Perspectives of Inflation Targeting,
In the Current Economic Context

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Abstract
In the context of economic crisis, monetary policy makers are facing a number of challenges, including the selection and implementation of the best monetary policy. In this paper, we want to see if inflation targeting is or is not a solution to exit the economic crisis.

If the answer is positive, then what would be the optimal level of inflation? Many central banks target an inflation rate of 2%. In this paper we intend to show that, in certain circumstances, a very low level of inflation can significantly reduce the stabilizing effects of monetary policy. A slightly higher value of inflation targeting would reduce the constraints on monetary policy, caused by the appearance of liquidity trap. The risk for the interest rates of monetary policy to achieve zero level is related to the central banks’ choice of the appropriate inflation target. We believe that an increase in the inflation target of 2% to 4% would ease monetary policy constraints arising from the liquidity trap problem.

If inflation targeting is not a solution to exit the crisis, then are there other strategies that would be a better alternative? Following this analysis, no obvious alternatives were identified, so far, there is no clear reason for that to abandon inflation targeting.

Keywords: Monetary policy, Inflation targeting, Liquidity trap, Financial stability.

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1. Inflation targeting. General issues

Inflation targeting is a monetary policy used by central banks, not only in Europe, but also in other parts of the world. This strategy was used for the first time by New Zealand in 1989. Some other countries have adopted this strategy, also, so that in 2012 there were already 27 countries that were using it, including Britain, Iceland, Canada, Sweden, Norway, South Africa, Chile, Brazil, several countries from Central and Eastern Europe, some European Union countries such as Czech Republic, Poland, Hungary, Romania and other countries that are not Member States, such as Serbia and Armenia.

First, we have to see exactly what inflation targeting means and how it is characterized. In literature, there are many papers on this subject, the topic being treated since the early 80's.

Inflation targeting can be defined simply by its characteristics, namely "announcement of official inflation target for one or more time horizons, and by recognizing explicitly that a low and stable inflation is the main objective of the monetary policy" (Bernanke and Mishkin, 1997).

According to Mishkin and Savastano (2001), inflation targeting involves the public announcement of numerical targets for inflation, a strong commitment of the central bank to price stability as a final monetary policy objective, and a high degree of transparency and responsibility.

Sudacevshi (2011) believes that "a regime of inflation targeting enables monetary policy to focus on domestic financial environment issues and to respond better to the shocks from the national economy".

Hammond (2012) believes that "inflation targeting is rather a model, than a rigid set of rules for monetary policy." Also, he highlighted the inflation targeting regime characteristics, such as:

- price stability is the primary objective of monetary policy;
- there are public communications regarding the inflation target in terms of quantity;
- monetary policy is based on a wide range of information, including forecasts of inflation;
- transparency;
- responsibility mechanisms.

It can be seen that the main objective of monetary policy should be price stability. In some countries, even if it is the main objective, it may be accompanied by one or more secondary objectives, specific for each central bank. They are often stipulated in the law, together with price stability. Monetary stability and financial stability are interdependent, both convergent and divergent, which prevents the subordination of respective functions of the each other central bank.
Regarding the public communications, most central banks draw up quarterly reports on inflation and establish inflation targets on a longer or shorter horizon time.

Most countries practice the target form with fluctuation of plus-minus one or two percentage points, because it offers the advantage of a higher flexibility. Inflation target is achieved when inflation is within the specified range. Selected range can be larger or more limited. Choosing a more limited range highlights the responsibility of the central bank, but there is the risk of exceeding this range. A larger fluctuation band gives the impression that the central bank treats lightly this commitment.

In most countries, the target is measured by the Harmonised Index of Consumer Prices (HICP). According to Eurostat, this index is "built to measure changes in prices for consumer goods and services purchased by households." It is used because it is more easily understood by the general public. However, its use has some disadvantages, including the fact that it includes administrative prices, easily influenced by the state, and also includes certain prices affected by seasonality.

Transparency of central bank is a condition for a successful inflation targeting regime. By transparency, the central bank earns more credibility. Credibility is necessary, because economic actors have confidence that the inflation target will be reached and will act accordingly, and then, their actions will help to achieve the proposed inflation target. A central bank earns credibility by the fact that the promises made are also performed, and therefore, the institution becomes credible in time; on the other hand, any misstep can cost all that it has achieved so far.

