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A PRIZE WORTH HAVING: THE IMF AND PRICE STABILITY

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Resumen
En este ensayo se evalúan los beneficios que trae un entorno de baja inflación a la economía mundial. Para comenzar, se resumen los principales costos de la inflación: cómo distorsiona los cálculos de rentabilidad, alentando los proyectos a corto plazo a expensas de la inversión de largo plazo y restando valor a las señales de precios relativos. Luego se analiza cuánto han avanzado muchos países en los últimos años en sus esfuerzos por lograr una baja inflación. El nuevo entorno de baja inflación ha reportado beneficios considerables: más crecimiento global, mayor estabilidad y menor vulnerabilidad. También se evalúa la contribución que hace el FMI para que los países miembros logren un entorno de baja inflación, resaltando el importante apoyo que presta el organismo a las iniciativas de reformas de política. Para finalizar, se analizan los desafíos que depara el futuro a los economistas y a las autoridades de gobierno: asegurar los beneficios de una baja inflación, determinar hasta dónde deben ir las políticas para bajar la inflación y expandir las fronteras del conocimiento sobre la transición hacia un esquema de metas de inflación.

Abstract
This essay assesses the benefits of a low-inflation environment for the world economy. To start, the main costs of inflation are reviewed—namely, how it distorts the calculus of profitability, encouraging short-term projects at the expense of longer-term investment and diminishing the value of relative price signals. Then, the progress that most countries have made in recent years toward achieving low inflation is reviewed. The new low-inflation environment has brought noticeable gains—faster global growth, increased stability, and reduced vulnerability. The role of the IMF in helping foster a low-inflation environment is also discussed, highlighting the Fund's important support for policy reform efforts in its member countries. To conclude, the essay identifies future challenges for economists and policymakers: locking in the benefits of low inflation, identifying how far policies should go toward lowering inflation further, and expanding the knowledge frontiers on the transition toward adopting inflation targeting.

Keynote speech delivered in the Ninth Annual Conference, Banco Central de Chile, October 2005.
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A Prize Worth Having: the IMF and Price Stability

Anne Krueger
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Good morning, and thank you Jose for that kind introduction. It is always a pleasure to be in Santiago and I am especially pleased to be able to join you at this annual conference which in its nine years has established a high reputation for the quality of the papers and the discussion.

This year's conference is focusing on the subject of inflation targeting. I want to set the scene for the two days of discussions by putting this in a broader context. My aim this morning is to assess the benefits to the world economy of a low inflation environment. I will start by reviewing the progress made in almost every country in recent years towards achieving low inflation. I will next analyze the gains that have accompanied this changing environment—notably more rapid global growth, greater stability, and reduced vulnerability. And finally I will say something about the role the IMF plays in helping to foster an environment of low inflation, especially as we seek to support the policy reform efforts of our members.

Much has been written about the origins of the worldwide decline in inflation. Ken Rogoff has argued persuasively that globalization and the growing importance of competition as economies become more integrated have made a major contribution to lowering inflation. But, equally important, we experienced an inflationary environment, and we learned its costs. As these were better understood, advances in our understanding, and practice, of monetary policy enabled most countries to bring inflation rates down, as I shall argue shortly.

Keynote Address by the author at the Ninth Annual Conference of Central Bank of Chile.

Monetary Policy under Inflation Targeting, edited by Frederic Mishkin and Klaus Schmidt-Hebbel, Santiago, Chile.

It is clear that the more rapid growth of the world economy reflects, in part, improved macroeconomic management in general across an increasing number of countries. We've seen evidence of this in every region of the world.

The topic for this conference underlines the extent of the global interest in the pursuit of sound monetary and fiscal policies. Twenty one countries currently have inflation targeting, and thirteen of those are emerging market economies. Inflation targeting isn't appropriate for every country. But it has a remarkable record of success and it arouses interest among policymakers because it is a benchmark of best practice, to use the language of modern management. Its track record is good, if short. And as the discussion here will demonstrate, we are still learning.

We at the Fund have found there is equal interest among members in other aspects of macroeconomic management. As we all learn from the experience of others, we have been able to refine our definition of sound fiscal policies, for example, so that it encompasses public expenditure management, tax administration, and structural balance, among other things; with clear and effective budgetary control at all levels of government, and long-term debt sustainability so that fiscal objectives are not undermined.

