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Ben S. Bernanke, Thomas Laubach, Frederic S. Mishkin, and Adam S. Posen, Inflation Targeting (Book Review)

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BOOK REVIEWS

Ben S. Bernanke, Thomas Laubach, Frederic S. Mishkin, and Adam S. Posen, *Inflation Targeting: Lessons from the International Experience.* Princeton, NJ: Princeton Univ. Press, 1999.

Inflation targeting has become a viable framework of monetary policy in a number of industrial economies in the 1990s. By applying this framework, central banks can emphasize their long-term commitment to price stability. They can diminish the scope of nominal indexation of prices, wages, and interest rates to a forecast rate of inflation that is usually lower than the one most recently observed. However, in order to move inflation expectations to the desirable low level, central banks need to explain to the public the rationale and the conditionality of inflation forecast, as well as the details of the policy implementation. This framework requires a high degree of transparency that is perhaps the main attractive feature of this approach to monetary policy. Yet it requires a complicated methodology of policy formulation and implementation. Central banks need to develop complex testing and forecasting models of inflation and to elaborate monitoring procedures. In spite of its complexity, inflation targeting has been remarkably successful in bringing about price stability and in reducing the volatility of interest rates, exchange rates, and money balances. This policy has also faced some criticism, mostly focused on its inability to smooth fluctuations in real output and employment.

The volume by Bernanke, Laubach, Mishkin, and Posen provides a comprehensive examination of inflation targeting practices of nine countries: Germany, Switzerland, New Zealand, Canada, the United Kingdom, Sweden, Israel, Australia, and Spain. It contains rich empirical material that helps to derive conclusions from the extensive international experience aimed at more coherent monetary policy-making in the United States and in the European Monetary System. It further provides useful lessons for developing more transparent and credible monetary policies in emerging market economies, particularly in the transforming economies of Central and Eastern Europe where disinflation is the primary goal of macroeconomic stability. The attractive and somewhat unique feature of the book is the case study method, which is rarely applied in macroeconomic analysis. This approach adds to the substantial informative value and shows the extraordinary diversity of modern monetary policies.

The authors view inflation targeting as a monetary policy framework rather

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than a rule. Consistently, they adopt a broader definition of inflation targeting as a "monetary policy characterized by the public announcement of official quantitative targets (or target ranges) for inflation rate over one or more time horizons and by explicit acknowledgement that low, stable inflation is the policy's primary goal." This approach to inflation targeting is broader than the recent analysis of direct inflation targeting, which refers to the central bank's assumption of inflation forecasts as intermediate policy targets. For instance, the wider approach allows for consideration of the German Bundesbank policy as an inflation targeting regime, although the Bank formally assumes M3-money growth rates as intermediate targets.

The strong emphasis on policy transparency is one of the most attractive features of this volume. Inflation targeting requires extensive communication of policy objectives, plans and tactics by central banks; thus, it may serve as a useful venue for gaining credibility and public support for monetary policy. The authors explore various channels of public communication applied by the examined central banks, including reports on the state of macroeconomic stability, inflation indicators, deviations between private sector and central banks' own inflation forecasts, success in meeting inflation targets, and possible reasons for missing the targets. Different means of public communication are also scrutinized. They include speeches, press releases, testimonies before the legislature, statistical releases, and special inflation reports. The analysis could be enriched by an attempt to assess the informational value of the Internet sites of individual central banks. They may be emerging as an important instrument of dissemination of public information by policymakers.

The volume addresses exhaustively the actual design and implementation of successful inflation targeting regimes. However, the comparative testing of policy outcomes of individual central banks in Chapter 10 is approached rather narrowly. The authors evaluate policy efficiency primarily on the basis of price stability and sacrifice ratios, that is, unemployment costs stemming from tight monetary policies aimed at reducing inflation. There are other criteria that could be used as a basis for the outcome assessment, including stability of exchange rates and interest rates, volatility of money balances, decreasing opportunity costs of holding money, and compliance between private and central banks' inflation forecasts. The authors could emphasize more explicitly at least two additional accomplishments of central banks in inflation targeting. First, inflation targeting in Sweden and in the United Kingdom helped to reduce significant fluctuations in money demand triggered by the September 1992 European Exchange Rate Mechanism (ERM I) crisis. Second, this policy approach in the economies initially experiencing moderate inflation, including Israel and New Zealand, has reduced the scope of nominal indexation. These accomplishments have been addressed partially by the volume in the individual country studies. They deserve more attention in the summary section.

The empirical analysis of inflation targeting regimes in the early 1990s focuses on the predetermined path of disinflation consistent with the official central bank forecast. At that time, inflation targets served as an essential tool of monetary discipline and the implementation of these targets involved some unemployment costs. At the present time, the U.S. Federal Reserve, the Bank of Japan, and the European Central Bank may be dealing with the issue of whether inflation targeting is a viable policy framework for averting deflation and declining profitability of businesses. The volume does not address adequately the recent dilemmas and efforts of monetary authorities to design policies aimed at preventing deflation.

Throughout the book, the analysis of inflation targeting seems to be entrenched in the marginal attention paid to the importance of the width of the inflation tolerance band. The authors define strict inflation targeting as a near-zero inflation target while exposing flexible inflation targeting to ubiquitous treatment as a policy prevailing at higher inflation levels. Alternatively, strict inflation targeting could be viewed as a system with a narrow tolerance band around the midpoint target and flexible inflation targeting as the system consistent with a wider band. A narrow band is more desirable for countries that are pursuing the path of disinflation aggressively since it enhances the policymakers' commitment to low inflation and serves as an important tool of policy discipline. The alternative approach seems to provide more useful lessons for policy design when inflation persists at upper single digit levels. Moreover, the alternative approach would allow a comprehensive set of policy monitoring rules and guidelines to develop. Specifically, flexible inflation targeting could be seen as a more desirable policy regime and consistent with more flexible exchange rates. This approach allows for a longer decision lag between the recognized macroeconomic disturbance and the policy response. Thus it helps to avoid possible policy overreactions and mistakes. It also diminishes the need for frequent target resetting.

Another aspect of inflation targeting that is addressed inadequately by the volume is a set of policy monitoring rules. Specifically, the authors did not elaborate on the use of various forms of the Taylor Rule by individual central banks that would ensure consistency between the intermediate target and short-run interest rates as supporting, monitoring targets. Nevertheless, the proposed analytical extensions would probably dilute the synthetic value of the reviewed project. They may serve as areas of future extensions to the research on inflation targeting.

As mentioned above, the inflation targeting experiences of well-developed industrial economies may provide useful lessons for Central Europe's transition economies still struggling with excessive inflation. The Czech National Bank has applied a system of core inflation targeting as of January 1998, and the National Bank of Poland has officially chosen a CPI targeting regime as of January 1999. By doing so, the central banks in transition economies attempt to reinforce their credibility and transparency. In addition, they wish to stabilize financial markets, interest rates, and exchange rates shaken recently by the contagion effects of the Asian and the Russian financial crises. Their inflation targeting systems are far from being well developed. The reviewed volume deserves careful examination by monetary authorities of economies in transition as a useful source of international lessons and information relevant for designing their monetary regimes. In sum, this volume provides a comprehensive, valuable examination of diverse international experience with inflation targeting regimes. It proves that modern monetary policies are divergent and distinct and that monetary authorities can and should learn a great deal from each other's experience.

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