Dealing with Inflation Targeting’s Limitations in Emerging Markets

for the Bank of Thailand’s International Symposium on
“Challenges to Inflation Targeting in Emerging Market Countries”

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1. A contextual rather than optimizing view of inflation targeting [IT]

1.1. Tendency to ex post rationalize IT as optimizing policy (e.g., Svensson)

1.2. Actually, risk management (Greenspan)/fire-fighting (Bernanke-Mishkin) in the best sense: practical balancing of flexibility and discipline vs. inflation risk
   1.2.1. Takes place in a context of disinflation underway if not completed
   1.2.2. Against a background of central bank independence rising (Kuttner-Posen)
   1.2.3. Information inclusive forward-looking strategy (Bernanke, et al)
   1.2.4. Transparency responds to both financial and political liberalization
   1.2.5. Bipolar view of exchange rates proves to be impractical (Frankel)
   1.2.6. Most of all, the time of “Great Moderation” (Blanchard; King)

1.3. So take as given some gains for emerging markets from inflation targeting
   1.3.1. Some reduction in inflation volatility without rise in output volatility (Cecchetti, et al)
   1.3.2. Some reduction in inflation levels (though perhaps driven by global factors – Ball-Sheridan)
   1.3.3. Improved ability to weather crises with anchoring of inflation expectations and bond market spreads, e.g., Brazil (Fraga, et al)
   1.3.4. Less clear results on inflation persistence, long-term credibility, cost of disinflation, stabilization of exchange rates (latter two are no surprise)
   1.3.5. Transparency per se has paid off less in accountability and short-run stability than hoped for, but politically seems irreversible

1.4. Therefore, IT is literally not a panacea, but particularly good at voluntarily replacing full discretion or short-run stable/long-run too stiff f/x pegs
   1.4.1. Somewhat implicit in the IMF ‘pre-conditions’ for IT approach
   1.4.2. Thus, some limitations are inherent or do not matter very much
   1.4.3. Others, though perceived as limitations, are just realities for EMEs

1.5. Three limitations, however, are likely to prove economically and/or politically difficult, especially as economic conditions change from last decade
   1.5.1. But the IT framework cannot be easily abandoned (though easier than leaving a peg) so these limitations must be dealt with constructively
   1.5.2. There is a temptation to do so by either expanding the range of explicit central bank objectives or complicating the target definition – Resist this!
   1.5.3. Inflation targeting banks should instead:

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1.5.3.1. narrow the central bank’s mission
1.5.3.2. explicitly delineate roles vis-à-vis the rest of government
1.5.3.3. announce and implement more explicit escape clauses

2. First limitation: Stabilization of exchange rates is not included in the target

2.1. Often, IT is adopted in the aftermath of a failed exchange rate peg
   2.1.1. This is not limited to EMEs (UK, Sweden in early 1990s)
   2.1.2. Sometimes, however, it goes the other way from exchange rate success to getting more monetary independence (Chile, Israel broadening their bands)
   2.1.3. The wildly divergent inflation outcomes for countries exiting exchange rate commitments indicates that pass-through is more limited and less deterministic than often thought

2.2. While the relative benefits of having independent monetary policy in a small open economy are still hotly debated, the default seems to be very managed float
   2.2.1. This is especially true in East Asia given geopolitical situation
   2.2.2. The de jure declaration of a fixed peg does have costs versus de facto but undeclared pegging (Kuttner-Posen)
   2.2.3. Given the lack of link between short-term exchange rate movements and fundamentals, inflation targeting alone does not stabilize exchange rates
   2.2.4. By the same token, though, pursuing IT does not destabilize rates, either
      2.2.4.1. MCI’s proved to be unnecessary to IT success (Freedman; Siklos)
   2.2.5. So it is unclear why the CB should care about exchange rates beyond their direct impact on the inflation/output forecast (contrary to Ho-McCauley) except insofar as they are a risk of crisis

