INFLATION TARGETING: LESSONS FROM THE INTERNATIONAL EXPERIENCE

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OUTLINE

! The Role of a Nominal Anchor

! Inflation Targeting: Theory

! Inflation Targeting: Experience and Lessons

    - Industrialized Countries
    - Emerging Market Countries

! Inflation Targeting: Operational Design

! Discussion of IMF Conditionality

THE ROLE OF A NOMINAL ANCHOR

! **Ties Down π Expectations**

! **Helps Avoid Time-Inconsistency Problem**

    - Time-Inconsistency Resides More in Political Process

    - Nominal Anchor Limits Political Pressure
      for Time-Inconsistency

BASIC MODEL
(Svensson, 1997)

$$\pi_t = \pi_{t-1} + \alpha_1 y_{t-1} + \varepsilon_t \qquad (1)$$

$$y_t = \beta_1 y_{t-1} - \beta_2 (i_{t-1} - \pi_{t-1}) + \eta_t \qquad (2)$$

Central Bank Minimizes Loss Function

$$E_t \ni \delta^{\tau-t} L_\tau \qquad (3)$$

$$L_\tau = (\pi_\tau - \pi^*)/2 + \lambda y/2 \qquad (4)$$

Yields "Taylor Rule"

$$i_t = \pi_t + b_1(\pi_t - \pi^*) + b_2 y_t \qquad (5)$$

INFLATION TARGETING

! 5 Elements

   1. Public Announcement of Medium-Term π-target

   2. Institutional Commitment to Price Stability

   3. Information Inclusive Strategy

   4. Increased Transparency through Public Communication

   5. Increased Accountability

! Inflation Targeting is *Much More* than 1.

INFLATION TARGETING
ADVANTAGES

! Allows Focus on Domestic Concerns and Mitigate Shocks

**! Uses All Available Information,
  Not Dependent on Stable M-PY Relationship**

- If $\lambda=0$ in (4), then i set so that

$$E_t\Pi_{t+2}=\Pi^*. \quad \text{i.e, "Inflation Forecast Targeting"} \quad (7)$$

- If $\lambda > 0$, then i set according to Taylor Rule in (5) and

$$E_t\Pi_{t+2} - \Pi^* = c(E_t\Pi_{t+1} - \Pi^*) \quad (8)$$

"Flexible Inflation Forecast Targeting": What is Done

INFLATION TARGETING
ADVANTAGES

! Easily Understood and Transparent

- Better than M-target if M-PY Relationship Unstable

INFLATION TARGETING
ADVANTAGES

! Increases Accountability

- Focus Debate to Reduce Political Pressures to Inflate

- Reduces Time-Inconsistency Problem

- But Need Institutional Commitment to Price Stability

  1. Insulation of Central Bank from Politicians
  2. Central Bank Instrument Independence

- Requires Regular Communication with Public,
  e.g., π-Report, Testify to Congress, etc.

INFLATION TARGETING
DISADVANTAGES:
Non-Serious

! Rigid Rule

! Too Much Discretion

    - No for Both: Is "Constrained Discretion"

! May Increase Output Fluctuations with Sole Focus on π

    - Not way it is practiced

! Produces Low Growth

- Opposite after Disinflation

INFLATION TARGETING
DISADVANTAGES:
Serious

! Weak Accountability at "High" π: π hard to control

- Phase in Slowly

- Controlled Prices require coordination on timing and magnitude of changes

! Does Not Prevent Fiscal Dominance

- Helps if Govt Helps Set Target

INFLATION TARGETING DISADVANTAGES:
Serious

! Partial Dollarization with Flex Rates a Potential Problem

- Depreciation => $ Debt Burden 8 => Financial Crisis

- "Benign Neglect" toward Exchange Rate Problematic

- Increased Concern with Prudential Supervision

INFLATION TARGETING DISADVANTAGES:
Serious

! See this by modifying model to allow for exchange rate effects

$$\Pi_t = \Pi_{t-1} + \alpha_1 y_{t-1} + \alpha_2 e_{t-1} + \varepsilon \qquad (1')$$