There is also an increased appreciation of the extent of complementarity of monetary, fiscal and indeed structural economic policies. We have seen enough examples of the problems that can ensue when structural and institutional weaknesses in one area can critically undermine policy achievements in another sphere of macroeconomic management. The failure to control inflation in the late 1960s, 1970s and 1980s was at least a contributing factor to the disappointing growth performance in many parts of the world over an extended period.

The Costs of Inflation

Yet it is perhaps only with hindsight that we can truly appreciate the costs of the worldwide inflationary surge that we experienced from the 1970s onwards. We knew about the dangers and the very high costs of hyperinflation. We had seen what this could do to a society in Germany in the 1920s and again in the immediate aftermath of the Second World War.

So the dangers of runaway inflation were clear. It undermined social cohesion. It distorted the economy in arbitrary ways. It redistributed wealth in a random fashion. It wiped out those, especially the poor, on fixed incomes and who were unable to hedge. It undermined longer term growth prospects by creating uncertainty and acting as a disincentive to longer term investment.

What was less obvious in the 1960s and later was that many of these costs were not confined to episodes of hyperinflation. Inflation at moderate levels was thought to be manageable. Indeed, it was regarded by governments and many academics as a useful tool to circumvent budgetary constraints, as for example, with the U.S. government during the war in Vietnam. Inflating out of trouble was politically tempting for governments around the world; and it was regarded as imposing relatively few long-term economic costs.

Other actors in society readily conspired with governments. Those with incomes that rose in real terms and those with debts that could be monetized were untroubled by moderate inflation and often welcomed it. By and large, people in upper and middle income groups could protect themselves and their assets. The poor, the most vulnerable, were those hardest hit.

The relaxed approach to inflation was already showing some signs of strain in the early 1970s. It was widely believed that the inflation rate could not be brought down without very high costs and that relatively high inflation would therefore always be with us. People thought the costs of reducing the inflation rate would be too great. But the policy response to the dramatic rise in the price of oil—by January 1974 it was 350 percent higher than the year before—turned out to be both misguided and harmful. Attempts to ease the impact of the oil shock by accommodative monetary policy helped fuel inflationary pressures, undermined fiscal discipline and resulted in significantly weaker growth in most industrial countries.

In the 1970s and 1980s, governments in both industrial and emerging market countries discovered that the more tolerant of inflation they were, the more inflation was likely to trend upwards, and the smaller the trade-off, if any, perceived between more unemployment and more inflation.

Inflation is damaging in its own right: it distorts the calculus of profitability, encouraging short-term investments and projects at the expense of longer term investment; and it diminishes the value of relative price signals. But weak government responses that try to contain inflation simply raise its costs. Trying to administer price controls introduces further distortions into the economy without addressing the fundamental problem. Providing subsidies to offset cost increases feed through to the fiscal deficit and accelerate inflation.

In this context, the British experience is a salutary one. In the 1970s, successive British governments struggled to control, let alone reduce, inflation through a variety of means: voluntary and statutory wage restraints, and price controls. In the 1980s, the emphasis shifted to control of the money supply and, in turn, the adoption of an exchange rate anchor. Each of these approaches achieved some short-term success. But governments, especially in the 1980s, were too quick to assume that success would be long-lasting. They relaxed their grip, loosened policy and could then only watch as the level of inflation rose once more.

Continuing failures undermined the efforts of the authorities to establish credibility for themselves. And the failure to build credibility in turn undermined the confidence of economic actors about the long term prospects for price stability.

Among the industrial countries, Britain had perhaps the worst chronic problem with inflation. But the stop-go cycle familiar to Britons was equally familiar to many in emerging market economies. The reforms introduced in Turkey from 1980 onwards were undermined to a considerable extent because of the persistent failure to tackle the problem of inflation. The result was the boom-bust cycle that characterized Turkish economy policy until 2000, with inflation averaging well above 60 percent over two decades and, crucially, lower average rates of growth than would have been possible in a low inflation environment.