2.3. Accordingly, the emphasis has shifted to limiting the damage from volatility
   2.3.1. Currency mismatches have become a key focus (Goldstein)
   2.3.2. Putting off ‘day of reckoning’ with hard currency borrowing and delayed response identified as amplifier of the problem (Frankel)
   2.3.3. “Original Sin” however is vastly exaggerated, which strengthens the argument for looking at financial system improvement
   2.3.4. Capital inflow controls have been disregarded because there has been a switch to capital outflows from developing markets, but are still useful

2.4. The Asian response of self-insurance via reserve accumulation is a bad deal
   2.4.1. Question of importing inflation and need for sterilization
   2.4.2. Benefits more the officials in office than the average EME citizen
   2.4.3. Leads to distortions of the transition to having a strong middle class
   2.4.4. Gives up autonomy not only of monetary policy, but of when the peg or intervention range is to be reset politically
   2.4.5. This is why South Korea was the (first) one to revalue after the crisis
   2.4.6. This is why Brazil has managed to get political support for IT
   2.4.7. It also does nothing to encourage capacity for coping with volatility
2.5. Proposal: Move to an explicit escape clause for exchange rate shocks

2.5.1. Early days of IT spoke about escape clauses, but they got disregarded

2.5.2. Exchange rate crises however are the perfect occasion for an escape clause

2.5.2.1. The conditions for a clause to be invoked are visible and verifiable,

2.5.2.2. The situation for the escape clause is both exogenous and finite

2.5.2.3. Could be defined in some total number of percentage point-days of movement in one direction (20 point days = 20%/1day, 10%/2day, etc)

2.5.3. Define the ‘escape’ as the central bank will suspend the inflation target until the currency stabilizes, after which the time-horizon is to be reset

2.5.3.1. There is to be no restoration of price-level to *ex ante*

2.5.3.2. With no inflation target, there is no justification for adjustment of CB’s instrument interest rate during the attack

2.5.3.3. Which should lead to automatic decline of real short-term interest rates, steepening of yield curve, and limit on OMO’s, all of which encourages the right fiscal-monetary mix and financial behavior

2.5.3.3.1. This is the complement of Caballero-Krishnamurthy case and addresses the Frankel-Wei concern

2.5.4. Commit the central bank to ceasing all exchange rate intervention

2.5.4.1. Remove speculators’ incentive to make money off of CB

2.5.4.2. Pre-commit to avoiding the last minute borrowing or encouraging that by the private sector which makes things worse

2.5.4.3. If it is a type I (fundamental) currency crisis, i.e., driven by fiscal or trade imbalance, there is nothing the intervention can do

2.5.4.4. If it is a type II (speculative) currency crisis, i.e., driven by attacking investors, reserves are best saved for clean-up rather than spent being acquired by speculators

2.5.5. Pre-commitment by the central bank that it will neither defend a particular exchange rate, nor resist more than pass-through inflation (which is what resetting the forecast/target post currency adjustment effectively does), will deter both speculators and (excessive) hard currency borrowing

2.5.5.1. This also removes the incentive to excessively accumulate reserves, which will allow them to be put to better use in the society

3. Second limitation: Sustained supply shifts do not appear to be inflationary

3.1. In theory, supply shocks should be dealt with by focusing solely on second-round effects (Bernanke, et al)

3.1.1. Anchoring of long-run inflation expectations by IT should ease response without loss of credibility (King; Kuttner-Posen)

3.1.2. Gradualism in responding to shocks accommodates (Ball; Svensson)

3.1.3. Target definition should be able to exclude the most volatile components

3.1.4. Goal is to remove inflation noise with respect to relative price signals
3.2. In reality, this has proven somewhat more difficult to do than expected

3.2.1. Target definition has been a particular sore point

3.2.1.1. Some financial observers are always skeptical of definitions

3.2.1.2. CB’s have proven reluctant to redefine as structures change

3.2.1.3. Core vs. headline inflation is a very open debate, both regarding welfare and with respect to econometric priority (Bean; Rogoff)

3.2.2. Gradualism has not significantly eroded credibility, but CB’s often seem to be paranoid that it will, so they create their own trap

3.2.3. Asymmetry has also proven to be difficult to handle

3.2.3.1. Rare successes in risking positive supply shocks (Federal Reserve on tech; Bank of England on immigration) are very much the exception

