

Conference Overview and Summary of Papers

*by Zahir Lalani and David Murchison**

1. Introduction

In a departure from his predecessor, Alan Greenspan, Ben Bernanke, the new Chairman of the U.S. Federal Reserve, has affirmed his support for adopting an explicit numerical target for inflation. However, at his U.S. Senate Banking Committee hearing in late 2005, he said “I will take no precipitate steps” towards a target. “This matter requires further study at the Federal Reserve as well as extensive discussion and consultation. I would propose further action only if a consensus can be developed that taking such a step would further enhance the ability of the FOMC to satisfy its dual mandate of achieving both stable prices and maximum sustainable employment.”

To shed light on this issue, the Canadian Consulate General in New York (Bank of Canada New York Office and Finance Canada) recently co-sponsored the conference “Inflation Targeting: Problems and Opportunities” with the New York Association for Business Economics (NYABE). The goal of the conference was to engage key Canadian and U.S. economists and market participants to explore the evolution of inflation-targeting frameworks and to examine the prospects of the Fed adopting an explicit inflation target.

2. Coming Soon: An Inflation Target for the Federal Open Market Committee?

Leading off the conference, Laurence Meyer presented the view that, under Ben Bernanke’s leadership, the Federal Open Market Committee (FOMC) will give active consideration to an explicit inflation target for the United States. However, the numerical definition of price stability is likely to be in the context of the dual mandate that Congress has set for the FOMC to promote full employment as well as price stability. He argued that neither Congress nor many of the FOMC members would accept a fundamental change in this mandate. While there will be some disagreements among the Committee members about the target rate, the inflation target is likely

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to be based on the core PCE centred at 1.5 per cent in a range of 1 per cent to 2 per cent. Unlike some other inflation-targeting countries, the Fed has been operating under an explicit dual mandate and an implicit inflation objective. He suggested that the Federal Reserve may be closer to best practice than some other central banks that are operating under an explicit inflation target within an implicit dual mandate. The FOMC, however, is not likely to identify a specific time horizon over which the inflation objective is to be attained, since this would be inconsistent with the dual mandate, and Meyer suggested that horizons are not needed for central banks that already have credibility. Operating under a dual mandate, the FOMC will continue to publish the Monetary Policy Report to Congress twice a year and will not switch to publishing an Inflation Report instead.

Alan Blinder essentially agreed with Meyer's position and viewed this as an incremental step that would provide important benefits in terms of making the Fed more accountable for achieving the target or explaining why it missed it. An explicit numeric inflation target, he argued, will also add clarity to the FOMC's external communications. Blinder was of the view, however, that the FOMC may have a preference for the core CPI as the reference as opposed to the PCE deflator.

3. Major Progress in Practical Monetary Policy: The Experience of Norway

Lars Svensson argued strongly in favour of inflation targeting and presented the Norges Bank as a model. Inflation targeting has been adopted by more than 20 countries over the last 15 years, and this has helped central banks to develop a more systematic and consistent framework for the decision-making process, more transparent communications, and has enhanced the degree of central bank accountability. Some of these central banks are now focused on whether they should publish the policy rate assumptions underlying their projections of inflation and other target variables, along with the other forecasts they publish. Svensson recommended that central banks should publish the entire path of current and future policy rates—and not just the first few months—along with the projections of inflation and the output gap. This would provide the private sector with the central bank's best forecast of future policy rates, inflation, and output gaps, while the central banks would benefit by having an approach for the most effective implementation of monetary policy, as well as more transparency for external evaluation of the central bank's performance. He used the example of the Norges Bank, which publishes such projections using fan charts that show the degree of uncertainty and alternative scenarios, together with a fair amount of discussion justifying the central bank's projections.

Michael Woodford discussed some of the issues that central banks have to deal with when they publish projections. For example, the projections are conditional on market expectations of the forward path of interest rates. However, the central banks can deal with this by using fan charts and alternative scenarios that make it clear that the path is not a commitment.

4. Future Trends in Inflation Targeting: A Canadian Perspective

John Murray reviewed the key features of inflation-targeting frameworks and identified some important issues that have yet to be resolved. Since the introduction of inflation targeting by New Zealand in 1990 and by Canada in 1991, there has been a remarkable convergence in the inflation-targeting frameworks used by various industrial and developing countries. By and

large, countries using inflation targeting have had considerable success. They have typically experienced

- (1) lower long-run inflation,
- (2) less sensitivity to outside shocks,
- (3) increased monetary policy independence,
- (4) increased monetary policy efficiency,
- (5) less variability in output growth and inflation,
- (6) greater success in meeting their inflation objective,
- (7) less inflation persistence, and
- (8) more firmly anchored expectations.

While non-targeters have also had success during this period, the inflation-targeting countries have generally done better. Some countries, such as the United States, however, have achieved an impressive performance without explicit inflation targets. Nevertheless, a comparison of Canada's performance with that of the United States shows that, in some areas, Canada has done better than the United States. For example, nominal interest rates and inflation in Canada have been lower than in the United States, long-run inflation expectations are also more volatile in the United States when compared with those of Canada, the United Kingdom, or Sweden. The bottom line is that while inflation targets may not be necessary for good macroeconomic performance, they do tend to improve the odds. While inflation targeting has worked very well in Canada, the Bank of Canada intends to study other substantive issues such as whether the inflation target can be lower, whether the current price index is appropriate, and price-level targeting as an alternative to inflation targeting.

David Laidler defended the virtues of inflation targeting but questioned whether the central bank's reliance on core inflation (excluding food and energy) as a good indicator for the underlying trend of inflation was appropriate.

5. Conclusion

Inflation targeting has come a long way over the last 15 years, and it is now viewed as best practice. While the inflation-targeting framework used by various countries has converged, some central banks, such as the Norges Bank, are experimenting with the publication of their forward-looking projections and assumptions. The Bank of Canada intends to study whether the inflation target can be lowered and whether they should be targeting the price level. The United States and Japan are exploring the possibility of adopting an explicit inflation target. The consensus view at the conference was that the FOMC will adopt an explicit inflation target but within its existing dual mandate.

