Inflation Targeting is Neither Necessary Nor Sufficient

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31 May 2006

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Fed Chair Ben Bernanke is a strong proponent of inflation targeting, conducting monetary policy to achieve an announced target. He and others argue that this would increase the transparency of the Fed and make it more accountable by providing a specific numerical objective on which performance can be judged. It is widely believed that such transparency would improve the inflation performance and the predictability of the future course of inflation and of monetary policy actions.

Japanese policy critics also call for the adoption of inflation targeting to enhance transparency. In Japan deflation is perceived to have been ended, so "zero interest rate" and "quantitative easing" policies are expected to change to allow a tighter policy to constrain inflation. Since policy must change anyway, critics argue, there is an easy opening to adopt a new policy regime. Clarity of communication is no substitute for performance, however. Unless a central bank that targets inflation and communicates its objectives well can also deliver on low and predictable inflation, transparency is worthless. Words are not substitutes for actions.

Transparency is supposed to be valuable because it allows markets to anticipate future policy and so reduces surprises that disturb resource allocation, employment, output and prices. Any policy risk premium in real and nominal interest rates should be lower in countries with higher degrees of transparency. Proponents of inflation targeting suggest that such countries better understand their responsibility for price stability and better communicate their superior policy target. Thus, they also should achieve lower inflation. Studies have failed to find evidence that inflation-targeting countries achieve lower or more stable inflation, however.

A new study by economists Sylvester Eijffinger and Petra Geraats (*European Journal of Political Economy,* March 2006) ranks central bank transparency for nine countries. The US is sixth, behind, in decreasing order, New Zealand, Sweden, the UK, Canada, and the Eurozone. Japan ranks even lower at eighth, behind Australia and ahead of last-place Switzerland. And that should raise red flags. Transparency must not be very important if the Swiss score so low.

Switzerland has a long history as a successful inflation fighter. Switzerland had the third lowest inflation in the group in 2005, only 1.0 percent. They also have the lowest excess of the 10-year government bond yield over recent inflation at 0.95 percent. If monetary policy can achieve low inflation and the lowest long-term interest rates relative to inflation despite the lowest level of transparency, then the latter cannot be worth much. The Swiss National Bank delivers, and they do so consistently, contributing to the lowest real cost of capital in the world.

Japan, often reviled as a failed central bank because of its 1990-2004 stagnation, has the lowest inflation rate in the group (-0.3%). In other contexts and in economic theory, such a degree of price stability or steady and moderate deflation would be an optimal result, though analysts have questioned this in recent years. Japan also enjoys the third lowest real interest rate at about 1.77 percent, at least as measured by the excess of the 10-year government bond yield over the most recent year's inflation rate at the end of 2005. Whatever Japan is doing, it seems to enjoy the lowest inflation rate and the lowest real rate of interest of the nine countries, despite their low transparency. Apparently their pursuit of price stability is being communicated more credibly than the rest.

At the other extreme, the country with the highest transparency, New Zealand, had near average inflation in 2005 (1.5%) and the highest real interest rate (4.3%). Having the highest transparency has not given the New Zealanders a lower cost of capital. In fact, the four countries with most transparent central banking policies are among the five countries with the highest excess of the government bond yield over inflation. Sweden, the only other country with high transparency and low inflation (0.5%), had the second highest real interest rate at the end of 2005 (2.8 %).

While the US ranks sixth in transparency, it had the second lowest real interest rate (1.1%) in the group, just above the rate in Switzerland. Apparently the Federal Reserve has a very high degree of anti-inflation credibility with the global marketplace, despite the surge in inflation to 3.4 percent in 2005, the highest pace in the group for the year ending in December 2005. Apparently the marketplace believes that this surge is temporary, so that nominal interest rates remained among the lowest in the world adjusted for inflation. No doubt the US could benefit from an explicit Fed target that is able to be monitored, but just taking up inflation targeting is not likely to be beneficial.

Countries that do not target inflation and therefore have the lowest central bank transparency generally had lower inflation and lower real interest rates in 2005. The patterns for inflation and real rates are not peculiar to 2005. They have longer standing than inflation targeting or concern for transparency. The 2005 real interest rates of the nine countries are systematically and negatively related to their transparency scores, hardly a selling point for transparency or its principal determinant, monetary targeting. There are, no doubt, other reasons why real interest rates vary across these countries, but it is difficult to think of how such reasons could give rise to such a significant negative relationship between transparency and real interest rates. Japan, the Swiss and the US have little to learn from central banks that target inflation, at least if market outcomes are the indicator of success.

References

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Table
Are there gains from transparency?

Central Banks	Transparency score	10-year bond yield	inflation rate	real interest rate
1. New Zealand	14.0	5.83%	1.50%	4.33%
2. Sweden	14.0	3.30	0.50	2.80
3. UK	13.0	4.22	1.92	2.30
4. Canada	10.5	3.93	2.15	1.78
5. Eurozone (*Germany)	10.5	3.4*	1.98*	1.42*
6. US	10.0	4.47	3.38	1.09
7. Australia	9.0	5.20	2.80	2.40
8. Japan	8.0	1.47	-0.30	1.77
9. Switzerland	7.5	1.96	1.01	0.95

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