High-level policy panel on monetary policy and exchange rate issues: some thoughts on the future of inflation targeting

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1. Introduction

Our recent experience with global financial instability and its spillover effects into real sector activity has prompted a rethinking of some principal tenets not only on the global financial architecture but also on monetary policy.

As our economies stabilise, this may be a good time to think about the future of monetary policy under inflation targeting, which over the years has gained much currency with central banks and has become associated with good monetary policymaking.

Overall, my sense is that the practice of inflation targeting, particularly in emerging-economy central banks, has been quite flexible, largely out of necessity, and this has allowed monetary authorities sufficient room for manifold considerations while remaining mindful of the primacy of the inflation goal.

That flexibility, in my view, may point to the way forward.

I would like to organise my remarks this afternoon in the following manner: First, I will speak briefly on the experience of inflation targeting. Then, I will share our own experience with IT. Finally, I will lay out some implications of the ongoing crisis and policy options for IT countries in general.

2. The inflation targeting experience

Let me begin by presenting some observations about inflation targeting.

IT experience has been generally positive

Carl Walsh's (2009) recent assessment of the overall cross-country experience with inflation targeting suggests that the experience has been generally positive.

First, inflation targeting has proven to be durable because, despite many missed targets, no central bank has abandoned inflation targeting. Indeed, the ranks of inflation-targeting central banks appear to have increased since New Zealand first began using inflation targets two decades ago. Since 1990, IT has been adopted by 24 countries, of which 16 are emerging markets.

Second, IT has been associated with good inflation and macro performance. Interestingly, the spread of IT occurred during the period of the Great Moderation. And therefore, its popularity as a monetary framework coincided with better macroeconomic performance and generally lower and less volatile inflation.

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Third, IT has enabled greater transparency in central banks. As a framework, IT emphasises transparency. Therefore, the move towards greater central bank independence, occasioned by changes in their governing charters and the consequent need for greater accountability, became conducive to the spread of the IT framework.

As central bankers around the world became more transparent about their goals and operations, they also began to place much greater emphasis on their communication strategies. In addition, it has become increasingly clear that managing expectations is a key objective of monetary policy. Communication policy, which is central in the IT framework, has therefore risen in stature within the central banker's toolkit.

Fourth, IT provided flexibility in the conduct of monetary policy. One trend that has been suggested by research is that inflation targeters have not been "inflation nuts" (ie they have not been fixated on the inflation target). IT central banks have pursued their inflation targets in a flexible manner. They have broadly also paid due attention to the short-term consequences for variability in output growth. As observed by Roger and Stone (2005), IT central banks have willingly accepted some variability in inflation from targets to dampen excessive volatility in growth or unemployment, while also ensuring that inflation is brought back on track over the medium term.

A purist may say, this is a classic example of the problem of "time inconsistency of policy" that Kydland wrote about years ago. I would disagree (but) with a qualification. A "flexible" IT framework, as I just described it, is time-consistent if policymakers uphold the primacy of price stability. What becomes critical and the linchpin to make the framework workable is clear communication of policy intent. The centrality of transparency in IT makes it best suited to be the commitment mechanism, as Kydland would refer to it. Clearly, time inconsistency in a monetary policy framework – whether IT or otherwise – would be avoided if the policymakers are committed to the objective, and are seen to be credible.

IT practice confronted with issues

Apart from credibility and commitment, there are other "sticky" (difficult) issues that need to be considered in an inflation targeting framework, particularly for emerging market economies.

First, a perennial issue in any open economy is the role of the exchange rate.

This has been a particularly difficult issue for inflation targeters who had previously relied on the exchange rate as the nominal anchor for policy (examples include Brazil, Chile, Israel, Poland and South Africa). In some cases, the transition has not been easy, in part because it has been difficult to convince the public and the financial markets that the central bank has subordinated exchange rate and competitiveness concerns to the inflation objective.

Second, IT countries are not immune to disruptive shifts in investor sentiment.

Capital flows tend to follow a cycle, rushing in when the economy is strong and rushing back out again during times of decline. Prior to the recent crisis, emerging-economy inflation targeters in Eastern Europe, Latin America, and Asia experienced strong capital inflows, putting upward pressure on exchange rates and leading to ballooning current account imbalances and foreign exchange reserves. Given the varied reasons for these flows, determining the appropriate policy mix is oftentimes highly challenging.[2]

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[2] Several central banks have felt compelled to respond with intervention in money and foreign exchange markets, administrative measures or restrictions to slow the pace of short-term capital inflows through regulations on foreign borrowing, foreign exchange transactions and operations of the banking system. The appropriate policy mix depends on various factors, such as the causes of capital inflows and outflows

3. The Philippine IT experience

Let me now move on to the Philippine experience.

