Gazi Erçel: Focus on inflation targeting

Opening remarks by Mr Gazi Erçel, Governor of the Central Bank of the Republic of Turkey, made at the Conference on Inflation Targeting which was organized by the Central Bank of the Republic of Turkey in Ankara on 19 October 2000.

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I am very honored to present the opening remarks at this conference on Inflation Targeting (IT) Framework. First I would like to extend our appreciation to the lecturers of the Conference who came a long way geographically, and considering the state of the economy they reach. The issues that are going to be addressed will be of great interest, particularly for developing and dis-inflating countries. The attendance of so many speakers from the Central Banks and international institutions is particularly motivating. This Conference will review the country experiences on inflation targeting, particularly touching on the best ways to design policy objectives, responses, and implementation issues. Some papers will consider not only inflation targeting framework, but also the case of economies during the shift to low inflation.

Let me begin my remarks by focusing on a framework that has been widely validated among academics and policymakers during the last 10 years.

Inflation targeting is an innovative approach to monetary policy being applied by a growing number of central banks of not only industrial but also emerging market countries of the world.

Now, more than ever, businesses are operating in a rapidly changing world. Even the marginal uncertainties have become important. Rapid changes in technologies, globalization and increasing competition are the challenges of the day for the business community.

In the dynamic economic environment of the 1990s, business communities have been taking not only the risks of their new investments on technology, but the risk of inflation as well. In an inflationary environment, businesses and individuals end up spending more time and money either protecting themselves against inflation or trying to benefit from it.

The rapidly changing environment affected not only the business decisions but the monetary polices as well. The traditional anchors for monetary policy and of central bank accountability - exchange rate targets and money aggregate targets - have fallen victim to liberalized capital mobility, inter-dynamic markets namely, by the introduction of new financial instruments, technology, financial globalization, and as a result unstable money demand.

At this juncture, the role of the central banks and the framework of the monetary policy needed to be drawn more clearly. The ultimate goal of monetary policy has become reasonable price stability, which is generally understood to point the inflation at rates low enough not to affect economic decisions.

Thus, the rise of an inflation targeting monetary framework is not a surprise but it is a natural reaction to a dynamically changing economic environment.

Here I would like to briefly review the footsteps of inflation targeting framework. The first issue that I would like to touch on is the *time-inconsistency problem* in monetary policy.

Monetary policy works with relatively long lags. Any action taken by a central bank today must be based largely on considerations about the rate of inflation one to two years down the road. So even though the underlying rate of inflation has been lower, central banks have to consider what is likely to happen to prices in the future. Long and variable lags made it difficult to know what the appropriate policy was at each moment for the purposes of fine tuning future economic activity. In addition, political pressures tended to emphasize the immediate or short-term benefits of stimulating the real economy at the expense of long-term increases in inflation from such policies (myopia). The combination of these lags and myopia imparted an inflationary bias to policy with the result that in the long run inflation was higher than it otherwise would have been, with no gain in real output. The more systematically monetary policy was used to fine-tune economic activity, the more the inflationary consequences of such policies were anticipated. An anticipated monetary stimulus would be passed through immediately to prices with no affect on real output.

A second problem of the monetary policy is the need for a *nominal anchor*.

If monetary policy could not be expected to dampen business cycles by fine tuning, it might do so by stabilizing inflation expectations as the result of a clear and credible commitment to a nominal anchor that is believed to stabilize prices on average in the long run.

Such a policy has two goals: the first is to provide the market with reliable information on what the rate of inflation will be so that investment, wage setting, and other market decisions can be made with greater confidence in what the future price level will be.

The second is to ensure that the inflation rate is very low in order to improve the quality of price signals. Such a policy might minimize the gap between actual and expected inflation that spill over to the real economy. By removing the inflation bias of discretionary policy, nominal interest rates would be lower, and by diminishing uncertainty over the future price levels, a credible nominal anchor would reduce the inflation risk premium in both nominal and real interest rates.

Here, there is a need for clear operational rules to know what short-run stance of policy would be appropriate for the future. The purest examples of such rules are a fixed exchange rate and a fixed rate of growth in a monetary aggregate. Either rule provides a clear anchor for inflation expectations.