Another issue which relates somewhat of credibility is central bank independence. Independence is the one that assures that they will take the best decisions to achieve objectives, without political intervention. Credibility is essential to the inflation targeting regime. If the central bank fails to be credible, established targets will not have the desired result and the public will not react positively, therefore strategy may not have the desired effects and objectives will not be achieved. We believe that the success of inflation targeting depends on the central bank’ ability to predict and forecast and on the prompt reaction that it must have in case of an inflationary pressures, and even faster, if in the future is expected such a situation of pressure. For these things to happen, is required a developed information system, and also the information obtained must be accurate and relevant to achieve the necessary forecasts.

Before the crisis started in 2007, inflation targeting was monetary policy’s gold standard. Monetary policy maintained the inflation down, without adverse effects on growth and employment. Price stability has become the primary objective of monetary policy by more widespread adoption of inflation targeting.

Before the crisis, most economists were convinced that:

- A low and stable inflation is essential for long-term economic growth and the optimal level of inflation was considered to be 2%.
- The existence of unused production capacity causes a decrease of inflation and vice versa, production capacity overused increase inflation.

In the last two - three decades, almost all the world's central banks have switched to inflation targeting, either implicit or explicit. This monetary policy regime model is based on neokkeynesian model. Phillips curve, in the standard neokkeynesian model, shows that inflation depends on expected inflation and on the gap between current output and potential output. This dependence means that inflation stabilization is sufficient to stabilize the output. The philosophy that supports the equation is that distortions that operates in the economy does not interfere with the shocks. Thus, if monetary policy keeps inflation on the target level, potential output and actual output moves in the same direction and with the same magnitude, that means that occurs the "divine coincidence", as it was called by Blanchard and Gali (2007). When inflation is stabilized, inflation is equal to expected inflation (Croitoru, 2014).

Before being modified, this philosophy was the theoretical support for the conception according to which the central bank must ensure price stability, without worrying about the consequences on output, whose stabilization is automatically ensured by price stabilization.

However, this automatism has not been validated in practice, which made Tobin (1998) say that "corollary commitment of monetary policy to stabilize prices is the official indifference to the real macroeconomic outcomes - employment and unemployment, real domestic product and its growth (...). That is, the actual results are a concern of policy only after central banks and governments are confident that the price stability target is achieved.”

The current crisis has shown that issues such as the appropriate level of inflation and its determinants connection with unemployment rates of inflation are far from being well understood. For example, despite the fact that after the crisis, in developed countries deflation was rapidly removed and returned to low and stable levels of inflation, the level of output is still significantly below the potential level.

2. The low level of inflation and the implications for monetary policy

Most economists have sustained a low and stable level of inflation, the optimal value being considered 2%. One of the arguments that supported this value of 2% is that this level is large enough to remain positive, when the business cycle would reduce the output below the potential level. But there may be two situations when, because of a low and stable inflation, macroeconomic policies cannot be used to achieve stabilization of the economy. The first situation occurs during the boom, and the second after a crisis occurs.
2.1. Inflation at a low and stable level, in the economic boom phase

The first situation where monetary policy becomes ineffective occurs when, concomitantly, the business cycle and financial cycle are at the ascending phase. If the central bank targets a low and stable inflation, then the inflation expectations are equal to the inflation target. Among other factors, a low and stable inflation will lead to higher decision-making horizons of economic agents and will stimulate consumption and productive investment. If the capital is free, too, then this economic growth can be large, financed by debt accumulation (Croitoru, 2014).

On the other hand, a low and stable inflation will encourage the feeling of complacency and euphoria. Thus, there will be an increasing trend of the potential output.

Let us assume that for a while, the actual output and the potential output have the same level and growth rate. From the perspective of the central banks, inflation stability is assured, and as long as this state will be maintained, there will be automatic a stable output, too. But the existence of a high economic growth, financed with credit, accumulates imbalances: property prices rise above potential, occurrence of imbalances between assets in national currency and foreign currency liabilities of firms and households, and increase the share of borrowers whose debts are financed with inflated assets. In other words, although output is at potential level and inflation is stable, there may be a financial bubble that will break later.

Theoretically, fiscal authority may wish to reduce the budget deficit, either to maintain public debt within sustainable limits, either to mitigate the increasing of the current account deficit. On the other hand, different types of productive public expenditures (education, research & development and infrastructure) can determine economic growth (Mura, 2014).

