Bangko Sentral ng Pilipinas
ECONOMIC Newsletter

No. 10-05
Sept-Oct 2010

Medium-Term Inflation Target for the Philippines

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Introduction

The key defining element of an inflation targeting (IT) framework is the inflation target itself. The careful design of the inflation target is integral to realize the associated benefits of IT and to help build the credibility of the monetary policy regime. Heenan, Peter and Roger (2006) point out that a well-designed inflation target could help anchor expectations, serve as yardstick for central bank accountability and reflect the central bank's objectives.

One of the critical aspects in the design of the inflation target is the target horizon. The target horizon refers to the period of time over which the central bank promises to achieve its inflation target.[2]

There is no existing standard on the choice of the target horizon. In fact, it varies considerably among inflation targeters. Some IT central banks have opted for a fixed target for a specified period of time (i.e., constant annual target over a multi-year period) while others have subscribed to an average target over the medium term. There are also IT central banks that set annual inflation targets that change from year to year.

This note presents the overall thinking behind the adoption of a fixed medium-term inflation target in place of the variable annual targets.

Country Practices

There is no acknowledged international best practice on the choice of a target horizon. In general, relatively new IT central banks and those from emerging economies choose to specify short-term inflation targets (i.e., annual targets) in line with a desired disinflation path.

The more advanced IT central banks typically set targets for a relatively longer horizon. That is, some central banks set their target as a fixed annual target for a multi-year period or as an average target over the medium term.

Some central banks adopt a fixed inflation target. In these cases, central banks set a constant target for a number of years or keep a target effective for an indefinite period of time. However, these targets are not exactly permanent targets. Rather, they are subject to periodic reviews by their respective central banks. In fact, in some cases, the targets are reviewed annually. However, these targets are perceived to be fixed due to the infrequent adjustments in the target.

Other central banks pursue an average inflation target over a multi-year period. A central bank operating under average inflation targeting does not have a target for a particular year but aims to bring inflation towards an average rate over the medium term.

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[2] This definition was adopted from Heenan, et al. (2006). The said authors identified three important time horizons for IT central banks. Apart from the target horizon, Heenan, et al. (2006) note that the forecast horizon and the policy horizon are relevant time frames for central banks. The forecast horizon refers to the period of time for which the central bank generates forecasts while the policy horizon refers to the time required to bring inflation within target.

The concept of average inflation targeting is continuing to gain popularity in the literature. The Reserve Bank of Australia (RBA) and Reserve Bank of New Zealand (RBNZ) are often cited as examples of central banks that pursue average IT because of the way their targets are specified. However, it should be noted that average IT as implemented by RBA and RBNZ appear to be less stringent than the definition provided in the literature (see Nessen (2002) and Warburton and Lees (2005). Strictly speaking, average IT requires that periods of higher-than-target inflation must be followed by periods of lower-than-target inflation in order to meet the medium-term inflation target.[3] In this case, bygones are no longer bygones as the central bank must compensate for the past deviation of inflation from the target.

However, Debelle (2009) explains that under the Australian IT framework, the average over the cycle horizon refers more to the distribution of inflation rather than the strict averaging of inflation. RBA implements medium-term inflation targeting by ensuring that the bulk of the distribution of year-ended inflation outcomes lies between 2 and 3 per cent. The same could be said of RBNZ which implements its medium-term IT framework by ensuring that inflation outturns fall into its target range in the latter half of the 3-year target horizon.

The table below presents a sample of IT central banks and their target horizon.

Advantages and Disadvantages of the Different Target Horizons

There are pros and cons associated with each target horizon. This section provides an overview of the said advantages and disadvantages.

A. Variable Annual Targets

The principal benefit of setting annual targets is that it can afford the central bank sufficient flexibility in the exercise of monetary policy. Compared to a fixed multi-year target or an average multi-year target, it allows monetary authorities to incorporate more recent information when they set the target. Thus, authorities may be able to adjust subsequent targets following a shock, in line with the desired adjustment pace. This implies more latitude to accommodate shocks.