3.2.3.2. Even then, the implication should be to raise rates on the ‘second round’ effects, such as wealth into real estate, and that does not happen

3.3. Trend technical changes and structural changes complicate target definition

3.3.1. We tend to think of supply shocks as about commodity prices and limited in duration without anticipation

3.3.2. We are moving however into a period where there are likely to be sustained trends in relative prices of factors of production

3.3.2.1. Growth in effective global (low-skilled) labor supply

3.3.2.2. Security ‘tax’ in period of asymmetric warfare by non-state actors increases the costs of transportation, commercial real estate, utilities

3.3.2.3. Increase in costs of energy (internalization of environmental costs)

3.3.2.4. Taxation moving away from capital, as long foretold, inducing repeated rises in indirect/administrative taxes

3.3.3. These relative price shifts will be anticipated, of long-duration, and will have significant redistributive (political) effects (Posen)

3.3.3.1. Even if they are net neutral for headline inflation

3.3.3.2. They are all likely to erode growth of disposable income, except to the degree that productivity growth pushes up wages in LDCs

3.3.4. CB’s will be unable and should be unwilling to resist these relative shifts

3.3.5. CB’s, however, will have difficulty in justifying ignoring the real costs of adjusting to them, even with relatively full transparency

3.4. Proposal: Replace domestic core inflation target definition with domestic headline inflation excluding globally set benchmarks of supply price shifts

3.4.1. The theory-based response to greater terms-of-trade shocks is to increase the ‘flexibility’ of inflation targeting when real rigidities exist – as they do in reality (Blanchard-Gali; Rogoff)

3.4.2. Given the suspicions of target redefinitions and ‘excessive’ gradualism, the optimal policy of allowing higher inflation for longer (in response to a negative supply/tot shock) may not be sustainable, especially for EMEs

3.4.3. An outside independently computed, if not objective, metric can reduce the credibility cost of utilizing flexibility

3.4.3.1. Set up an IMF/FAO or ASEAN Secretariat tracking price trends

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3.4.3.2. Factors to track could only be set by international agreement, meaning country-specific factors (to exclude from inflation target definition) would need high-level of domestic justification 

3.4.3.3. Weight of various supply factors in individual countries’ economy and price index could be set nationally if transparent and posted 

3.4.3.4. Distances some decision-making from local lobbying/pressure 

3.4.3.5. Provides inherent technical assistance and economies of scale 

3.4.3.6. Focuses national preference issue for IT CBs on degree of gradualism (Svensson) rather than raising questions 

3.4.3.7. Where administrative/public-sector price shifts are involved (e.g., taxing environmental externalities, funding aviation security), better to encourage coordination across countries for supply of public goods 

3.4.4. Assessments of tot shifts should be made backwards-looking 

3.4.4.1. Forecasting would be far more controversial than data collection 

3.4.4.2. If shift is a sustained trend, little is lost by looking at current data 

3.4.4.3. If there is instead a short-term supply (true) shock, better not to react to it, and instead to wait for effects in policy time-horizon 

3.4.4.4. Arguably, responding to data with a lag builds in flexibility 

3.4.5. Encompasses or improves on some of the leading alternative targets 

3.4.5.1. This would bring in common part of global trends to CB policy rules in open economies without estimating cyclical synchronization beyond the national inflation and output gap forecasts 

3.4.5.2. Unlike Export Price Index Target (Frankel), captures tot effects without encouraging lock-in of specific sectors or excessive variability 

3.4.5.3. Exchange rate effects, rather than being taken directly into the policy rule, would be offset by common policies of similar countries 

3.4.6. Monetary policy’s stabilization effectiveness would be increased by encouraging commonly timed policy movements in a common direction 

4. Third limitation: IT is neutral towards structural (fiscal/financial) reform 

4.1. Proposal: Clearly delineate where CB’s responsibility stops, but also how forecast (and thus policy) depend upon productivity/budget outcomes 

5. Not a limitation: Asset prices excluded from target 

5.1. Be glad it isn’t included and keep it out! 

6. The limitation to embrace: Communicating what monetary policy can and cannot do
References


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