Suppose that attempts to reduce the budget deficit by cutting public spending (equivalent, in terms of strict deficit reduction, taxes could be increased). Consequently, the output will fall below the potential level at which existed before the fiscal contraction. In these circumstances, if expected inflation and target are equal, as it should be when inflation targeting is rigorous, then inflation will fall below the target.

So, the fiscal contraction is in contradiction with the fact that the central bank targets inflation. Regardless of the inflation targets level, the central bank will cut interest rates to ensure that the inflation target will be reached and the credibility will not be affected. Fiscal policy could temper economic growth temporarily, if the central bank keeps interest rates unchanged. But, if the central bank keeps interest rates, inflation falls below the target. In this case, there are two undesirable consequences. First, the policy is not optimal anymore, namely, increase the losses for the society. Second, if inflation is low, inflation expectations could become deflationary.

Reducing interest rates will stimulate the increase in the value of securities and thus will increase consumption and private investment. In addition, the currency may depreciate, stimulating growth in exports and expenses, including those necessary to produce more goods for export. Finally, increasing of the private spending, caused by the reduction of the nominal interest rate by the central bank, will compensate the reduction of the public spending initiated by the tax authority. Thus, the aggregate demand remains unchanged, showing that macroeconomic policies cannot mitigate a financial boom.

2.2. Inflation at a low and stable level during the crisis. Liquidity trap

The second situation when monetary policy loses its effectiveness occurs when, after a long period in which the inflation level was low and stable, we are facing a crisis. At the end of the bottom of the business cycle, macroeconomic imbalances are large. Asset prices, especially property and credit prices, already increased a lot, although in real time, output is, or at least seems to be, at the potential level. Later, when the market corrects these imbalances, effective output decreases sharply.

However, in practice, inflation decreases a little, because she already is low and stable. Even if prices changes, the behavior of producers and consumers is relatively stable, which is reflected in the persistence of inflation, ie in its dependence on their previous levels. This means that after a deflation, inflation has stabilized around the level anticipated by the society in the long period before the crisis.

We know that the real interest rate is equal to the difference between the nominal interest rate and the expected inflation rate.

After the crisis, productivity decreases, and in order to stimulate production so as to reach the potential level, we assume that it takes a real interest rate of minus 4%. Knowing also that inflation is 2%, means that nominal interest rate should be minus 2%.

But the central bank cannot keep the nominal interest rate to a negative level than for a short time, so that in fact, the nominal rate will be reduced to zero level. Accordingly, the real interest rate is equal to minus inflation, ie minus 2%.

So, the real interest rate remains twice higher than necessary to restore the balance between supply and
demand at the potential level. In other words, the economy is in the liquidity trap. When a central bank aims to increase aggregate demand, faces a constraint: nominal interest rates cannot have values below zero. In "General Theory", Keynes (1936) presented the danger of such a situation, which he called it “liquidity trap”. However, for decades after Keynes wrote about this issue, economists considered liquidity trap a theoretical idea, that has not been taken into account in monetary policy practice. The reason was that nominal interest rates significantly exceeded zero level, and in times of recession, central banks were able to reduce nominal interest rates without reaching the zero level.

When the liquidity trap appears, conventional monetary policy is ineffective, because of the low level of inflation. If in our example, the inflation rate would have been 4%, the real interest rate would be equal to minus 4% and the production would be increased to get to the potential level.

After the interest rates are zero, fiscal policy has a stabilizing role. But in many cases, fiscal policy cannot act, because governments are too indebted and market does not finance the deficits growth that could stimulate aggregate demand.

Even if the central bank faces the danger of deflation, and even if the nominal interests rate are close to zero, the central bank is not completely powerless. In this situation, to stimulate demand, the central bank resorts to unconventional monetary policy measures.

The reaction of central banks in crisis often resulted in remarkable technical innovations designed to improve the operational framework of monetary policy. However, the typology established several years ago by Ben Bernanke and his colleagues still stands. According to these authors, unconventional monetary policy measures are of three types: forward guidance, quantitative easing and credit easing (Cerna, 2014).

Many of these instruments were actually used lately by some central banks: Bank of Japan - in the early 2000s and the Fed - after 2007.

3. The higher and stable inflation and the implications for monetary policy

Analysis of the evolution of inflation explains why in the past there was not the problem of zero nominal interest rates, that limits the freedom of action of monetary policy. In many countries, the deepest recession of the 1945 and 2008 occurred in the 1970s and early 1980s. During this period, inflation and nominal interest rates were raised, so, the central banks were able to significantly reduce nominal interest rates without reaching the zero level. For example, during the US recession of 1981-1982, the Fed has managed to decrease the nominal interest rate by 10 percent, from 19% to 9%.

