Contra: No, because …

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Before discussing some conceptual shortcomings of inflation targeting as a strategy for monetary policy, it may be useful to characterise the constitutional and macroeconomic framework a central bank faces. The typical features of the scenario envisaged here are the following: The central bank is provided with instrument independence, but its ultimate objective is determined externally. At whatever institutional level this ultimate objective may be defined, it is assumed to consist in achieving and maintaining price stability. It is further assumed that the decision-making body of the central bank is made up of persons of different minds and economic policy ideas.

The principal macroeconomic constraints the central bank faces are (1) the various lags governing macroeconomic adjustment processes because of limited flexibility of production, goods prices and nominal wages, (2) the possibility of bounded rationality of expectation formation by the public, and (3) excess volatility of flexible exchange rates.

As regards the purely theoretical viewpoint, Lars Svensson, in particular, has demonstrated in numerous papers[1] the overwhelming appeal of the strategy of inflation targeting, as well as the inferiority of monetary targeting. Svensson's work is worth mentioning because it is one of the few that explicitly recognise the lag problem in monetary policy making. However, the lag structure is not the only constraint on monetary policy. An important additional constraint is given by the fact that neither market agents nor the central bank have full knowledge of the 'true' macroeconomic model (in theoretical analyses, this problem is simply assumed away via the 'rational expectations' hypothesis). Since precisely this is the main feature of the real world that substantially justifies a discussion of monetary policy strategy, analyses that disregard this point are of limited value.

Because of the various lags in the transmission process, the choice of the intermediate target is critical. The intermediate target should enable market participants to assess the performance of monetary policy even in the short run. Additionally, it is the main object of daily communication between the central bank and the public. Under inflation targeting, the forecasted inflation rate serves as the intermediate target. This value is based on a macroeconomic model which has to be developed, estimated, and published by the central bank itself. In terms of credibility and accountability, the basic flaw of this procedure lies in the public having to monitor monetary policy on the basis of information which is supplied by the central bank itself. This means that, in the short run, the public will not be given any opportunity to compare central bank announcements and actual measures with statistically objective data. Moreover, under inflation forecast targeting the central bank would run an additional credibility risk concerning its performance as a forecasting agent.

In practice, it is impossible to judge current monetary policy decisions by their effects on the ultimate goal. This is, first, the consequence of the lag problems. Second, actual inflation is measured as the change of a price index in discrete time; this statistical feature does not permit the breakdown of price index movements into level changes and trend changes. But price level shifts can result from demand or supply shocks, induced by fiscal policy, wage policy or international influences. Therefore, the adequate assignment is to hold monetary policy responsible for the trend component alone. This implies that, if this fact is disregarded, the concept of inflation targeting will create an incentive for

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1 See, for example, Lars E.O. Svensson (1997), "Inflation Forecast Targeting: Implementing and Monetoring Inflation Targets", European Economic Review 41, 1111–1146; Lars O.E. Svensson (1999) "PRICE STABILITY AS A TARGET FOR MONETARY POLICY: DEFINING AND MAINTAINING PRICE STABILITY", NBER Working Papers No. 7276, August.

moral hazard behaviour in the other economic policy areas.

The final point concerns the decision making process within the policy making body of the central bank. Here, the strategy is of great importance in that it serves as a kind of constitutional platform that cannot be questioned on a case-by-case basis. Although this is a necessary requirement for a time-consistent monetary policy, it is not sufficient. This is because it would be wrong to treat the policy making body as a homogenous group of individuals who are always in agreement. The possibility that some members have discretionary policy ambitions cannot be ruled out *a priori*. A well-designed strategy will help to minimise the risk of discretionary decisions. This risk is the higher, the more opportunities the strategy offers for debating quantitative figures, as provided by the need to set forecasted values for particular macroeconomic variables or to use parameter estimates. In these debates, discretionary policy ambitions may well be concealed by 'judgements'.