$$y_t = \beta_1 y_{t-1} - \beta_2(i_{t-1} - \Pi_{t-1}) + \beta_3(e_{t-1} - e_{t-2}) + \eta \qquad (2')$$

$$e_t = \varphi i_t + u_t \qquad (9)$$

Optimal Policy sets i with Modified Taylor Rule

$$i_t = \pi_t + b_1(\pi_t - \pi^*) + b_2 y_t + b_3 e_t \qquad (5')$$

- If $\lambda > 0$, then i set according to Taylor Rule in (5) and

$$E_t \pi_{t+2} - \pi^* = c(E_t \pi_{t+1} - \pi^*) \qquad (8)$$

- Continue to get "Flexible Inflation Forecast Targeting"

- Same Result if Worry About Financial Stability

INFLATION TARGETING:
EXPERIENCE AND LESSONS
INDUSTRIALIZED COUNTRIES

HAS INFLATION TARGETING BEEN A SUCCESS?

YES

! Inflation Targeting Has Been Successful in Controlling Inflation.

    ! π Reduced

    ! Lower than Forecast with Pre-Regime VARs

HAS INFLATION TARGETING BEEN A SUCCESS?

! Inflation Targeting Weakens the Effects of Inflationary Shocks.

! No Ratcheting Up of Π

- After GST (VAT) Tax Increase in Canada in 1991

- After Sept. 1992 Devaluation in UK and Sweden

HAS INFLATION TARGETING BEEN A SUCCESS?

! Inflation Targeting Can Promote Growth and Does Not Lead to Increased Output Fluctuations.

    ! Once Disinflation Achieved, Growth is High

    ! Output fluctuations no higher

HAS INFLATION TARGETING BEEN A SUCCESS?

! Inflation Targets Do Not Necessarily Reduce the Cost of Reducing Inflation.

! Π Expectations Don't Immediately Fall After Adoption

! Sacrifice Ratios No Lower in Industrialized Countries

! Tentative Evidence that Cost of Reducing Π is Lowered in Transition from Moderate to Low Π in EM Countries

INFLATION TARGETING: EXPERIENCE

TRANSPARENCY AND ACCOUNTABILITY

!The Key to Success of Inflation Targeting is It's Stress on Transparency and Communication with the Public.

! Stress on Transparency and Communication

- Inflation Reports
    1. Goals and Limitations of Monetary Policy
    2. How Targets to Be Achieved
    3. Reasons for Deviations from Targets

- Speeches

- Testimony to National Parliaments
- Glossy Brochures

TRANSPARENCY AND ACCOUNTABILITY

! Inflation Targeting Increases Accountability Which Helps Ameliorate the Time-Inconsistency Problem.

    ! Focus Public Debate on Appropriate Long-Run Issues

    ! Lowers Political Pressure for Time-Inconstant M-policy

TRANSPARENCY AND ACCOUNTABILITY

! **Increased Transparency and Accountability Under Inflation Targeting Helps Promote Central Bank Independence.**

  ! Provides Benchmark to Evaluate Monetary Policy

  ! Led to Independence of Bank of England

  ! 1996 Debate Increased Support for Bank of Canada

TRANSPARENCY AND ACCOUNTABILITY

! Accountability to the General Public Seems to Work as Well as Direct Accountability to the Government.