The BSP formally adopted the inflation targeting framework in 2002. Our experience shows that inflation generally trended downwards from 1991 to the first two quarters of 2009. Output performance has also been generally steady during the period.[3] However, economic activity has been affected by the downturn in external demand, especially during the latter part of 2008 in the aftermath of the global financial crisis, even though the Philippine financial system was only moderately affected by the turmoil.

In our case, the key benefits of IT were to enhance the policymaking process, increase policy discipline, improve focus on the price stability objective, and strengthen the credibility of the central bank. It has also greatly improved transparency.

Allow me to cite some empirical work to support these conclusions.

- Dincer and Eichengreen (2009) observed that among Southeast Asian countries, the Philippines has been the most transparent since 2002 insofar as monetary policy is concerned.[4]
- Research at the BSP indicates that inflation expectations have become a potent channel of monetary transmission under inflation targeting, and that the BSP policy rate is an important factor in shaping inflation expectations (Bayangos, Basilio, Floro and Glindro 2009).[5]
- McNelis (2009) shows that persistence in price-setting in the Philippines has fallen during the IT regime. McNelis, using a dynamic stochastic general equilibrium

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(permanent or temporary), availability and flexibility of instruments and the condition of the domestic financial market.

3 The simple linear trend line from 1991 to 2009 shows that Philippine inflation has decelerated while real Philippine GDP growth has increased (with attached chart at the end of the presentation). A closer look at pre-IT and IT periods shows the following average for inflation and real GDP growth:

Table 1

Average inflation and real GDP growth

	Inflation (%)	**Real GDP growth (%)**
Pre-IT Period (Q1 1991-Q4 2001)	8.27	2.96
IT period (Q1 2002-Q2 2009)	5.46	5.01

4 Dincer and Eichengreen's transparency index is based on Eijffinger and Geraats' (2006) definition, which includes political transparency (that is, openness about policy objectives), economic transparency (openness about data, models and forecasts), procedural transparency (openness about the way decisions are taken, achieved mainly through the release of minutes and votes), policy transparency (openness about the policy implications, achieved through prompt announcement and explanation of decisions), and operational transparency (openness about the implementation of those decisions), with three subcategories within each of these five dimensions. Their overall index is the sum (equally weighted average) of the sub-indices for these five dimensions. The values are found at the end of the presentation.

5 In particular, a sustained one percentage point rise in the real BSP policy rate was simulated over a period of two years beginning January 2005. Simulations show that a sustained one percentage point rise in the real BSP policy rate reduces the expected inflation rate by 0.6 percentage point in the first 12 months and by an average of 1.1 percentage points over the entire 24 months.

(DSGE) model for a small open economy, estimated the effects of the monetary regime shift in the Philippines to inflation targeting. He finds strong evidence of structural changes in the Philippine economy following the shift in the monetary regime. In particular, the implementation of inflation targeting has reduced persistence in the pricing of home goods by more than 60 percent.

Looking more closely at our inflation performance under IT, however, it can be shown that there have been quite a few breaches of our inflation targets on both the upside and the downside. These breaches have stemmed from a confluence of global and supply-side factors beyond the control of the BSP, such as the surge in the international prices of oil and food commodities in 2008, resulting in higher domestic fuel and rice prices. Supply shocks, which continued over a longer period, contributed to second-round effects, affecting the wage and price-setting behaviour of businesses and households. These external and supply-side factors are listed under the BSP's explanation clauses.

In addition, in the course of implementing IT, the BSP has had to contend with certain operational and institutional hurdles that were not specific to IT itself. These issues include the BSP's ability to issue its own debt securities for monetary operations; the impact of off-balance sheet activities of banks on liquidity; and statistical gaps which include non-bank transactions. Such concerns, although fairly important, have not, however, gravely limited the BSP's effectiveness in liquidity management. The BSP Charter has empowered the BSP with sufficient flexibility to employ other creative monetary tools, allowing the BSP to carry out the necessary real-time assessment that underpins monetary decision-making.

