

Evaluate the effectiveness of inflation targeting as a key element of a government's monetary policy.

Since the 1970s inflation targeting has become widely adopted as a key element of monetary policy by many developed economies. Inflation targeting requires central banks to keep inflation close to an agreed level. Inflation targets were introduced to help reduce inflationary expectations and help avoid the high inflation which was seen in the 1970s and which can destabilise economies. Many central banks adopted inflation targeting as a response to the failure of other monetary policy options, such as those that targeted the rate of growth of the money supply. However, since the recession which followed the financial crisis of 2007-09 economists began to question the importance attached to an inflation target and worried that a commitment to low inflation can conflict with other more important macro-economic objectives such as economic growth and low unemployment.

To be successful, inflation targeting needs the central bank to be able to conduct monetary policy with a degree of independence (the Bank of England is operationally independent of the government). Secondly, effective inflation targeting usually requires monetary authorities not to target other indicators, such as the level of unemployment. In fact it is not possible to target both the exchange rate and inflation rate. In the UK the Bank of England has a symmetrical inflation target of $CPI = 2\% \pm 1\%$. They also have a remit to consider, but not target, wider macro-economic issues such as output and unemployment and to generally support the government's economic strategy. The European Central Bank has a non-symmetrical target of keeping inflation below but close to 2% in the Eurozone. In the United States the Federal Reserve has a dual target to keep long term inflation at 2% and to maximise employment.

One of the major advantages of inflation targeting is that it stabilises inflationary expectations among economic agents such as firms, workers and consumers. If everyone knows that inflation is always going to be around the 2% level then firms are able to plan pricing and investment decisions because of the implied economic stability. Workers will base their wage negotiations on an inflation rate of 2% which reduces the possibility of cost push inflation resulting from a wage-price spiral. Low inflation also helps to maintain the price competitiveness of a country's exports. Nevertheless even if inflation is stable at the relatively low rate of 2% money will lose half its purchasing power / value in just 36 years.

Another advantage of inflation targeting is that volatile swings in the trade cycle (sometimes called boom and bust) should be less likely. The UK economy in the 1970s and 80s was particularly prone to this; inflation targeting was designed to help to 'flatten' the trade cycle and create more economic stability, by ensuring that monetary policy would be used pre-emptively ahead of potential booms and busts. Indeed, the late 1990s up until the financial crisis of 2008 has been called the NICE decade of Non-Inflationary Continuous Expansion. The then-Chancellor Gordon Brown prematurely boasted that we had seen the end of boom and bust. However, how much this was due to inflation targeting and how much the result of benign global economic conditions (e.g. low inflation due to competitive Chinese exports) is a

*A nice start with some **context** to inflation targeting and its history, and a clear **definition**.*

*The **key arguments in favour of and against** inflation targeting are introduced, setting the scene for a **strong essay**.*

*This is a useful paragraph because it **indicates clearly which factors are important** in ensuring that inflation targeting has a chance of being successful. The **use of examples** from 3 different countries / areas is helpful in demonstrating that there is not just one approach to inflation targeting.*

*This paragraph starts very strongly with a **clear and succinct** advantage, and supported with **excellent economic language** throughout the entire paragraph.*

*Good structure – clear and brief **outline** of another key advantage at the **start of the paragraph**, followed by **contextual knowledge** of the UK economy*

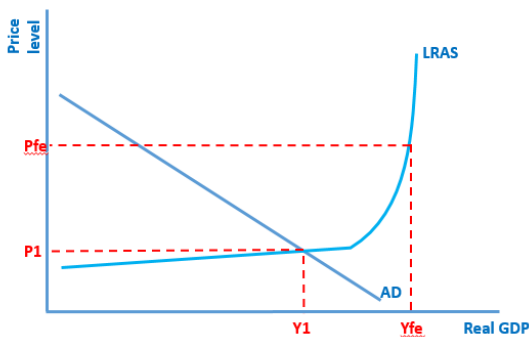
*More good **structural signposts** – “however” indicates **evaluation***

matter of debate. In addition the financial crisis of 2008-09 certainly brought 'bust' back with a vengeance. The low inflation of the NICE decade also disguised an asset price bubble and banking boom which demonstrated that a successfully targeted low stable level of inflation isn't necessarily a sign of overall economic stability.

*A careful **final sentence** that links directly back to the question **providing some judgement***

Thirdly, by having an inflation target the central bank is tolerating a certain level of inflation; this makes it less likely that an economy will slip into deflation, which has become a major concern in developed economies in recent years after the financial crisis. The existence of negative output gaps following the crisis means that aggregate demand is low and that

*This is a nice point because it is very much **grounded in recent economic history***



resources are unemployed, which puts downwards pressure on the price level due to weaker bargaining power of workers and a reduction in resource scarcity. This is shown in this diagram, in which macroeconomic equilibrium at Y1 is below the full employment level of output at Yfe.

*The **diagram** is **explained and integrated** into the written analysis.*

However, a large output gap in an economy doesn't necessarily lead to deflation and sometimes it is difficult to even know what the inflation rate actually is, and to determine the causes of inflation. One difficulty for a central bank is deciding which inflation measure to target, e.g. should the Bank of England target CPI or RPI, or an alternative measure? Inflation is notoriously difficult to measure because of different spending patterns by different households. A further problem is deciding what inflation rate the target should be - 2%, 3% or 5% - and symmetric, asymmetric, or no tolerance at all. There is also the problem of inflation created from a rise in costs, as cost push inflation is not really controllable by monetary policy which acts most effectively on the demand side of the economy. Cost-push inflation can cause a temporary rise in inflation, and during the financial crisis and in the years that followed the UK experienced inflation of 5% due to rises in oil prices, a rise in VAT and increased student tuition fees. However, these were cost-push factors and higher interest rates would have been ineffective and potentially disastrous with rising unemployment at the time – sticking to the inflation target at this point would have been both difficult and damaging.

*A **variety of evaluation points** are wrapped up together in this paragraph, demonstrating some **holistic thinking** about inflation issues.*

*Good **practical** evaluation.*

Inflation targets can be very successful, especially during 'normal' economic circumstances as occurred in the UK in the ten years prior to the financial crisis in 2009-09. When economies are not in 'normal times' and hit by shocks, central banks should take a more flexible and transparent approach to their monetary policy e.g. allowing inflation to rise to 5% in the UK and introducing schemes such as QE and funding for lending, so that economic agents continue to have confidence in strategists such as those on the Monetary Policy Committee.

*This final sentence is vital in ensuring that the evaluation points being made are **carefully linked** to the question*

*This is an **excellent conclusion** in which a **judgement is reached** on the circumstances in which inflation targeting is successful*