! Direct Accountability to Government in New Zealand Doesn't Work Better than Less Formalized Approaches

TRANSPARENCY AND ACCOUNTABILITY

! **Inflation Targeting is Consistent with Democratic Principles.**

    ! Instrument but Not Goal Independent

        - Greater Oversight =>
         Policies Consistent with Society's Interests

INFLATION TARGETING
EMERGING MARKET EXPERIENCE

! Chilean Experience with Gradual Hardening quite Successful

- Inflation from above 20% in 1991 to 3% now

- Growth very High until Target Undershot Recently

    M-policy too tight in response to 1998 shocks
    Too Much Focus on Exchange Rate,
    Eased in 1999 and Decreased Exchange Rate Focus

- Adopt Full π-Targeting Regime Only in May 2000

INFLATION TARGETING
EMERGING MARKET EXPERIENCE

! Brazil has all "Bells and Whistles"

    - Shows that this can be implemented quickly - 4 months

    - Jury is not out:

        Has worked better than expected

        Fiscal policy and independence of central bank unclear

! Mexico and Peru moving toward Inflation Targeting

! Colombia: *No* **demonstrated commitment to**

Inflation Control

- Inflation Targeting Has to Be Done Right

INFLATION TARGETING
LATIN AMERICAN EXPERIENCE

! Sound Financial System Key to Success

    - Rigorous Prudential Supervision Key to Success for Chile

    - Mexico ? and Peru

! Fiscal Discipline Key to Success

    - Problem for Brazil and Colombia

    - Multi-year π Targets with Govt help, but not enough

INFLATION TARGETING:
OPERATIONAL DESIGN

! Inflation Targeting is Far From a Rigid Rule.

! No Mechanical Instructions

! Flexible, Targets Modified

! "Constrained Discretion"

OPERATIONAL DESIGN

! **Inflation Targets Have Always Been Above Zero With No Loss of Credibility.**

    ! Midpoints of Target Ranges Between 1 and 3%

    ! No loss of Credibility

    ! Optimal Level of π Still Controversial

OPERATIONAL DESIGN

!Inflation Targeting Does Not Ignore Traditional Stabilization Goals.

    ! π-Targeters Not "Inflation Nutters"

       - Do Express Concerns About Output

       - Gradual Convergence to Long-Run π-Goal =>
       Weight on Output Fluctuations (Svensson, 1997)

       - Stabilization Goals in Appropriate Long-Run Context

OPERATIONAL DESIGN

**! Undershoots of the Inflation Target are as Important
  as Overshoots.**

> ! π-Targeters (Canada) emphasize Floor of Target
>   as much as Ceiling
>
>   - Avoids Characterization as "Inflation Nutter"
>
> ! π-Target Helps Stabilize Economy because it makes it
>   Easier for Central Bank to Respond to Negative
>   Demand Shocks Without π^e Rising
>
>   - Helped Australia React Quickly to East Asian Crisis

! ECB Needs Clearer Communication that Floor is 0%

OPERATIONAL DESIGN

!When Inflation is Initially High, Inflation Targeting May Have to be Phased in After Disinflation.

! π-Targeting Phased in After Successful Disinflation

- Both in Industrialized and EM Countries
(see Chile later)

! Reason:

- Credibility at High π Low

- Harder to Control π at High π

OPERATIONAL DESIGN

! **Edges of Target Range Can Take on a Life of Their Own.**

  ! New Zealand Focus on Narrow Misses, 1995

  ! UK Chancellor of Exchequer Resists Tightening in 1995

   Because Π still below 4% Ceiling

  ! Focus on Edges, Not Midpoint => Bizarre Objective

  ! Argues for Point Target (with report to Parliament when

   Miss is Big)

OPERATIONAL DESIGN

! Too Short a Horizon and a Narrow Range Can Lead to Controllability and Instrument Instability Problems.

    ! Monetary Policy Has Long Lags (2-3 Years for π)

    ! Controllability Problem: Too Frequent Misses

       1995 RBNZ Overshoot

    ! Output Fluctuations Higher

       New Zealand too Tight at End of 1996

! Instrument Instability Problem:

- Interest Rates, Exchange Rates Fluctuate Too Much

- Focus on Exchange Rate Because Works Faster
- Both Problems in New Zealand

! Solutions

1. Longer Horizons (2 Years)
2. Wider Range (But Problem of Possible Loss of Credibility)
3. Escape Clauses (but hard to design)
4. Core π Measures
5. Multi-Year Targets or Additional Long-Run Target

New Zealand Now Uses 1st 3

OPERATIONAL DESIGN

!Targeting Asset Prices Like the Exchange Rate Worsens Performance.

