The Future of Inflation Targeting

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A decade ago, Bernanke and Mishkin coined the term "constrained discretion" to summarise the essential elements of an inflation targeting regime. I think this term is a very useful one, and I'm going to use these two themes of *constraint* and *discretion* to organise my comments today.

Let me start, though, with a brief comment about definitions. Different people mean different things by inflation targeting. At the most general level, it could be said that any sensible, independent monetary policy regime is really an inflation target. Why? Because a sound monetary framework has to involve some notion of the inflation rate you're aiming at, along with a suitable degree of commitment to achieving it. On this broad definition, both the Fed and the ECB might be thought of as inflation targeters. We have a pretty good idea of the inflation rates they regard as acceptable, and their commitment to inflation control is well understood.

Others prefer a stricter definition, and would define inflation targeting as a package that includes not just a numerical target but also things like a formalised delegation of responsibility for hitting the target, penalties for over- or under-shooting, and a particular style of inflation report with fan charts and the like. Along these lines, I was once asked whether Australia practiced something called 'fully fledged inflation targeting'. I wasn't quite sure how to respond, because the alternative of owning up to having a 'half-baked inflation target' that didn't seem all that attractive. This kind of definitional debate doesn't get us very far but, for what it's worth, I favour a pragmatic definition. Inflation targeting means having a numerical target and a commitment to achieving it, and putting that commitment at the centre of your communication strategy. But that general definition can cover a wide range of practices and institutional details.

This brings me back to the notion of constrained discretion. The conduct of monetary policy necessarily entails an element of discretion, simply because it's impossible for a central bank to specify in advance how it's going to respond to every contingency. The point of having an inflation target is to embed that discretion in a framework that imposes discipline and credibility. When countries like Canada, New Zealand and the UK adopted inflation targets in the late 1980s and early 1990s, they were seeking to restore credibility after policy regime failures, in the form of either excessive inflation or the collapse of a fixed exchange rate. In other words, they were emphasising the *constrained* part of constrained discretion. New Zealand in particular pioneered the credibility-building features of inflation targeting – namely, strict boundaries for inflation control combined with the threat of disciplinary action in the event of a breach.

It's interesting to note, however, that modifications to these regimes have so far generally been in the direction of loosening the constraints. New Zealand has lifted its initial target and softened the edges. Canada suspended the original program of

lowering its target to the 0–2 per cent range. And the initial UK target was also loosened up in some respects. It seems logical to think of this as a natural evolution. Credibility-building constraints are important when you're seeking a decisive change in expectations. But once that battle has been won, it gives you the scope for greater flexibility.

In this context, a useful way of thinking about the future of inflation targeting is to think about the relative importance of the two elements of constraint and discretion, and how they might be developed from here.

One possible vision would be to focus on further development of the constraining elements. That is, we could embark on a program of moving inflation targeting regimes ever closer to an ideal where discretion and uncertainty are eliminated from the decision-making process. Is that where we want to go? There's certainly no shortage of proposals that would shift things in that direction. They include things like quantifying the decision-makers' objective functions, efforts to mechanise the forecasting process so as to squeeze out elements of judgment, and proposals to tighten up the target specification, like moving to a price-level rather than a rate-of-change formulation.

I think I'm as committed to inflation control as most central bankers, and I hope that what I say here won't be interpreted as undermining that. Nevertheless, my judgment is that we have reached a point where further development along the lines I've just outlined would amount to an over-engineering of the policy process.

Let's take the levels-versus-changes question as a case in point.

I understand the arguments why a price-level-path target is theoretically superior to a rate-of-change target. It reduces uncertainty by eliminating price-level drift, and in doing so it should reduce risk premiums in long-term nominal contracts. But that theoretical improvement is going to be small compared to the big gains that have already been made in moving inflation from double- to low-single digits. More to the point, I suspect those theoretical gains are also small compared with our uncertainty about how the world works, and about what is the right model for conducting the cost-benefit analysis in the first place.

For example, we don't really have a good basis for saying whether price stability should be defined in terms of consumer prices or product prices (or, indeed, some other definition). In a world of rapidly changing relative prices, such as we have now, that distinction will swamp the difference between level and rate-of-change targets for whatever index is chosen. Another difficulty is that price-level comparisons become less meaningful when we extend them over long periods of time. Chain price indices work by making stepwise comparisons between adjacent time periods where consumption baskets can be thought to be reasonably comparable. But a comparison of today's price level with that of 50 years ago doesn't have a great deal of economic meaning, because the consumption baskets in the two periods are vastly different. For these reasons, proposals aimed at reducing the long-run variance of consumer price indices strike me as an exercise in false precision.

We have to be mindful, too, of the need to explain our framework in a way that can be understood by the general public, whose support we ultimately can't do without. I find it hard to believe that the rationale for a levels-target would be widely understood; or that, some years from now, we could get the public to accept the case for an interest rate change based on the deviation in the price level from a path that might have been set years earlier. My general point here is that we have made the big gains already, and we should be wary of putting those gains at risk by overselling the case for incremental further improvements. I've used levels-targeting as an illustration, but the same goes for other proposals to tighten up the framework.

For these sorts of reasons, I don't see the future of inflation targeting as being in the direction of further strengthening the constraints and reducing the scope for discretion. Rather, I think the main challenge over the next few years will be to use the flexibility we've earned to respond to developments that weren't envisaged at the time when inflation targets were first adopted.

I see these challenges as being in two main areas.

The first is the challenge posed by major shifts in relative prices. Much of the discussion of inflation targeting puts relative prices aside and assumes a single inflation rate. But in the real world, relative price changes can have big effects on inflation and on the trade-offs between inflation and output. For forecasting purposes, central bankers routinely look at core or underlying measures of inflation designed to look through the temporary effects of volatile components like food and energy. But we seem to have entered a period where these relative prices are both more volatile and may be undergoing a permanent upward shift. At the very least, this is going to make distinguishing signal from noise in our inflation measures more difficult. More broadly, since this represents a gradually unfolding supply shock, it may also mean significant shifts in the policy trade-offs that central banks will have to manage. Another factor here is the carbon pricing regimes being considered in a number of countries, which are likely to be a further source of relative price change. Inflation-targeting central banks are going to have to do some careful thinking about how to respond to these developments: to what extent should they be thought of as one-time price changes, at what point do a series of such changes constitute ongoing inflation, and so on.

The second challenge concerns the interrelationship between monetary policy and financial stability. I expect others might have more to say on this, so I'll be very brief on this point. The debate on the role of monetary policy in pursuing financial stability objectives is far from settled. What does seem clear is that financial factors (asset price fluctuations, credit events and the like) have played a major role in driving the most recent business cycles in the major economies. There's no reason to expect that such events won't continue to be important, and quite possibly they'll be more important than conventional supply and demand shocks. So again, inflation-targeting central banks are going to have to give careful consideration to the way these factors fit into their policy frameworks.