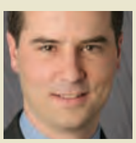
Is an explicit inflation objective consistent with a dual mandate?

It can be. An inflation objective can be implemented even when a central bank has more than one mandate, which the Federal Reserve does—to provide "maximum sustainable employment" in "an environment of stable prices." In fact, in countries like the United States, where weight is given to variables other than inflation, monetary policy performance may be even more effective than if the central bank had only a single mandate.



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In addition, the experiences of other countries that have worked with an explicit numerical objective for many years suggest that a flexible inflation targeting regime may actually be more effective than a strict rule, even if price stability is the primary concern. By "flexible," we mean that the central bank identifies factors that could cause it not to raise interest rates in response to high inflation. Often the factors may indicate that the headline, or overall, inflation increase is expected to be temporary.

New Zealand and Norway are two countries whose experiences in implementing inflation targets illustrate that a flexible inflation targeting regime works well, especially when central banks have additional goals. Both countries have small, open economies: New Zealand trades substantially with Asian markets and, as an exporter of agricultural goods, is very sensitive to exchange-rate movements. Norway—a major oil exporter—is heavily exposed to fluctuations in oil prices, which cause economic variability above and beyond exchange-rate volatility. These sources of added volatility make setting appropriate monetary policy even more challenging than in the United States, and thus make these two countries interesting case studies.

New Zealand

The Reserve Bank of New Zealand (RBNZ) started pursuing a strict inflation target in 1990 with the sole purpose of price stability. It established a "hard" annual percent target range in its CPI of 0 to 2 percent. At the time, the RBNZ reacted so aggressively to inflation rates above its target range that it was rumored its governor would lose his job should the RBNZ fail to deliver on its promise. (An effective credibility mechanism!) Unfortunately, such hawkish policy, instead of leading to greater stability, was associated with a volatile period for interest rates, exchange rates, and output.

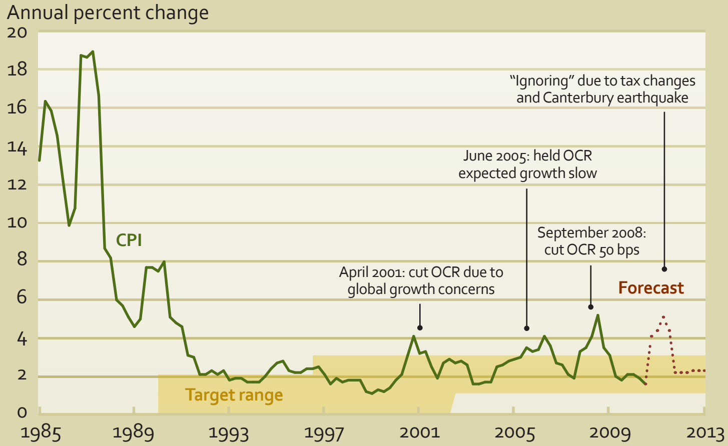
In response, the RBNZ and the government of New Zealand slowly edged away from a strict regime, becoming more flexible in the approach toward inflation targeting over time. In fact, the RBNZ's mandate now reads, "In pursuing its price stability objective, the Bank ... shall seek to avoid unnecessary instability in output, interest rates, and the exchange rate." In a way, this change made the RBNZ's objective closer to the Federal Reserve's dual mandate.

The figure illustrates New Zealand's flexibility, as the RBNZ has at times either held or cut its main policy tool—the official cash rate (OCR)—even when the annual trend in inflation was above its stated target range. Greater flexibility has likely contributed to reduced macroeconomic volatility, but the RBNZ has still been successful at lowering inflation back into its target range following significant economic shocks. While increasing flexibility does come with the risk of losing credibility, survey measures of inflation expectations have remained within the RBNZ's target range, evidence that expectations remain anchored.

GETTY IMAGES

The Reserve Bank of New Zealand started pursuing a strict inflation target in 1990 with the sole purpose of price stability.

New Zealand's CPI

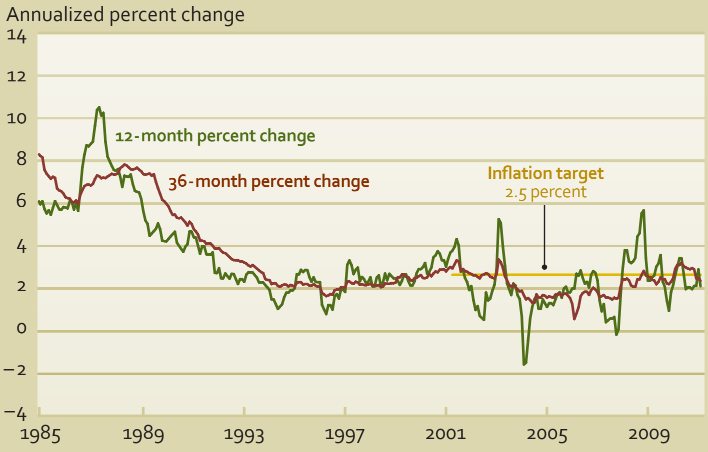


Sources: Statistics New Zealand; Reserve Bank of New Zealand.


NORGES BANK

Since the Norges Bank adopted an explicit inflation target in 2001, the longer-term (three-year) trend in inflation has been relatively well anchored near 2.5 percent.

Norway's CPI



Source: Statistics Norway/Haver Analytics.

Norway

The Norges Bank (the central bank of Norway) has operated a "flexible inflation targeting regime" for the past 10 years. Under this set of rules, weight is given to stability in inflation, employment, and output (similar to the Federal Reserve's current dual mandate). The Norges Bank's operational target for inflation is an annual CPI inflation rate of 2.5 percent over the medium term. Should inflation deviate from its target as a result of a shock to the economy, the specific length of time it will take for inflation to return to its target will depend on the type of shock that buffeted the economy.

With such flexibility, a central bank needs to communicate its policy in a transparent and credible manner, lest the public lose faith in the bank's ability to deliver on its promises. The Norges Bank does this by publicly announcing policy objectives, providing its assessment of current economic conditions, and releasing its forecasts for macroeconomic variables such as GDP and inflation.

Norway has experienced significant shocks to its economy. For example, in January 2003, its headline CPI—which has been and continues to be more volatile than many other developed countries—jumped to above 5 percent, largely due to a spike in the relative price of household electricity stemming from supply issues, only to fall below zero a year later. But despite these episodes, the Norges Bank has succeeded at returning inflation to its targeted level. Relative price swings do make it hard to get an accurate reading on inflation, and even harder to communicate to the public. However, since the Norges Bank adopted an explicit inflation target in 2001, the longer-term (three-year) trend in inflation has been relatively well anchored near 2.5 percent.

Judging from the experiences of these two countries, moving to an explicit numerical inflation objective can be consistent with the Federal Reserve's dual mandate. Indeed, these two countries show that when inflation expectations are well anchored, the central bank can be freer to take short-term stabilization actions if the public does not fear inflation. ■

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