Instead, the Japanese decline in the 1990s and the Great Recession of 2008-2009 occurred in a period characterized by a low level of targeting inflation by central banks.

Nominal interest rates were much lower compared to the 70s and 80s, such as monetary policy actions taken during the recession have made that the interest rate to achieve quickly the zero level.

This experience shows that a level of inflation of 4% is more recommended than 2%. There are more and more arguments in favor of increasing inflation targets over the 2% level. The strongest argument refers to the fact that a moderate inflation, slightly higher, would reduce the risk that nominal interest rates of monetary policy to achieve zero level and thus will help the exit the liquidity trap. For this reason, many economists (Blanchard, Dell'Ariccia and Mauro, 2010) have proposed targeting a moderate and stable inflation, not necessarily a low and stable inflation. A moderate inflation would give more scope for monetary policy to counteract the decline in aggregate demand, avoiding the decrease in output. Economic practice found that a positive inflation is advantageous and the costs are lower than in the case of deflation. Deflation increases the real interest rate positive and discourage investment and economic growth.

But central banks worldwide are reserved to target an inflation of 4%, because they fear that they will lose their credibility, for its achievements that have made a lot of effort.

4. Abandoning the inflation-target regime?

Inflation targeting strategy is blamed for not being able to handle cost shocks, not being able to maintain financial stability and not being able to stimulate growth when needed. Is it better to abandon this strategy? Before attempting to answer this question, we must know the consequences of abandoning the inflation-target regime.

We must take into consideration that central bank transparency, responsability and independence will disappear. For instance, transparency would have to be compromised to achieve higher inflation than expected, which is the key to stimulate growth and redistribute income between debtors and creditors. By entering redistributive policies, central banks would also lose their independence, since they do not have the legitimacy to make such choices (Bini Smaghi, 2013).

So far, after joining the euro area, only Finland and Spain have abandoned the inflation targeting strategy, and therefore the European Central Bank's control over their monetary policy (Ambler, 2014).
But, are there strategies with superior advantages, that can substitute inflation targeting?

4.1. Price-level targeting?

Some economists recognized that targeting an inflation of 2% causes the occurrence of the zero nominal interest rates of monetary policy, however, they still reject an inflation of 4% as a solution. Instead, they support a different policy: price-level targeting (Eggertsson and Woodford, 2003; Coiboin et al, 2012). This policy produces a low average inflation, but inflation increases temporarily in case of a zero nominal interest rate episode, which determine the decrease of the price level below the long-term target.

Some economists (Ambler, 2014) suggest that monetary policy based on price-level targeting has multiple advantages than the inflation targeting strategy, particularly in times of economic distress. The main difference between inflation targeting and price level targeting refers to the consequences arising after the target failure. In case of price level targeting, unexpected shocks to inflation can be corrected more easily than in the case of inflation targeting, when there aren’t too many ways of action. So far, only the Bank of Canada has seriously considered adopting this strategy.

4.2. Nominal GDP targeting?

Another alternative to inflation targeting is nominal-GDP targeting. Targeting nominal GDP is not a new idea, it appeared since the 1980s, when it was seen as a solution to the difficulties of targeting the money supply, particularly with respect to velocity shocks. But, nominal GDP targeting is difficult to achieve in practice because of two things. First, inflation targets are quite well understood and transparent; a nominal-GDP target is incredibly fragile, nonrobust to changes in definition and time period. Second, nominal GDP is not something you can communicate intuitively (Posen, 2013).

5. Conclusion

Following this analysis, the conclusion that can be drawn is that there is no clear reason to abandon inflation targeting, as yet there is no obvious alternative.

In order to ensure sustainable economic growth, we need to stabilize inflation and output. Monetary policy can stabilize the two variables, provided that there is a correct identification of the relationship between them and the appropriate level of inflation.

In most economies, central banks pursuing an inflation target around 2%. In this paper we have tried to show that macroeconomic policies cannot mitigate a financial boom, when inflation is low and stable and output is on the potential level. Financial boom, inflation low and stable and equality between actual and potential output may coexist, if the growth rate is high and equal to the potential growth rate.

We believe that an increase in the inflation target of 2% to 4% would ease monetary policy constraints arising from liquidity trap problem. Nominal interest rates would be higher and would provide more space for monetary policy action.

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