! Exchange Rate Should Be a Concern

- Direct Effects on Π (Pass-Through)
- Affects Competitiveness and National Pride
- Effects Balance Sheets and Financial Stability
   (in Emerging Market Countries Only)

! Danger of Too Much Focus on Exchange Rate

    - Risks Transforming Exchange Rate to Nominal
      Anchor (Israel and Chile)

! Effects of Depreciation Different Depending on Shocks

    - Portfolio Shock is Inflationary => i 8

    - Terms of Trade Shock, Exports 9 => i 9

    - Likely to Get Wrong Response to Real Shocks

      E.g.: New Zealand, Chile Versus Australia, 1997-99

! Response to Exchange Rates or Other Asset Prices Can't Be Mechanical

- Different Response Depends on Assessment of Shocks

- MCI is a Bad Idea

- Asset Prices Hard to Control,
  CB Looks Foolish When Miss Targets, Yet

- If CB Targets Asset Prices, Public Fears CB Too
  Powerful

- Govt Not Better than Market at Knowing Appropriate
Prices

OPERATIONAL DESIGN

! Who Should Set π Target?

- Common View: Central Bank Should Be Instrument
    Independent (e.g CB sets *i)*
    CB Should be Goal Dependent
    (Govt Sets Long-Run π Goal with CB)

- Problem: Horizon for Medium Term Target Involves Goal and
    Technical Decisions

    1. Weight on Output Fluctuations Affects Horizon
    2. Length of Policy Lags Affect Horizon

    - Less of Dilemma if Near Long-Run Goal
        Big Dilemma During Transition from high to low

∏
! May Want CB to Set Medium-Term Target

INFLATION TARGETING
SPECIAL ISSUES FOR EM COUNTRIES

! EM Countries Need Pay Special Attention to Exchange Rate

- Probably have gone too far

- Run risk of moving to exchange rate anchor

-Passthrough is Regime Dependent
        May Improve over Time

- Rigorous Prudential Supervision Helps

INFLATION TARGETING
SPECIAL ISSUES FOR EM COUNTRIES

! How to Deal with Exchange Rate

    - Smooth as is done with interest rates:

        1. Should Have Exchange Rate Affect i as in Modified
           Taylor Rule in 9'

        2. Determined by Market over longer horizon
        3. Avoid FX Intervention

INFLATION TARGETING
SPECIAL ISSUES FOR EM COUNTRIES

TRANSITION FROM MODERATE TO LOW π

! Basic Problem at Initially High π

    1. Low Credibility of Central Bank
    2. Hard to Control π

! Gradual Hardening of Targets

! Shorter Horizon (1 Year)

    - Multi-Year Targets (but deviations likely)
    - Annual Target Only

TRANSITION FROM MODERATE TO LOW π

! Point Target

   - Range Can Weaken Credibility

! Asymmetric Inflation Targeting

   - Low π: Stress Undershoots as Much as Overshoots:
      Symmetric Approach

   - High π: Lose Credibility if Overshoot
      More Aggressive on Preventing Overshoots
         Danger: Output Loss Too Great and Lose Support

CONCLUSIONS
FOR EMERGING MARKET COUNTRIES

! Issue:

- *Not* Fix vs Flex

- Whether Have Institutions so Can
   Constrain Discretion

- Issue is relevant Now because π is low(er)

! No Regime is Panacea

- Must Prevent Fiscal Dominance

- Need Rigorous Prudential Supervision for

Sound Financial System

CONCLUSIONS
FOR EMERGING MARKET COUNTRIES

! Be Skeptical of "Original Sin"