The Success of Counter-inflationary Policy

Conversely, countries that were successful in reducing inflation experienced more rapid growth. In the United States, the Federal Reserve under Paul Volcker re-established its credibility in counter-inflationary policy, and Alan Greenspan consolidated it. In the past two decades or so, the US economy has been one of the most rapidly growing industrial countries and, indeed, over that period has grown more rapidly than many emerging market and low income countries.

Canada and Australia, too, have experienced more rapid growth, in part as a result of sound macroeconomic policies, not least of which is effective monetary policy.

And following monetary policy reforms started in 1992, Britain has at last overcome its chronic inflation problem. Inflation declined sharply in the wake of the reforms, and has remained low as a result of the implementation of a credible monetary policy, including inflation targeting. In 1997 these reforms were buttressed when the Bank of England became independent. From its most recent peak, almost 8 percent in 1991, the inflation rate has declined almost continuously: it is projected to be 1.99 percent this year, almost exactly the target rate of 2 percent.

The consequence of the markedly improved inflation performance in Britain has been more than a decade of uninterrupted growth.

Among emerging market economies, of course, it would be hard to find a better example of successful counter-inflationary strategy than Chile. In the early 1970s, inflation averaged somewhere between 500 percent and 1000 percent depending on the index used. Yet since that time, with only a few brief exceptions, inflation has declined sharply.

In 1980, steps were taken to insulate monetary policy from the political process; and in 1989, the central bank was made independent. Inflation targeting was introduced from 1990. The results of these policy reforms are clear. The average inflation rate has fallen in successive decades. In the ten years to 2004 the average inflation rate was below 5 percent. In September, twelve month inflation was 3.8 percent.

The result of these policies, along with reforms in other areas, including fiscal, social security and trade policies, has been sustained and high growth rates over a very long period. Chile stands out among its neighbors, but also among emerging market economies more generally, as a strong and stable economy, growing rapidly and capable of withstanding shocks.

More recently we have seen other dramatic examples of successful counter-inflationary policy. In Turkey reforms introduced from 2000 onwards have been designed to bring macroeconomic stability and create the conditions for rapid growth. The success of these reforms has exceeded all expectations. In 1997, Turkish inflation peaked at almost 85 percent. This year it declined to single digits, for the first time in 35 years. That by itself is a remarkable achievement, and reflects the success of sound monetary and fiscal policies. But this decline in inflation has been achieved at a time of remarkably rapid economic growth.

The progress made in countries like Chile and Turkey is indeed striking. But the drop in inflation is a truly global phenomenon.

The global inflation rate has declined from an annual average of close to 15 percent in 1980-84 to 3.7 percent in 2004. The average inflation rate in the industrial economies fell from almost 9.5 percent between 1975 and 1979, and nearly 9 percent in the early 1980s, to 2 percent in 2004 and a projected 1.6 percent this year.

In developing countries, the decline has been steeper and more rapid. In the early 1990s, the average inflation rate in developing countries was just over 80 percent; by 2004, that had declined to 5.8 percent, and is projected to rise only slightly, to 5.9 percent, this year. Even in the transition economies, which in the early 1990s experienced average inflation rates of more than 360 percent, the average rate of inflation was down to 9.2 percent in 2004.

Last year, only three of the IMF's 184 members had inflation rates in excess of 40 percent: Angola, the Dominican Republic and Zimbabwe. Indeed, only eight countries experienced inflation above 20 percent last year and only 32 countries had double digit rates of inflation. That is a remarkable global transformation, relative to the 1970s and 1980s.

As I already noted, accompanying this significantly improved inflation performance has been more rapid global growth. In 2004, the world economy grew more rapidly than at any time in the past three decades, with growth in every region. Periods of global expansion are longer, and worldwide slowdowns are fewer and shorter. At a time of considerable geopolitical uncertainty and shocks that have included a sharp rise in oil prices, the world economy has exhibited more resilience than we would have anticipated a few years ago. Improved macroeconomic performance of which the fall in inflation rates is part goes at least part of the way towards explaining this.

Towards Price Stability

In part, at least, the story of falling inflation worldwide is simply one of success breeding success. In many cases, initial efforts to curb and then permanently reverse the rise in inflation rates were made by policymakers confronting rates in excess of 20 percent. These efforts needed tough monetary medicine, with the focus particularly on quantitative controls on the money supply. Typically, this approach had, in its initial stages at least, a sharp impact on growth.