Despite these supply-side shocks, external factors and institutional issues, the Philippines still saw a reduction in the volatility of headline inflation during the IT period. From a level of 3.47 from first quarter 1996 to first quarter 2001, the standard deviation of monthly inflation fell to 2.08 from the first quarter 2001 to the second quarter 2007. In a similar manner, average inflation fell from 5.84 percent to 5.04 percent during the same period.[6]

In sum, while the BSP's overall experience has been positive, we are aware that inflation targeting does not offer a magic formula for insulating a country from external financial disturbances or other influences on the real exchange rate and external competitiveness. In that respect, IT is no different from alternative policy regimes. However, for the Philippines at least, the formal adoption of IT clearly defined the specific objectives and parameters under which monetary policy decisions should operate. The IT framework continues to provide a focus in the implementation of monetary policy, and provides an anchor for accountability and transparency. These have made communication of policy actions much more efficient and effective.

4. Implications of the global crisis to IT and monetary policy settings

Let me now just quickly speak about some implications of this current crisis for IT and monetary policy setting.

The experience of the ongoing global crisis has sparked debates on whether central banks can afford to care only about inflation, even though the primary goal of monetary policy is still price stability. A key question going forward is how to maintain a primary focus on inflation in a context where concerns about financial stability, the potential volatility of international capital flows and asset prices, and the variability of economic growth are also seen as important policy objectives.

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[6] See Siregar (2008), "Inflation Rates of Emerging Market IT Economies," IMF, July.

Recently, the idea that central banks should also care, in particular, about asset prices has gained some support. A view that has gained greater currency is that policymakers should care about asset price and credit booms, especially because build-ups in systemic risks often precede economic downturns. Equally important, asset price movements have important implications for the real sector and for spending behavior via the wealth effect.

As the debates develop, we shall see that the concern about asset prices in fact relates to the broader issue of the nexus between monetary and financial stability.

Indeed, the evolving nature of our economic operating environment, as evidenced by the roots of this crisis and the rapidity with which it spread, begs a second look at how we conduct policy. Going forward, there may be a need to combine monetary and regulatory policies into a macro financial stability framework. This necessarily calls for closer cooperation between monetary authorities and financial regulators in assessing the build-up of systemic risks and in deciding how to mitigate them. Central banks should further enhance the understanding of financial linkages in the transmission of shocks and monetary policy. This need has been made more evident in this crisis by the fact that aggressive and non-conventional monetary policy action had to be undertaken to rein in the impact of shadow banking. Shadow banking, as we now all realise, was created largely by the unregulated financial engineering that took place in the guise of risk mitigation. Finally, as financial markets become more integrated, central banks will have to also pay closer attention to vulnerabilities posed by the financial systems of other countries, as well as to the impact of other jurisdictions' monetary policies on our own domestic markets.

There have also been proposals for a more countercyclical conduct of both monetary and regulatory policies. For instance, both monetary and regulatory instruments could be used to lean in a systematic way against credit excesses in the upswing of the cycle.

Although there is merit in these suggestions, there must also be the realisation that such a framework would imply a different mindset. Such may require, for example, that, from time to time, interest rates would be raised even when near-term inflation seems to be well under control. In addition, such efforts to mesh together monetary and supervisory policy would need to be done on a broad, all-encompassing scale, since attempts to reduce risk in one segment of the financial system (for example, the banking system) may only shift risk-taking activity away to other segments or markets.

As we move forward, we will again see that, as in all that is dear to central bankers, a tight balancing act is required.

5. Conclusion

Allow me to conclude with these thoughts:

- It is clear that inflation targeting has made a significant mark on the practice of monetary policymaking, and the overall experience with inflation targeting appears to have been positive. Inflation targeting is thus likely to remain a good choice of many central banks for the foreseeable future.
- The experience also suggests that, far from being a strictly rules-based activity, the practice of monetary policy under an inflation targeting regime has ample room for the judgment and discretion of policymakers. More importantly, inflation targeters do not care solely about inflation, as they also give due consideration to output conditions.
- Finally, perhaps the relevant question going forward is whether inflation targeters will begin to broaden their objectives, to allow for important considerations such as financial stability, for example. Judging from the relative flexibility in the

implementation of inflation targeting that we have seen thus far, particularly in emerging economies, my thinking is that this may be the case in the future. A broader reaction function may be viewed by some as a dilution of – or at least a shift away from – the original idea of inflation targeting. To my mind, however, it would represent an evolution of the framework and a way forward for IT central banks.

The work of the Asian Research Program has been a great support to the BSP in our own research and as we have tried to fine-tune our own monetary policy implementation. Let me therefore take this opportunity to commend the BIS and all those who participated in the ARP. As we continue to try to find answers to the questions I have raised today on the way forward for monetary policy, in general, and inflation targeting, in particular, I am certain efforts such as the ARP will continue to be useful and I hope will be sustained.

Thank you for your attention.

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