

Krzysztof Rybiński: Inflation targeting and the challenges ahead

Opening remarks by Mr Krzysztof Rybiński, Deputy President of the National Bank of Poland, at the "Inflation Targeting - Third Joint NBP & SNB Seminar on Monetary Policy", Warsaw, 18-20 May 2006.

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Ladies and Gentlemen,

I am pleased to welcome you at the third seminar on monetary policy organized jointly by the Swiss National Bank and the National Bank of Poland. Let me start by thanking staff members from the host central banks, who have not spared their efforts on preparing this seminar.

For the first time in our seminar, apart from economists from the host central banks we have invited representatives of other central banks to share with us their knowledge and experience with inflation targeting. Thus I would like to warmly welcome our guests from the Czech National Bank – the first inflation targeter in Central and Eastern Europe, and from the Central Bank of Turkey – a brand new inflation targeter, which has adopted the framework only this year.

The topic of this year's seminar is inflation targeting (henceforth called IT). As the distinguished former Fed chairman Paul Volcker recently remarked¹, inflation targeting may sound like an oxymoron since usually central banks strive to fight inflation rather than to breed it. So should we gather here to discuss ways of breeding inflation?

Needless to say, Paul Volcker perfectly knows that it is low and stable inflation and not any inflation that inflation targeters are trying to achieve. Yet, if we know that low inflation is our objective then what is the most suitable monetary policy? How low should the inflation target be, which price index to target, what about stabilizing output or preventing asset bubbles, should we be strict or flexible inflation targeters, how to communicate our policies? All central bankers, both those beginning the IT adventure and those more advanced with it, have to address these questions. I hope this meeting will provide an opportunity to do it.

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Since 1990, when the pioneering Reserve Bank of New Zealand first introduced IT, over twenty countries have followed its example. The National Bank of Poland along with the Czech National Bank were among the first emerging market countries' to adopt IT.

From the very beginning IT has been practiced in very diverse economies, from the UK and Peru to Korea and Ghana. Many other and more diverse countries consider following the fashion, just to mention Botswana or China. IT attracts growing interest both in developing countries, some of which are still struggling with high inflation, and countries with relatively long history of macroeconomic stability such as the United States or Japan. It is widely known that Alan Greenspan's successor Ben Bernanke is a strong advocate of IT² and this makes Fed's adoption of IT quite probable. Some economists urge the Bank of Japan to soon join the IT club³. So, what is so special about IT and what makes it so attractive for so many central bankers and economists?

Undoubtedly, the source of the growing IT popularity is its effectiveness in ensuring macroeconomic stability. Firstly, IT has proved effective in delivering price stability. Though the contribution of IT to lowering inflation is still a matter of debate⁴, empirical research suggests that it has significantly

¹ Volcker P. "Panel discussion: The Art of Central Banking" at "Monetary Policy: A Journey from Theory to Practice - An ECB Colloquium held in honor of Otmar Issing", 16 March 2006.

² See: Bernanke B.S. "A Perspective on Inflation Targeting", Remarks at the Annual Washington Policy Conference of the National Association of Business Economists, Washington, D.C. 25 March 2003.

³ According to Ito the Bank of Japan has not yet adopted IT for political reasons. See Ito T. "Inflation Targeting and Japan: Why has the Bank of Japan not Adopted Inflation Targeting?", NBER Working Paper 10818, September 2004.

⁴ See "Does Inflation Targeting Matter?" Ball L., Sheridan N. in Bernanke B.S., Woodford M. (ed.): The Inflation-Targeting Debate, NBER, 2005.

contributed to lowering inflation and its volatility, especially in emerging markets⁵. Secondly, empirical evidence suggests that IT has also improved other macroeconomic variables (lower output sacrifice ratio, decreased influence of price shocks and output shocks on inflation, smaller inflation persistence⁶). Thirdly, it has facilitated stabilisation of long-term inflation expectations⁷, thus reducing the cost of maintaining low inflation. Certainly, IT was not the only factor behind reduced inflation and good macroeconomic performance. There were other fundamental things at play, such as spreading central bank independence. But for sure, as the Governor of the Bank of England Mervyn King puts it, “inflation targeting made our job easier by reducing the cost of making the right decisions”⁸.

If IT has proved so successful then is there anything left to do to improve or shall monetary economists and central bankers go on holidays? Surely, a good rest is always an attractive option, yet some questions about IT remain unresolved, so the holiday should not be too long.