A credibly fixed exchange rate is the most transparent nominal anchor. A floating exchange rate with a money growth rule as the nominal anchor is also easy to monitor, if somewhat more difficult to achieve. *Both anchors* suffer, to some extent, from being indirect routes to the real objective of monetary policy, which is price stability. Targeting the price level directly, however, was generally considered not possible since the linkages between policy instruments and prices were somewhat uncertain and contained the long and variable lags.

These problems led to two new issues which brought about a revolution in the approach to central banking. These are transparency and improved forecasting.

Clearly, monetary policy is most effective in the presence of a firmly established nominal anchor, and the more understandable that anchor is to the public the better. An effective commitment to long-run price stability is just such a nominal anchor that the target rate of inflation communicates to the public the price level the central bank is aiming to achieve at specified dates in the future.

Any move away from policy rules for long periods must face and deal with long and variable lags in the economy’s response to changes in policy stance. Improved modeling and forecasting is giving central banks increasing confidence in basing current policy decisions on expected future outcomes.

When we sum up these developments in monetary policy, we need a monetary framework which includes the following components. It should be:

- transparent;
- accountable;
- predictable and easy-to-monitor; and
- reliable.

This is also why the IT (inflation targeting) countries introduced these institutional and operational features into their monetary policy frameworks.

Before passing to the key issues for the success of IT regime, I would briefly like to focus on the basic key requirements of the inflation targeting framework in the literature. These are:

- The public announcement of medium-term numerical targets for inflation with due advance notice.

- The recognition of price stability as the sole objective of monetary policy without other nominal targets.
- Increased transparency of the monetary policy strategy through communication with the public and the markets about the plans, objectives and decisions of the monetary authorities.
- An independent central bank both in the context of the institutional and operational arena.
- Development of appropriate policy instruments and a clear understanding of the underlying monetary policy transmission mechanism or at least a reliable model for forecasting medium to long-run inflation.

The announcement of inflation targets communicates the central bank's intentions to the financial markets and to the public, and in doing so helps to reduce uncertainty about the future course of inflation. Many of the costs of inflation arise from this uncertainty or variability rather than from its level; for example, uncertainty about inflation exacerbates the volatility of relative prices and increases the riskiness of non-indexed financial instruments and contracts set in nominal terms.

By making explicit the central bank's medium-term policy intentions, inflation targets improve planning in the private sector, enhance the public debate about the direction of monetary policy, and increase the accountability of the central bank.

Under an inflation targeting regime the central bank would be forced to calculate and publicize the long-run implications of its short-run actions, thus ensuring that they would be subject to public scrutiny and debate. To the extent that the central bank governors dislike admitting publicly that they may miss their long-run inflation targets, the existence of an inflation targeting framework provides an incentive for the central bank to limit its short-run opportunism.

The advantage of the inflation targeting regime is its great emphasis on the regular communication with the public and transparency. This property plays an important role in the success of inflation targeting, particularly in the industrialized countries. The policy makers in the developed countries use every opportunity to communicate with public speeches, and takes a step further by way of inflation reports.

Transparency and openness of the operating framework of monetary policy can bring important credibility gains, and institutional arrangements such as greater independence of the central bank can be helpful in this regard. European Central Bank and central banks in the EU zone are good examples for a model. Hence, it is perhaps not surprising that in many countries the adoption of official inflation targets has been accompanied by moves toward central bank independence and accountability. Nowadays, central banks are increasingly publishing information on their policies that they would have considered state secrets only twenty years ago, like minutes of board meetings and policy models.

The key for the success of inflation targeting is the existence of a strong institutional commitment to price stability. This is particularly important in emerging markets that have had a past history of monetary mismanagement. The institutional commitment involves having a central bank that: 1) is insulated from political interference; 2) has full and exclusive control over the setting of monetary policy instruments and 3) has a mandate to achieve price stability as its primary goal.

To conclude with, I will stress once more that the IT approach appears to be very propitious for emerging market countries in converging with international levels of inflation. However, concrete macro fundamentals still remains the indispensable condition for preserving price stability under any monetary policy framework.

Now, I would like to leave the floor to Mr Douglas Laxton who is one of the senior economists in the Research Department of the Fund.

Thank you.