But as persistence paid off, and inflation rates did indeed start to fall towards 10 percent, it became increasingly apparent that the benefits of lower inflation exceeded the short-term costs of counter-inflationary policy; and that as inflationary expectations responded to declining inflation rates those benefits increased. As a result, the focus of policy shifted again, towards getting inflation rates into single digits, and aiming for price stability.

The adoption of inflation targeting has played a key role in the success that many countries have achieved in moving towards price stability. Inflation targeting has so far been successful in both the industrial and emerging market countries that have adopted it. Regardless of the origins of the inflation targeting policy, the evidence suggests that inflation targeting can contribute significantly towards the achievement of price stability. It helps build credibility for the monetary authorities, crucial given the important role that expectations play in determining the future path of inflation. And in spite of the wide variations in the economic and institutional circumstances of the countries that have so far adopted inflation targeting, they share common factors: central bank independence, improvements in implementation and increasing transparency.

IMF research shows that missing the target may not undermine the longer term success of a targeting regime. Among countries targeting stable inflation, the targets were missed about 30 percent of the time. Among countries seeking to achieve significant disinflation, the figure is even higher. This is not a sign that inflation targeting has failed however. No country has abandoned inflation targeting as a result of missing its targets, even when the target has been missed by a significant margin, or for a prolonged period. Rather, people have sought to learn from experience. Inflation targeting appears to be a resilient policy framework, providing flexibility in the face of shocks, as well as transparency and accountability. To be sure, credibility is a key aspect, and the monetary authorities must focus single-mindedly on the targets to which they commit.

Inflation targeting anchors expectations and so helps lock in the benefits of declining inflation. It strengthens the independence of the monetary authorities, and reduces the risk that short-term political objectives will undermine policy. And because experience with inflation targeting has tended to highlight the importance of transparency in policymaking, it has brought important and, we hope, lasting improvements in economic governance. Of course, there is still much to learn about why inflation targeting has been so successful and about its design and implementation and this is why we are here today.

The benefits of low inflation

Inflation targeting has already contributed to our awareness of the benefits of low inflation. At one time, the most powerful argument in favor of firm policy action to reduce inflation was to reduce its associated costs, although it was perhaps not always appreciated that one of these costs was growth foregone. In countries that succeeded in reducing inflation, distortions were fewer. The uncertainty that inhibited investment and affected consumers' behavior was greatly reduced. The prospects for economic growth improved as did the ability to withstand shocks. Low and falling inflation made macroeconomic stability attainable.

But as inflation has declined worldwide, the benefits have become increasingly obvious. As I noted, economic growth has accelerated in those countries that have experienced significant declines in inflation. Even in Africa, the countries that have done most to achieve macroeconomic stability—of which low inflation is an essential element—are generally the ones that have started to see higher growth rates. In spite of higher oil prices and poor harvests, inflation performance has continued to improve across the continent. This year, 30 sub-Saharan African countries will achieve inflation rates in single digits, up from 28 countries in 2004. Average inflation rates across the region should fall to 8.3 percent next year.

And the growth numbers are equally striking. The IMF expects three non-oil producing countries in Sub-Saharan Africa—Ethiopia, Mozambique and Sierra Leone—to experience real GDP growth in excess of 7 percent this year; growth in real per capita GDP should approach or exceed 5 percent in those countries. Ghana, Tanzania and Uganda are among other African economies with continuing strong performance. Sub-Saharan Africa as a whole should grow by 5.3 percent next year. There is still a way to go to achieve growth rates that will permit significant poverty reduction, but compared with the growth rates experienced even just a few years ago, the signs are hopeful.

As the Chileans here today know, countries with low inflation do significantly better in terms of growth performance than countries with higher rates of inflation, even in the same region. Chile's success over a prolonged period reflects a sustained commitment to reform across a wide range of economic policies. But low inflation has been a critical element of those reforms. Similarly in Turkey: rapid growth is the result of strict adherence to monetary, fiscal and structural reforms: but again, the objective of a rapid decline in inflation was a central part of the reform strategy. And Turkish growth rates during a period of major fiscal consolidation have been well above even the most optimistic expectations.