First, there is the question of flexible versus strict inflation targeting⁹, i.e. a way of incorporating output and employment fluctuations into monetary policy decisions. IT-guru Lars Svensson claims that in practice “all real-world inflation targeting is flexible inflation targeting”¹⁰. By that he means that considerations on output (and employment) are always present in the decision-making process. However, though most central bankers agree that limiting output and employment fluctuations should enter the policy equation, there’s no consensus about how to do it in practice. No wonder some central banks find it difficult to clearly express their approach regarding output stabilisation. A promising example in this respect is the Norgesbank, which is explicit about its flexible approach. Norwegians state openly that they “operate a flexible inflation targeting regime, so that weight is given to both variability in inflation and variability in output and employment”¹¹. Also the monetary policy objectives of the Fed are formulated in this vein¹². It is worth stressing however that the degree of appropriate flexibility in a particular country may depend on the duration of low inflation¹³. Thus the Norwegian case may not be applicable to countries during disinflation or shortly thereafter.

Another important question regards the choice of the targeted price index. Should it be headline inflation which is more familiar to the public or core inflation which is less vulnerable to short-term deviations? And what about asset prices? Should they be included in the index? The question of including asset prices into the targeted price index is related to a wider policy debate, namely on the

⁵ “Although macroeconomic performance improved in most non-industrial countries over the past decade, countries adopting inflation targeting have, on average, outperformed countries with other monetary policy frameworks.” - IMF, *“Inflation Targeting and the IMF”*, March 2006. Empirical evidence show also that inflation targeters achieve better sustainability records in terms of disinflation, though the findings are statistically not robust – Hofstetter M. *“Why have so many disinflations succeeded?”*, Documento Cede 2005-65, November 2005.

⁶ See: Corbo V., Landerretche O., Schmidt-Hebbel K. “Does Inflation Targeting Make a Difference” in: Loayza N., Soto R. (ed.) *“Inflation Targeting: Design, Performance, Challenges”*, Central Bank of Chile, 2002.

⁷ Gürkaynak R.S., Levin A.T., Marder A.N., Swanson E.T. *“Inflation Targeting and the Anchoring of Inflation Expectations in the Western Hemisphere”*, forthcoming in Mishkin F., Schmidt-Hebbel K. (ed.), *Series on Central Banking, Analysis and Economic Policies X: Monetary Policy under Inflation Targeting* (Santiago, Chile: Banco Central de Chile), 2006 and Gürkaynak R.S., Levin A.T., Swanson E.T. *“Does Inflation Targeting Anchor Long-Run Inflation Expectations? Evidence from Long-Term Bond Yields in the U.S., U.K., and Sweden”*, Federal Reserve Bank of San Francisco Working Paper 2006-09, March 2006.

⁸ King M. *“What Has Inflation Targeting Achieved?”* in Bernanke B.S., Woodford M. (ed.): *The Inflation-Targeting Debate*, NBER, 2005.

⁹ Strict inflation targeting implies monetary policy focused only on price stability. In contrast, “flexible inflation targeting implies that the central bank is not exclusively concerned about stabilizing inflation around the inflation target but is also concerned with the stability of the real economy, as represented by the output gap, the employment gap, or the unemployment gap.” – Svensson L. *“Optimal Inflation Targeting: Further Developments of Inflation Targeting”*, October 2005.

¹⁰ “Although inflation-targeting central banks normally acknowledge that they are flexible inflation targeters, they are normally not very explicit and transparent and probably not very consistent about the relative weight they attach to stability of other variables than inflation.” – Svensson L., op. cit.

¹¹ “Norges Bank operates a flexible inflation targeting regime and seeks to achieve an interest rate path that provides a reasonable balance between the objective of bringing inflation up towards 2.5% over time and stabilising developments in output and employment.” - Norgesbank, *Inflation Report*, March 2006.

¹² According to the Federal Reserve Act, the Board of Governors and the Federal Open Market Committee should seek “to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”

¹³ Cukierman A. *“Central Bank Independence and Policy Results: Theory and Evidence”*, Lecture prepared for the International Conference on: “Stability and Economic Growth: The Role of the Central Bank”, Mexico City, 14-15 November 2005.

way central banks should respond to asset prices. Fed Chairman Bernanke claims that central bankers should respond to asset prices only insofar as they affect output gap and thus inflation¹⁴. Another FOMC¹⁵ member Donald Kohn has described this approach as “conventional strategy” and proposed, what he called, an “extraaction” policy¹⁶. Monetary “extra action” – according to Kohn – would be required if there were clear signals of an asset bubble building up – especially a one fuelled by excessively loose monetary policy – and if costs of “extra action” policy were smaller than the costs of further build-up and subsequent collapse of a bubble. This question basically relates to the Year-old discussion of “should the central bank prick bubbles or not?”