 -   Recent Successes suggest Countries can Grow Up

 -   Inflation Targeting an Option for Several of Them

UNRESOLVED ISSUE: PRICE LEVEL VS π TARGET

! Price Level Target Better More Forward Looking is Price Setting

- Evidence Unclear

! Problem of More Likely Deflations with Price Target

UNRESOLVED ISSUE: PRICE LEVEL VS π TARGET HYBRID POLICIES

! π Target with Small Amount of Error Correction

- Additional Long-Run Average Target

! π Target with Deflation Escape Clause

- Price Level Target Only if Deflation Sets In

IMF CONDITIONALITY
AND INFLATION TARGETING

! Conditionality based on Financial Programming Framework

    - Net Domestic Assets
    - Net International Reserves

! Do NDA Ceiling and NIR Floor Make Sense Under π Targets?

IMF CONDITIONALITY
AND INFLATION TARGETING

! Alternative Approaches to Monitoring

1. Monetary Policy Institutions
    - Central Bank Independence
    - Central Bank Mandate
    - Central Bank Transparency and Accountability
2. Bands Around Π Target
3. Taylor Rules
4. Assessment of CB Procedures
    - Forecasting
    - Explanation of Actions
        Similar to issue for Supervision of Risk Management

EXCHANGE RATE TARGET
ADVANTAGES

! Fixes π for Internationally Traded Goods

! Provide Nominal Anchor and Ties down π expectations

! Transparent: Simple and Clear

! Automatic Adjustment Mechanism (Rule)

- Prevents Time-Inconsistency?
  M-policy and F-policy

EXCHANGE RATE TARGETING DISADVANTAGES

! Loss of Independent Monetary Policy

- Illustrated by following simple model (Svensson, 1997)

$$\pi_t = \pi_{t-1} + \alpha_1 y_{t-1} + \varepsilon_t \tag{1}$$

$$y_t = \beta_1 y_{t-1} - \beta_2 (i_{t-1} - \pi_{t-1}) + \eta_t \tag{2}$$

Central Bank Minimizes Loss Function

$$E_t \ni \delta^{\tau-t} L_\tau \tag{3}$$

$$L_\tau = (\pi_\tau - \pi^*)/2 + \lambda y/2 \tag{4}$$

Yields "Taylor Rule"

$$i_t = \Pi_t + b_1(\Pi_t - \Pi^*) + b_2 y_t \hspace{3cm} (5)$$

! Loss from Exchange Rate Target Small Only If Pegging Country is Highly Integrated with Anchor Country

-Then inflation and output gaps are highly correlated so anchor country Taylor rule OK for domestic country

! Bottom Line:

"Good" M-policy Better than None for larger Countries

SOFT PEG
DISADVANTAGES

! **Open to Speculative Attacks**

   - Europe: Sept. 1992; Mexico: 1994; Asia: 1997

! **Weakened Accountability: Lose Exchange-Rate Signal**

SOFT PEG:
DISADVANTAGES
EMERGING MARKET COUNTRIES

! Makes Financial Crisis More Likely

Financial Crisis = Nonlinear Disruption to Information =>
Can't Channel Funds to those with most productive
investment opportunities

! Institutional Features in Emerging Market Countries

1. Short duration debt
2. Debt denominated in foreign currencies

HOW A DEVALUATION CAN TRIGGER
A FINANCIAL CRISIS

! E 9, Debt burden 8, Assets same => Net Worth 9
=> moral hazard 8, adverse selection 8 => lending 9

! E 9, Banks debt burden 8, Assets 9 because firms default
=> Bank capital 9 => Bank's restrict lending

! i 8, Bank capital 9 => central bank reluctant to raise i
=> speculative attack more likely => E 9

! E 9, π^e 8, i 8 => interest payments 8, cash flow 9
=> balance sheets 9 => lending 9

WHY EXCHANGE-RATE TARGETING MAKES FINANCIAL CRISES MORE LIKELY IN EMERGING MARKET COUNTRIES

! **Devaluation => Nonlinear 9 Balance Sheets**
    Banks and Nonfinancial Firms

! **Devaluation => ¤ Surge => i 8 => Balance Sheets 9**

! **Encourages Capital inflows =>**
    Lending Boom, Bad Loans =>
    Deterioration in Bank Balance Sheets =>
    Currency Crisis

! **Story in Chile 1982, Mexico 1994-95, East Asia 1997-98**

SOFT PEG:
DISADVANTAGES
EMERGING MARKET COUNTRIES

! Loss of Lender of Last Resort?

