Inflation Targets in Emerging Markets*

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* Comments on Williamson , John, “Should Central Banks Target only Inflation,” presented at REDIMA, CEPAL; October 2006. This discussion is based on De Gregorio, J. (2006), “Esquemas de Metas de Inflación en Economías Emergentes”, Documento de Política Económica No.18, and De Gregorio, J. (2006), “Defining Inflation Targets and the Output Inflation Tradeoff,” mimeo, Central Bank of Chile.

Outline

1. ¿Is inflation the only target and unemployment is irrelevant?

2. ¿What is the role of the exchange rate and asset prices?

1. Inflation targets and output

There are three issues that are important regarding this discussion:

1. Low and stable inflation is good for growth and welfare.
2. Flexible inflation target do take into account unemployment and the output costs of disinflation.
3. Monetary policy must provide a nominal anchor and this is achieved with a credible inflation target.

1. Inflation targets and output

- From the welfare point of view, both, inflation deviations form its target and the output gap are important:

$$\mathrm{L} = a(y - \bar{y})^2 + (\pi - \pi^*)^2$$

- In the long run inflation has no effects on full employment output: there is no tradeoff between inflation and unemployment. In the short run there is a tradeoff inflation-unemployment:

$$\pi_t = \alpha\pi_{t-1} + (1-\alpha)\mathrm{E}_{t-1}\pi_t + \delta(y - \bar{y}) + \nu$$

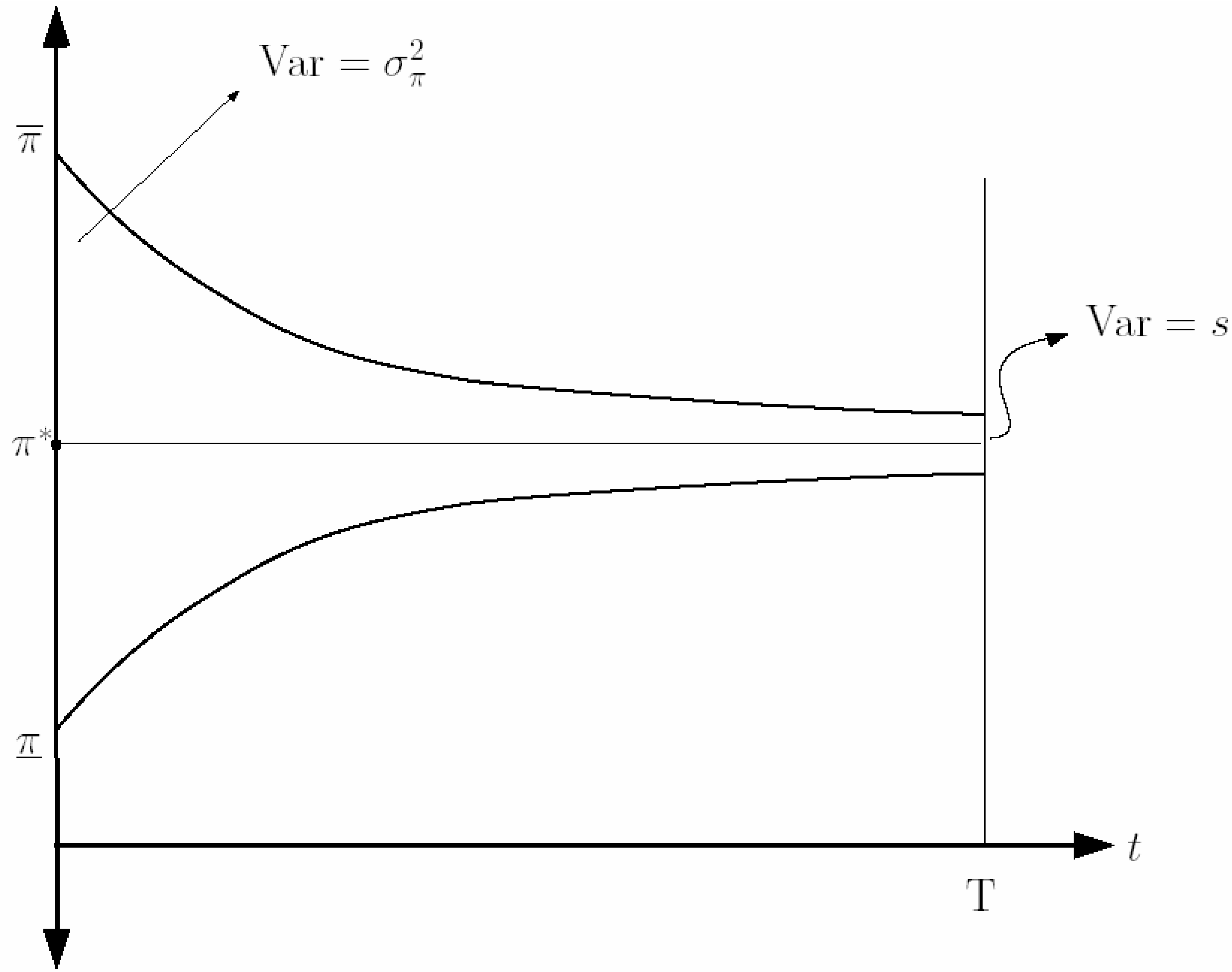
- The optimal policy involve gradual adjustment of inflation to its target, which recognizes the costs of the output gap:

$$\pi_t - \pi^* = \rho(\pi_{t-1} - \pi^*) + \epsilon_t$$

- There cannot not be two objectives for one instrument, but could everything be done in terms of output? No because there would no be a nominal anchor.

1. Inflation targets and output

Definition of the Inflation Target and Policy Horizon



1. Inflation targets and output

So ¿Why not two objectives or just focusing on activity target?

- Inconsistencies and risks for uncertainties about the level of potential output.
- Monetary policy has no effects on long-run output, but it has effects on inflation and prices. Monetary policy must provide the nominal anchor.

2. The exchange rate and other asset prices

- Flexible exchange rate: impossible trinity, but fear of floating. **How does the exchange rate influence monetary policy?**
- **By its effects on inflation:** as long as it affects inflation forecast. Stabilizing effects: strengthening currencies, everything else equal, will call for a looser monetary policy reducing pressures for appreciation. For example, Chile December 2005 after a sharp appreciation of the peso: *"Annual CPI inflation and its short-term projection have declined, influenced by the rapid normalization of fuel prices and the significant appreciation of the peso."* However, effects not very large due to decline in passthrough from exchange rates to inflation.

2. The exchange rate and other asset prices

- **By its effects on financial stability:**
  - Central banks have in general also an objective of financial stability.
  - Inflation targeting regimes, and models to implement them, do not take into account the occurrence of financial crisis.
  - It is possible to think that the inflation target could be transitorily suspended in order to maintain financial stability. For example reducing interest rates in a liquidity squeeze eventhough inflation forecast are relatively high.
  - Malfunctioning of the exchange rate market could distort monetary policy and add vulnerability of the financial system: the case for exceptional intervention.

2. The exchange rate and other asset prices…and output

- Summing up: the exchange rate acts as a buffer to shocks, have effects on inflation and on financial stability, therefore it must be taken into account when making monetary policy. But, monetary policy has little effects on long run equilibrium real exchange rate (Montiel 2006).
- How do exchange rates enter inflation target regimes? The Chilean practice:

  "Since the last Report, the peso has appreciated significantly, in both real and nominal terms…. The assessment is that the peso has strengthened beyond various real exchange rate estimates consistent with long-term fundamentals, particularly the terms of trade… As a methodological assumption for the projections in this Report, the peso is forecast to show a moderate depreciation in the projection horizon, in line with the baseline scenario that considers a gradual nominalization of external conditions." (IPOM, January 2006, p. 8).

2. The exchange rate and other asset prices…and output

“The Chilean peso depreciated slightly less than 5% in real terms with respect to the closing of May’s Report, and 1.5% since September 2005. Taking as a reference the average of the two weeks preceding the statistical close of this Report, the current real exchange rate is believed to be consistent with its long-term fundamentals. Although the terms of trade are significantly above what should be their long term level, the fact the economy has been able to save most of its transitory gain -reflected in the current-account surplus- supports this evaluation. As a methodological assumption, the real exchange rate is projected not to differ much from its current figures.” (IPOM, September, 2006, p. 4)

2. The exchange rate and other asset prices…and output

- The same arguments use for the exchange rate could be used for other asset prices. But, this should be exceptional and for this reason be rule-based. For example, formality about announcing the suspension of the regular macroeconomic regime.
- Targeting activity: a sharp recession can also affect financial stability, so the previous arguments would apply regarding transitory suspension of the exchange rate regime. However, it is difficult to think that it is inconsistent with the inflation target.

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