Today asset price considerations are present in central banking practice in many countries – Norway, eurozone or Japan, to name just a few. Norgesbank speaks openly that when setting interest rates it does not ignore developments in asset and credit markets¹⁷ and its inflation report contains an asset price forecast. The ECB’s president Trichet has in turn acknowledged that the monetary pillar of the ECB “contributes to assessing the extent to which excess creation of liquidity and over-extension of credit can be a driving force behind excessively valued assets [...] and might reflect the inflating of an asset price bubble”¹⁸. Bank of Japan said in its “New Framework for Monetary Policy” that “risk factors include [...] generating an asset price bubble” and that “in conducting monetary policy, the Bank needs to do its utmost to prevent the materialisation of such potential risks.”¹⁹

A hot issue in today’s discussion about IT is transparency and communication. More and more economists realise that communication is the primary channel of central bank’s impact on the economy and monetary policy is increasingly becoming an art of managing expectations. Lars Svensson argues that current level of central bank interest rates matters very little for future inflation and economic activity, while Michael Woodford claims even that apart from expectations, little else matters²⁰. For this reason inflation targeters put an ever larger weight to effective communication. Useful tools for it are decision statements, inflation reports, published inflation forecasts and central bankers’ public speeches. These tools are now standard in communication among the best IT-performers. For central banks from emerging markets applying these standards is very desirable, as in this way they can gain some ‘confidence premium’ from the market, who perceive such central banks as ‘goodpractice’ followers. This is very important especially amid growing internationalisation of financial markets, when interpreting central bank’s policy is much easier under standard communication.

Surely, it is not the amount of communication that matters but rather its quality. This refers especially to central bankers’ talk. It is more important, what you say than how you say it as unclear signals may actually misguide the market. A recent example of communication problems was the puzzle over the first congressional testimony of Governor Bernanke and his later comments.

Transparency and communication earned attention of most central bankers, yet some are keener than others. In 1997 Reserve Bank of New Zealand started publishing its three-year interest rate forecast. Since 2005 the bank has been presenting a central interest rate scenario. The RBNZ innovation has

¹⁴ McCulley P. “*The Root of All Evil*”, Global Central Bank Focus, PIMCO, May 2006.

¹⁵ FOMC: Federal Open Market Committee.

¹⁶ “The extra-action strategy responds to a perceived speculative boom with tighter monetary policy - and thus lower output and inflation in the near term - with the expectation of significantly mitigating the potential fallout from a possible future bursting of the bubble. Thus, the strategy seeks to trade off the near-certainty of worse macroeconomic performance today for the chance of disproportionately better performance in the future, on the theory that the repercussions of a major market correction could be highly nonlinear. But the extra-action proposal is by no means a bold call for central banks to prick market bubbles.” - Kohn D. “*Monetary Policy and Asset Prices*” at “Monetary Policy: A Journey from Theory to Practice - An ECB Colloquium held in honor of Otmar Issing”, 16 March 2006.

¹⁷ “Interest rate setting must also be assessed in the light of developments in property prices and credit. Wide fluctuations in these variables may in turn constitute a source of instability in demand and output in the somewhat longer run.” – Norgesbank, Inflation Report, March 2006.

¹⁸ Trichet J.C. “*Asset price bubbles and monetary policy*” Speech of the President of the ECB, Mas lecture, Singapore, 8 June 2005.

¹⁹ Fukui T. “*New Framework for the Conduct of Monetary Policy: Toward Achieving Sustainable Economic Growth with Price Stability*”, Summary of a Speech Given by Toshihiko Fukui, Governor of the Bank of Japan, to the Japan Chamber of Commerce and Industry in Tokyo on 16 March 2006.

