in March 1995 (see Haldane 1995), some clear similarities were seen among countries that had adopted inflation targets. In particular, all had had high inflation, all had been forced to float their currencies, and all had found monetary aggregates too unstable to target. Satisfaction with the adoption of targets, including the adjustment of expectations, and the implications of explicit targets for the communication of monetary policy, seemed to be widespread. Freedman said he viewed targets as necessary but not sufficient for achieving low interest rates. In Canada, for example, appropriate fiscal policy was also needed.

Freedman also responded to Allen's statements that the Bank of England preferred not to focus on an index of monetary conditions. Freedman stressed the importance of distinguishing between the desired and the actual level of the monetary conditions index (MCI), and pointed out that the Bank of Canada interprets exchange rate movements according to whether they change desired monetary conditions. For example, a depreciation in the dollar due to factors associated with changes in the market assessment of political or fiscal risk would not change the desired monetary conditions. The depreciation would be expansionary and would require higher interest rates. However, movements in the exchange rate due to other shocks, such as a domestic demand shock or a terms-of-trade shock, would imply a change in the desired monetary conditions. He agreed that the mix of monetary conditions is not always ideal and can be driven by various factors, including fiscal policy. Allen commented that he agreed with Freedman on the need to interpret exchange rate movements but worried about adopting a frame of mind in which exchange rate movements are treated as being exogenous. Sherwin commented that the Reserve Bank of New Zealand started using the MCI more publicly at the end of 1996, and has found it a useful tool. Both Heikensten and Sherwin cautioned, however, that it is easy to misuse the MCI, taking too simplistic an approach.

Glenn Rudebusch asked the panel members whether they viewed the adoption of targets as just a change in operating procedures or also a change in the monetary policy goal. Allen replied that he could not see a distinction between the two. Targets were adopted as the best means to bring about price stability. Heikensten said that the adoption of targets was a change in objectives and procedures.

Juha Tarkka from the Bank of Finland outlined the Finnish experience. Finland adopted an inflation target in early February 1993. The target was expressed in terms of a target point¯2 per cent inflation from 1995 onwards¯rather than in terms of a target range, and the measure of inflation was the CPI excluding interest rate costs and indirect taxes. He said that targets were initially implemented as a crisis management tool following a large and sustained depreciation of the markka. Now they are viewed as part of the co-ordination mechanism for fulfilling the requirements of European economic and monetary union. In hindsight, he felt that greater thought could have been given to the measure of underlying inflation, and the central bank could have been more open in publishing its own inflation forecasts.

Daniel Sichel asked the round-table discussants why they had all adopted the CPI as the main base index and what discussion there had been about measurement errors. Both Sherwin and Heikensten said that while errors are likely in their measures of the CPI, they feel that they are generally small, and should not be focussed on. Allen and Heikensten stressed that the main factor in choosing the CPI is the need to use a measure of prices that is generally familiar. Allen commented that the United Kingdom excluded mortgage interest costs from the CPI, and Heikensten said that Sweden may consider excluding some items from its measure of underlying inflation in the future.

David Johnson questioned why the round-table participants had stressed the need for consistent fiscal policy. Allen replied that an unsustainable fiscal policy leads to pressure on the central bank to monetize the debt, thus reducing credibility in monetary policy. Both Heikensten and Sherwin mentioned the impact that fiscal policy can have on the mix of monetary conditions. Heikensten said that perceived shifts in fiscal policy can have a substantial effect on interest rates. Sherwin said that the New Zealand government is now running a surplus. Recent tax cuts and spending increases, while still prudent fiscal policy, are contributing to push the exchange rate higher.

All three round-table participants stressed the need for effective communication of the principles and analytical framework underpinning monetary policy, and noted that the adoption of targets was accompanied by a shift to more frequent and more transparent communications with the public. George Rich, from the Swiss National Bank, asked how the nature of communicating monetary policy should change when inflation is low. In particular, he questioned whether more attention must be given to discussing different shocks and the appropriate monetary policy responses¯that is, what the central bank's reaction function should be in a world of low inflation. Allen agreed that there had been a shift in communication towards explaining the need for stabilization rather than the disinflation policy. Sherwin said that the Reserve Bank of New Zealand specifies publicly its reaction function, and its regular reports include descriptions of shocks occurring and how the Reserve Bank intends to respond.

Reference

Haldane, A. G., ed. 1995.
Targeting Inflation. Proceedings of a conference of central banks on the use of inflation targets, organized by the Bank of England. London: Bank of England.