Recap Information 10: Inflation targeting

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The lecture slides associated with this part of the course provide the most comprehensive information about what I find of relevance. Nevertheless, this note briefly lists the key concepts that you are supposed to know and be able to explain.

Key concepts you should know

What is inflation targeting?

- Numerical specification of policy objectives concerning inflation
- Point targets, tolerance bands, inflation concepts, horizon, escape clauses
- Flexible versus strict inflation targeting
- Accountability
- Downplay of monetary aggregates
- Inflation forecast as potential intermediate target
- Transparency
- A framework form appropriate "constrained discretion."

Simple static model of inflation targeting

- Elimination of the LM-curve from the IS/LM/AS model
- The expectations-augmented Phillips curve (PS curve)

- The inflation targeting rule (MPR curve)
- Inflation and output gap determination by the PS and MPR curves
- The associated nominal interest rate setting
  - Introduction of an IS curve
  - Nominal interest rate increases by more than one-for-one if inflation expectations raises => the real rate decreases
  - The interpretation of inflation forecast targeting:
    * If expected inflation is above (below) the inflation target, raise (lower) the nominal interest rate

A dynamic model of inflation targeting

- Simple AS/AD model with control lags
- Example with strict inflation target
  - Nominal interest rate set so as to set two-year ahead inflation expectations equal to target (the horizon at which the nominal rate affects inflation)
  - Inflation expectations (=forecasts) as intermediate target variable
- Implied instrument setting as a Taylor rule
  - Form of interest rate rule shows that variables entering the rule says little to nothing about the goals of monetary policy
  - Output gap is in the rule as it helps predicting future inflation
  - As in simple model: If inflation forecast is above (below) the inflation target, raise (lower) the nominal interest rate
- Monitoring performance based upon forecasts
- Monitoring when central bank has private goals
  - Public can infer the private goals and hold central bank accountable for target misses
  - E.g., modelled as a "punishment" term in the central bank's loss function
  - Equivalent to a Walsh contract and/or Rogoff conservativeness
- Example with flexible inflation targeting
- Conventional "leaning against the wind" first-order condition (taking control lags into account)
- The higher emphasis on output stabilization, the longer it takes for inflation expectations to return to target