²⁰ Woodford M. “For not only do expectations about policy matter, but (...) very little else matters.” – *Interest and Prices: Foundations of a Theory of Monetary Policy*, Princeton University Press, 2003.

been followed recently by the Norgesbank²¹. At first (since 2003) the Norwegian MPC published its monetary policy intentions only for the next four months in the form of an interest rate forecast interval. Last November it went further and started publishing a forecast for interest rates three years ahead in the form of a central forecast (with two alternative scenarios) along with a fanchart). These bold steps made New Zealanders and Norwegians push the frontier of central banking ahead and set a new benchmark for inflation targeters²². Are we ready to follow?

In 2000 Mahadeva and Sterne measured central banks transparency²³. Back then the Polish central bank was below the average among inflation targeters. However since then the NBP has made considerable progress. Major changes to communication have been introduced such as publication of inflation forecasts, modification of inflation reports and decision statements in order to make them more forward-looking. Łyziak et al. have applied the Mahadeva-Sterne and Eijffinger-Geraats indices to assess current transparency of the NBP and showed that it has markedly improved²⁴. Nevertheless, we are not resting complacently. There are still ways to go and things to learn. Later today Marek Rozkrut will present results of an empirical study conducted at the NBP²⁵ showing that central bank communication strategies in the Czech Republic, Hungary and Poland exhibit large differences. The Czech National Bank seems to do a much better job than the other two banks in matching words with deeds. There is also some evidence that pursuance of too many targets under IT framework leads to inconsistencies also in central bank communication, as in the case of the Hungarian National Bank.

Finally, to those of you, who intend to adopt IT in the future let me say one last thing. A standard view is that IT should not be introduced unless a number of criteria are fulfilled. As Piotr Szpunar will tell you in the first presentation, at the time Poland adopted IT one could claim we were not ready as we did not comply with all of these criteria (e.g. a robust and well examined transmission mechanism)²⁶. Yet Poland succeeded. Today we have low inflation with fairly low interest rates. What was the source of this success? We could probably think of a bunch of factors, but one thing cannot be overlooked. "The evidence suggests that successful adoption of inflation targeting depends more on establishing a credible commitment to the strategy than on fulfilling a lengthy list of technical prerequisites²⁷". To put it bluntly, credible commitment to price stability is the very key and there's no substitute for it. Those who ignore it are bound to fail.

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I am sure the seminar will spark inspiring discussions and give us a deeper insight into the problems of inflation targeting. I hope that it will also address some open questions about the future of IT and monetary policy at large. Let us not forget that the ideas of today shape the world of tomorrow. And the monetary policy of tomorrow is still to be discovered.

I wish you a pleasant and interesting seminar.

²¹ "When our MPC decided to move forward and publish a forecast of the central bank interest rate path, the decision was based on several arguments. One was the well established theoretical argument that monetary policy mainly works through expectations. Monetary policy is only effective if the central bank is able to influence interest rate expectations." - Qvigstad J.F., Speech at the conference "The ECB and Its Watchers VIII" in Frankfurt on 5 May 2006.

²² The Norgesbank is keen to recall that this innovation is not necessarily suitable for all central banks: "[...] one should bear in mind what Alan Blinder and Charles Wyplosz said at the American Economic Association conference last year: "The appropriate volume and methods of central bank communication depend crucially on the nature of the monetary policy committee." So what is useful and correct to do in Oslo may not be the best solution in Frankfurt. The MPCs are set up in different ways. There is not necessarily "one fit for all." - Qvigstad J.F., op. cit.

²³ Mahadeva L., Sterne G. (ed.) Monetary Policy Frameworks in a Global Context, Routledge, 2000.

²⁴ The improvement of monetary policy transparency in Poland is documented in Łyziak et al. "Central bank credibility and transparency – the case of Poland", mimeo, 2005.

²⁵ Rozkrut M., Rybinski K., Sztaba L., Szwaja R. „Quest for Central Bank Communication. Does It Pay To Be "Talkative?“, mimeo, April 2006.

²⁶ "According to Debelle (1997) and Mason et al. (1997), one of the key prerequisites for the successful adoption of inflation targeting is that the central bank must have an adequate ability to produce inflation forecasts and to assess the impact of changes in monetary instruments on inflation (the magnitude of the effects, their lags etc.)." In Poland until 1998 (IT was introduced in 1999) there was no clear statistical linkage between changes in the short-term policy interest rates and changes in inflation - Christoffersen P., Wescott R. "Is Poland ready for inflation targeting?", IMF Working Paper, 1999.

²⁷ IMF, op. cit.

Thank you.