Heenan, et al. (2006) also argue that a shorter horizon for the inflation target places greater emphasis on the target itself. This minimizes the possibility for a central bank to pursue other goals such as short-run output stabilization. As such, a short target horizon could help build the credibility of monetary authorities. In general, this approach is more appropriate for countries that are still in the disinflation stage.

Meanwhile, setting annual targets that vary from year to year could have implications on the credibility of the policy framework.

Variable Annual Inflation Target	**Fixed Annual Inflation Target**
Bank of Indonesia	Banco Central de Chile
Bangko Sentral ng Pilipinas (from 2002-2011)	Bank of Canada
	Bank of England
Average Multi-year Inflation Target	Bank of Israel
Bank of Korea	Bank of Thailand
Magyar Nemzeti Bank	Sveriges Riksbank
Reserve Bank of Australia	
Reserve Bank of New Zealand	

Source: Various Central Bank Websites

[3] Warburton and Lees (2005)

Frequent changes in the inflation targets could undermine the integrity of the inflation targets, particularly if the public perceives that the adjustments are undertaken to ensure that the central bank actually hits the target.

In addition, variable annual targets could also affect inflation expectations. Annual revisions in the targets could hinder the consolidation of inflation expectations at a particular level for a sustained period of time.

Moreover, a shorter horizon could also be associated with greater volatility in interest rates and the real economy. This arises as monetary authorities may need to adjust policy rates more frequently in order to drive inflation to target over a shorter period of time.

B. Fixed Multi-Year Targets

The main advantage of a fixed target for a multi-year period is that it may work better in stabilizing inflation expectations at a desired range for a longer period of time. Rezessy (2006) is of the view that a fixed target could reduce long-term uncertainty in monetary policy. It helps increase the predictability of monetary policy and as such, is better able to guide long-term inflation expectations.

However, a fixed multi-year target could reduce the flexibility of monetary policy. This becomes costly, particularly if a series of major supply-side shocks hit the economy.

Furthermore, the use of a fixed target may present a challenge to forecasting. Heenan, et al. (2006) note that there is a general tendency for forecasting models to converge to long-run equilibrium or diverge due to misspecification over longer horizons. Thus, the informational value of forecasts generated beyond the 2-3 year horizon may be low. In turn, this could have adverse implication for policymaking as inflation forecasts are vital to policy assessments under an IT regime.

C. Average Multi-year Targets

IT central banks that subscribe to an average multi-year inflation target such as the RBA and the RBNZ often cite its flexibility as an advantage of this approach. Stevens (2003) explains that the on average, over the cycle design of the target in Australia reflects the fact that inflation is difficult to control particularly for short periods of time and that attempts to do so may impact adversely on real sector activity. The medium-term perspective in the Australian IT framework also provides monetary authorities with some room to respond to short-term output fluctuations. This flexibility is essential for Australia since the RBA is also mandated to promote full-employment. Meanwhile, Bollard (2002) notes that the set-up in New Zealand allows monetary authorities to look beyond the transitory fluctuations in inflation.

It could be argued theoretically that a less aggressive monetary policy response could be expected if the target is expressed as an average over the medium term. This applies both to the less stringent average IT frameworks of RBA and RBNZ, as well as the more stringent case as defined in Nessen (2002) and Warburton and Lees (2005). For the cases of the RBA and the RBNZ, monetary authorities could be less aggressive as annual inflation does not always have to be within the target range but is only required to be within the range on average over the horizon. Intuitively, extending the horizon for the target inflation suggests that the impact of a shock on actual inflation is likely to be attached a lesser weight and in turn, would require a less aggressive policy response from monetary authorities.

There are some disadvantages of adhering to an average inflation target. While a longer horizon for the target provides some scope for monetary authorities to pursue short-term output stabilization goals, this could have implications on the credibility of the IT framework. The perception that the central bank is pursuing other short-term objectives could undermine the target.

