Challenges to inflation targeting: raising some issues[1]

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Prior to my appointment at the BIS in 2004 I was the Chief Economist of the Central Bank of Iceland. There I played a role in the 2001 adoption of the inflation targeting (IT) framework. At that time, I was a great fan of IT. However, experience has brought with it a better appreciation of the challenges that come with it. Iceland was the first country that I am aware of to suspend IT because of a financial crisis. Prior to that episode some countries had left IT, but they did so only to enter a monetary union. At the BIS, I took an attitude to IT that is similar to that of Winston Churchill's about democracy: "No one pretends democracy is perfect or all-wise … indeed, it has been said that democracy is the worst form of Government except all those other forms that have been tried from time to time."

It is a fact that IT has been a great success story. New Zealand was the first country to adopt the framework, following the Bank of New Zealand Act of 1989. Since then, the IT group has grown to over twenty countries, among them several from Latin America. No country has to my knowledge regretted its adoption, although, as I noted, some left the group. The results have also been impressive in terms of the mean and the variability of inflation, without having a significant cost in terms of output volatility. Nonetheless, other countries have experienced similar developments, suggesting that, in some sense, this was driven by a benign environment, or good luck if you like. Despite such favourable conditions, it also seems to be the case that shocks to inflation have been less persistent among IT countries than among non-IT countries. But the goal of this session is not to discuss the success of IT. That story has been told over and over. Rather, we are here to discuss recent challenges that are putting IT to the test. Among those are the following:

- First, how should IT central banks react to persistent and potentially long-lasting changes in relative prices of oil and other commodities, as experienced in the recent past?
- Second, how does the ongoing process of financial globalisation complicate the conduct of monetary policy, especially in smaller countries? Related to this are the questions of how to deal with shrinkages in capital flows, the exchange rate, and the role, if any, of foreign exchange intervention in an IT framework.
- Third, in light of the potential medium-term damage to macroeconomic and price stability that can come from boom-bust cycles in credit growth and asset prices, how should those cycles be dealt with in an IT regime?
- Fourth, to what extent should financial stability concerns be factored into monetary policy decisions? Should there be more flexibility, longer horizons, leaning against the wind of asset price booms? Should there be a risk management approach in terms of financial disruptions – as generally spoken by Mishkin – or, should it be all of the above?

I am not here to provide any answers. To discuss the issues, we called a very distinguished group of panelists.

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