South Africa has experienced a doubling of its growth rate, to a projected 4.3 percent this year, compared with the average growth rate in the decade to 1996 of 1.7 percent. And its inflation rate has fallen dramatically over the same period from an average of 12 percent in the ten years to 1996 to 3.9 percent projected this year.

As the benefits of low inflation become apparent, and as governments learn more about how to reduce inflation, so inflation is projected to continue to decline, albeit it at a much more modest pace according to the IMF's latest World Economic Outlook.

Beyond the recognition that economic performance improves as inflation declines, perhaps the most important lesson learned from the experience of recent years is that reducing inflation can impose fewer short-term costs on an economy that is sufficiently flexible than had previously been thought. The stop-go or boom-bust cycles to which I referred earlier had led many policymakers to believe that a rapid decline in inflation could only be achieved by severely squeezing domestic demand, with obviously painful consequences. This led policymakers, first, to postpone counter-inflationary policies until action was forced on them in the context of a crisis of one kind or another; and then to relax policy as rapidly as they could. The inevitable result of such an approach was a failure to ensure inflation was on a declining path.

In recent years, however, we have seen that this cycle was far from inevitable. An increasing number of countries have experienced the benefits that Chile and others have long enjoyed—a virtuous circle, whereby low inflation helps create macroeconomic stability which is the prerequisite for sustained rapid growth. A credible monetary policy reduces economic uncertainty among all actors; and it reduces the distortions caused by actors anticipating a pickup in inflation.

Low inflation is also an important tool in the effort to reduce poverty. First, since the poor are those most vulnerable to the effects of high inflation and least able to hedge against the risks, sustained low inflation brings obvious benefits for them. And second, low inflation is a prerequisite for, and a precursor of, more rapid growth which is, in turn, essential for a sustained reduction in poverty.

But in this new world of low inflation other benefits are becoming apparent. The greater stability that national economies experience as a result of price stability has a global impact as more countries achieve it. Global growth is less volatile—and higher. Low inflation helps national economies reduce their vulnerability to shocks, and to cope more comfortably with cyclical slowdowns. This, too, has an impact on the global economy. The global slowdown of 2001 was more modest than previous episodes, and the world economy recovered more rapidly.

Low inflation ensures that there are fewer government-induced shocks in an economy, although it does not, of course, eliminate economic shocks altogether. Nor can it insulate economic actors, or national economies, or the global economy, from such shocks. But it does help reduce the impact of those shocks. It can help raise potential growth rates and it can make economies more resilient. Effective monetary policy aimed at controlling inflation can also help offset the second round effects of shocks instead of exacerbating them as we saw in the 1970s oil price increases.

The Role of the IMF

Essentially, I've been describing a global learning process as the benefits of low inflation have become increasingly apparent in recent years. We at the Fund have learned as much as anyone from this process.

Just how far the economic profession has come in understanding the benefits to be had can be found in the October 1959 volume of IMF Staff Papers. U Tun Wai, then chief of the Statistics Division at the Fund, set out to explore the links between inflation and growth. Let me quote his opening sentence:

The relation between inflation and economic growth in less developed countries is a subject on which there are still very wide differences of opinion.

Mr. Tun Wai's contribution was significant: using statistical analysis he was able to conclude that where the data existed for a long enough period, and for countries that had experienced wide variations in inflation, low inflation was clearly linked with economic growth.

The Fund works with members to advance the process of reducing the inflation rate in a number of ways. Surveillance is at the heart of the Fund's work, of course. We conduct Article IV consultations with our members to identify policy weaknesses and successes. Where governments are seeking to implement appropriate polices we can be supportive; where we identify policy shortcomings we can try to persuade the authorities of the need for reforms.

Our surveillance work is greatly strengthened by the Fund's unique cross-country insight. Our ability to monitor closely the economies of all 184 members enables us to identify what works and what doesn't. It helps inform our research as we seek to improve our understanding. Our membership gains directly from that: they can benefit from experience elsewhere when shaping their own policy framework to their national concerns and priorities.

The Fund's efforts go beyond surveillance and policy advice to technical assistance with policy implementation. This is particularly important for our low income members. Having the right policy objectives is one thing: lacking the technical expertise to implement these objectives can be a significant obstacle for some countries, and the Fund can help. We provide technical assistance on a wide range of issues, not least in the area of monetary policy and central bank strategies.