In addition, Heenan, et al. (2006) explain that there are undesirable effects of relying on average inflation. Averaging, for instance, could smooth out price fluctuations and thereby mask some emerging inflation trends. This could lead to a delay in necessary policy adjustments. Averaging could also weaken

policy accountability as it may lengthen the measured lag between policy decisions and inflation outcomes.

Similar to a fixed multi-year target, the adoption of a medium-term inflation target could also pose a complication to forecasting. As argued in the previous section, there is a limit to the capacity of any model to generate meaningful forecasts especially over longer horizons.

Adoption of a Fixed Medium-Term Target for the Philippines

After a careful review, the DBCC approved the shift to a fixed medium-term inflation target on 9 July 2010 under DBCC Resolution No. 2010-3. The adoption of a fixed medium-term target is expected to help promote a long-term view on inflation, increase the predictability of monetary policy and better anchor inflation expectations. In turn, this should facilitate and promote better-informed decisions relating to consumption and investment, as it helps reduce uncertainty.

Authorities also acknowledged that there are associated challenges with the shift to a fixed medium-term inflation target, such as the need for more calibrated responses to supply shocks and more rigorous inflation forecasting capability. It could be noted, however, that the BSP has already predefined since the adoption of IT in 2002, a set of acceptable circumstances under which the BSP may not achieve its target. These acceptable circumstances pertain mainly to supply-side related shocks that fall largely outside the domain of monetary policy. These include: (a) volatility in the prices of agricultural products; (b) natural calamities or events that affect a major part of the economy; (c) volatility in the prices of oil products; and (d) significant government policy changes that directly affect prices such as the changes in the tax structure, incentives and subsidies. With regard to concern on generating forecasts extending to the medium-term, the BSP continuously refines, improves and expands its forecasting capability.

There is preference for a fixed annual target over a multi-year period as it is easier for the general public to understand. As argued in the literature, averaging of inflation could also weaken policy accountability as it may lengthen the lag between policy decisions and inflation outcomes.

Another crucial aspect relating to the shift to a fixed medium-term inflation target is the determination of the appropriate target range. Essentially, authorities need to identify a target that is optimal for the economy, a quantitative representation of the medium-term goal of price stability. Typically, IT central banks do not set high inflation targets as high inflation could have a detrimental impact on output growth. It could also have significant distributional effects as it erodes the value of money. However, IT central banks also do not aim for zero inflation. There are several reasons why zero inflation may not be appropriate. First, there are downward rigidities in the economy which could prevent prices and wages from adjusting downwards. A positive inflation could allow for adjustments in real terms, thereby making price and wage systems a bit more flexible. Second, there are inherent biases in the measurement of the consumer price index (CPI). CPI measures are said to be biased upwards and authorities must provide allowance for this bias by setting a higher than zero inflation target. Third, targeting zero inflation raises the likelihood of a deflation. Thus, the preference for most IT central banks is a low, positive inflation target.

The assessment of the DBCC showed that a target of 4.0 percent with a ± 1.0 percentage point tolerance interval for the period 2012-2014 is appropriate for the Philippines. The said target range is consistent with latest inflation forecasts, the private sector's inflation expectations, and the growth prospects of the economy.

Most central banks with medium-term inflation targets set their targets within 1-3 percent range. However, it is not necessary for the Philippine target to be exactly aligned with their targets since the inflation targets should incorporate country-specific factors. An inflation target of 1-3 percent for the

Philippines may be too restrictive since this may entail large interest rate adjustments to effect a significant reduction in the current inflation.

Going forward, the fixed medium-term inflation target will be periodically reviewed to determine its continued suitability to macroeconomic conditions. This is consistent with the general practice of other central banks adopting a fixed annual target. The periodic review is also part of the process for determining the appropriate target for the subsequent period.

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Websites of Selected Central Banks

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