    - Overstated for Emerging Market Countries Currently

       Debt Structure Makes LLR Ineffective Anyway

! Bottom Line

Soft Peg Bad Idea in EM Countries, Except for Initial Stabilization When π is Very High

    - Issue of Exit Strategy

HARD PEGS
CURRENCY BOARDS VS FULL DOLLARIZATION

CURRENCY BOARDS

 ! Subject to Speculative Attacks

 ! High Interest Rates From Currency Risk?

FULL DOLLARIZATION

 ! Reduce Interest Rates to International Levels?

  - Country Risk Problem (e.g. Confiscation of $-Assets)

   Fiscal insolvency => confiscation of $-deposits => Banking Crisis

HARD PEGS
BOTTOM LINE

! Two Necessary Conditions:

      1. Sound Financial System
      2. Sound Fiscal Policy

! Hard Peg Does not ensure 2 conditions will be met

EXCHANGE RATE TARGETING: EXPERIENCE AND LESSONS

! Successful in Reducing π

    - France:
        1987: π = 3%, 2% above Germany
        1997: π = 2%, = Germany

    - U.K.:
        1990: π = 10%
        1992: π = 3%

   - Argentina: Currency Board
        1989-90: π > 1000%
        1994: π = 5%

EXCHANGE RATE TARGETING:
EXPERIENCE AND LESSONS

! Output Variability 8 Because Lose Independent M-Policy

- Problems after German Reunification
U.K., French Monetary Policy too Tight:
Clarida, Gali and Gertler (1997)

- Argentina: 2 Serious Recessions in 1990s

EXCHANGE RATE TARGETING:
EXPERIENCE AND LESSONS

! Still Subject to Speculative Attacks and Bank Runs

    - Argentina in Tequila Crisis had Deposits9 17%
    - Bank Panic in Panama in 1988-89

! Hard to Exit

    - Feasible if Currency Appreciating, but Political Will Weak
    - Worse for Dollarized Economy:
        New Money and M-authorities lack credibility

EXCHANGE RATE TARGETING:
EXPERIENCE AND LESSONS

! Two Necessary Conditions for Exchange Rate Peg to Work:

      1. Sound Financial System
      2. Sound Fiscal Policy

! Even Hard Peg Does not ensure 2 conditions will be met

- Weakness of Argentina's Banking System almost brought   down
      Currency Board in 1995
   -   Soundness of Panama Banks Result of Foreign Ownership

   -Panama's Fiscal Policy No Better
      Request for 13 IMF Programs - Most in Latin America
   -   Argentina Still Has Fiscal Problems

EXCHANGE RATE TARGETING: BOTTOM LINE

! Soft Pegs Highly Dangerous

- May be Useful for Stabilization, but Not for Long Run Strategy

! Hard Pegs only Feasible Strategy in Some EM Countries

If political and economic institutions cannot support independent central bank focused on price stability

MONETARY TARGETING

! 3 Elements

1.Use of M-aggregate to guide conduct of M-policy

2. Announcement of M-target

3. Accountability to Meet Target

MONETARY TARGETING:
ADVANTAGES

! Able to Cope with Domestic Considerations

! Nominal Anchor that is Fairly Understandable

! Signals are Immediate

! Immediate Accountability of Central Bank

MONETARY AGGREGATES:
DISADVANTAGES

! Advantages Only *IF* Strong Relationship between M and PY

    - Illustrate by adding money demand function to model above

$$m_t - p_t = \curlyvee y_t - \kappa i_t + \cup_t \tag{6}$$

    - Presence of $\cup_t$ and uncertainty about parameters $\curlyvee$ and κ =>
        Weak Relationship between M and PY,
        M-Targeting Deviates from Optimal Policy in (5),
        Higher Volatility of Y, $\sqcap$ and i.