And the Fund has been active in fostering research into, and discussion of, inflation targeting. The latest World Economic Outlook, for example, contains a wide-ranging assessment of experience with inflation targeting. And, as you can see from the conference timetable, IMF economists are presenting papers at this conference, a further reflection of the Fund's active research agenda into this important topic. The more we know about inflation targeting, its effectiveness and its implementation, the more we can assist our members both through our surveillance work but also through the provision of advice and technical expertise to those countries adopting, or considering, inflation targeting.

The Ongoing Challenge

Much has been achieved in recent years in terms of delivering low inflation and experiencing the benefits of macroeconomic stability. The challenges for economists and policymakers going forward are threefold.

First is to ensure that the benefits are locked in-and that means putting in place policies that will continue to lower inflation and then maintain price stability within a given target range. Currently we are seeing a worrying tendency among some governments to try to protect consumers from the impact of higher oil prices. This is distortionary, and the fiscal impact can itself be inflationary: it is not possible to protect economic actors from market realities indefinitely. Trying to do so stores up enormous problems for governments: the cost of subsidies, for example, places an unsustainable burden on government budgets, undermining attempts to maintain fiscal discipline. If consumers aren't exposed to market realities they will not have the incentive to adjust their behavior and, in the case of higher oil prices, act to conserve energy and so reduce demand for oil.

The consequences of such distorting behavior will, ultimately, be higher inflation rates and lower growth rates as the objectives of macroeconomic stability are progressively undermined. So far in most countries there is little evidence of second round effects of the energy price increases. It is particularly encouraging, for example, to see the government of Indonesia recognizing the inherent dangers of fuel subsidies and seeking to remove them and provide direct targeted assistance to the poor who are most vulnerable to the effects of more expensive fuel.

The second challenge facing policymakers is, in a sense, a consequence of recent success in achieving price stability. How far should policies to lower inflation go? I noted that the costs of lowering inflation, when there is sufficient flexibility in the economy, had been much less than had been assumed by many policymakers in the past. That is certainly true. When we look at the more rapid growth that has accompanied the dramatic fall in Turkish inflation, for example, we can see clearly that the benefits far outweigh the costs.

And finally, we need to know far more than we yet do about the transition to inflation targeting: how best to design and implement the new framework, and how to decide on issues such as defining the target and introducing an appropriate degree of transparency. Which brings us to this conference. These, of course, are some of the issues that will be discussed here over the next two days.

Conclusion

So let me sum up briefly. The sharp decline in inflation rates we have witnessed has been as remarkable as it has been widespread. It has been achieved at a lower cost than we would have thought possible twenty five years ago; and the benefits have been greater than once seemed likely. Low inflation has been at the heart of the improved economic performance we have witnessed. No country has achieved sustained rapid growth without low inflation—just as no country has achieved sustained rapid growth without opening up to the rest of the world.

Successful monetary policy that consistently delivers low inflation is therefore critical to long-term economic success. And monetary policy can only be successful over time with a proper institutional framework, one that makes it difficult for long-term stability to be sacrificed for short-term political advantage. Inflation targeting is clearly one solution that provides this framework, hence its attractiveness for many, and hence the focus of this conference.

The challenges I have identified for policymakers going forward are a consequence of success. When inflation is high, or rising rapidly, the question of how to maintain price stability once achieved seems a rather less pressing one. These are challenges that apply regardless of the means adopted for achieving and maintaining price stability. But any policy framework must be capable of assuring its continuity. And any framework needs some way of assessing the benefits and costs of particular policy options if it is to succeed over the medium and longer term.

This is an area where the Fund, with the unique overview that its surveillance provides, along with the extensive research work we undertake, can contribute. We can help identify best practice in inflation targeting; and, as we do in many other areas of economic policy, provide advice, support and technical assistance tailored to the individual needs of our member countries.

As a relatively new development in economic policymaking, inflation targeting is an area rich in opportunities for research. We have much to learn, and countries seeking to achieve price stability have, potentially, much to gain from the fruits of economic research—and from the Fund's surveillance activities. This conference is therefore both timely and important and I look forward to hearing much of the discussion.

Thank you.

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