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Does Inflation Targeting Make a Difference?

Jeremy M. Piger

Over the past 15 years, an increasing number of central banks have adopted explicit inflation targeting as a framework for conducting monetary policy. Inflation targeting takes many forms, but at its heart is an announcement by the monetary authority of its quantitative point target (or range) for inflation, regular communication with the public on the progress being made toward hitting the target, and mechanisms by which the monetary authority is held accountable should it miss its target. Inflation targeting was adopted by a handful of mainly industrial countries in the early 1990s. Spurred by its perceived success, a large number of countries, including many emerging market economies, have recently adopted inflation targeting.

Despite the popularity of inflation targeting around the world, and a general perception that it "works," most early research studies found little evidence that economic performance in non-inflation-targeting countries had suffered because they did not adopt inflation targeting. As more data have become available, however, recent studies have begun to unearth significant differences in the performance of inflation-targeting vs. non-inflation-targeting economies.

One such study found that inflation targeting affects the public's expectations about inflation.[1] In particular, under an inflation-targeting regime, expectations about inflation, particularly at longer horizons, should be "anchored" by the target, and thus should be less affected by changes in actual inflation. The table uses estimates from this study to show how the public's expectations of future inflation (five and ten years out) would change in the face of a 1-percentage-point increase in average realized inflation over the preceding three years. For a group of inflation-targeting countries, comprising Australia, Canada, New Zealand, Sweden, and the United Kingdom, the estimated response of inflation expectations to this increase in realized inflation is quite small. However, for the non-inflation-targeting economies, namely, the euro area, Japan and the United States, the estimated responses are large and statistically significant.

Having inflation expectations that are well anchored—that is, unresponsive to short-run changes in inflation—is of significant benefit to a country's economy. Because expectations of higher future inflation will be negotiated into various sorts of pricing contracts, such as labor contracts, the public's expectation of future inflation can be self-fulfilling. Thus, keeping inflation expectations anchored helps to keep inflation itself low and stable.

Of course, there are also potential drawbacks to the adoption of inflation targeting that might offset any potential benefit in terms of anchored inflation expectations. For example, some Federal Reserve policymakers have argued that inflation targeting removes the flexibility needed to respond to changing macroeconomic conditions, as well as unusual events. Whether or not the United States would experience a net benefit from adopting inflation targeting is an active topic of debate, both inside and outside of the Federal Reserve. The outcome of this debate will be important in shaping the Federal Reserve's policy framework of the future. ■

[1] Levin, Andrew T.; Natalucci, Fabio M. and Piger, Jeremy M. "The Macroeconomic Effects of Inflation Targeting." Federal Reserve Bank of St. Louis *Review*, July/August 2004, *86*(4) (forthcoming).

Estimated Response of Inflation Expectations to Change in Realized Inflation

	Horizon of inflation expectations (years ahead)	
	5	**10**
Australia, Canada, New Zealand, Sweden, United Kingdom	0.09%	0.01%
Euro area, Japan, and United States	0.29%	0.24%
Euro area and United States	0.34%	0.24%

SOURCE: See footnote 1.

Views expressed do not necessarily reflect official positions of the Federal Reserve System.