MONETARY TARGETING: EXPERIENCE AND LESSONS

! **Not Successful in U.S., Canada, U.K.**

- Not Pursued Seriously

- Instability of M-PY Relationship

    "We Didn't Abandon Monetary Aggregates, They Abandoned Us."

MONETARY TARGETING:
EXPERIENCE AND LESSONS

! Has Not Been Practiced in EM Countries like Latin America

   - Many central banks have first element, but not others

   - Peru is cited as having Monetary Anchor in 1990s,
        but never *Announced* Target
        Strategy is discretionary

   - Instability of M-PY Relationship When $\Pi < 20\%$

        Mexico:
            1997: MB > MB* by 4.1%, $\Pi = 15.7\% = \Pi^*$, 15%
            1998: MB < MB* by 1.5%, $\Pi = 18\% > \Pi^* = 12\%$

1999: MB > MB* by 21%, $\Pi = 12.3\% < \Pi^* = 13\%$

MONETARY TARGETING: EXPERIENCE AND LESSONS

! Swiss and Especially German Experience More Successful

- Not Bound by Monetarist Orthodoxy

- Means to Communicate Strategy and Focus on
  Long-run

   Inflation Goal Explicit and Work Backwards to M-target

- Flexible:

   Target Ranges Missed 50% of time

π-Goal Varies and Adjusted Slowly to Long-Run Goal

MONETARY TARGETING:
EXPERIENCE AND LESSONS

! Germany: Highly Successful Even with Flexibility

   - Produced Low Π => Anchor Country for ERM

   - Kept Π in Check after German Reunification

   - Criticism: Asymmetric Response to Target Misses =>
                     Not Concerned Enough About Undershoots,
                     Policy Too Tight in mid 1990s?

MONETARY TARGETING: EXPERIENCE AND LESSONS

! **Switzerland: Problematic Since 1988**

   - 1989-92: π 8 to 5%

   New Interbank Payment System Distorts M-PY
Relationship

   Exchange Rate Shocks

   - Result: Move to Much More Flexible Framework

MONETARY TARGETING: EXPERIENCE AND LESSONS

! Bottom Line: Key Elements

   - Flexibility

   - Transparency

   - Accountability

! Same Elements in π-Targeting

! Germany and Switzerland Closer to π-Targeting than to Monetarist M-Targeting

MONETARY POLICY WITH AN IMPLICIT BUT NOT AN EXPLICIT NOMINAL ANCHOR: "JUST DO IT"

! **Greenspan Fed**

! **Implicit Commitment to Price Stability**

! **Forward-Looking and Preemptive to Deal With Long Lags**

"JUST DO IT"
ADVANTAGES

! Able to Cope with Domestic Considerations

! Does Not Rely on Stable M-PY Relationship

! Demonstrated Success: Worked Well in the U.S.

! If It Ain't Broke Why Fix It

"JUST DO IT"
DISADVANTAGES

! Not Transparent

! Lack of Accountability

! Exposure to Inflation Scares

! Missed Opportunity to Focus Debate on Long-Run

- Contrast of Response to 1997 M-tightening in UK and US

!   Makes CB More Consistent With Democratic Principles

- Promotes CB Independence

JUST DO IT
DISADVANTAGES

! Requires Good Monetary Policy and Political Institutions

- U.S. Has Good Institutions

But Even Fed Has Fallen Off Anti-π Wagon in Past

Especially Good Policymakers Recently in U.S.

Greenspan, Rubin, Summers

Unprecedented Cooperation Between Fed and Treasury

- Most Other Countries Don't, Particularly EM Countries