Teacher Instructions

This activity is designed to help students learn the advantages and disadvantages of inflation targeting as a tool of macroeconomic policy. This activity can also be used to help students build skills of analysis and evaluation.

Students should read through each of the statements, and decide whether they are an advantage or a disadvantage of inflation targeting. It could be used as a worksheet, on which students ‘tick’ or ‘cross’ advantages and disadvantages, or for a more kinaesthetic exercise each statement could be printed onto separate cards and then sorted into piles of pros and cons. As an extension task, students could prioritise the advantages and disadvantages.

Background theory

Inflation targeting refers to a strategy or policy used by central banks, in which they announce, to the general public, the rate of inflation that they will try to achieve. Often the inflation target is expressed as a “range” i.e. the Bank of England’s target of 2% ± 1%. This policy is designed to lead to price stability in an economy.
Instructions: sort the following statements into advantages and disadvantages of inflation targeting.

If the central bank consistently manages to hit the inflation target, it improves general confidence in the economy, which can in turn lead to rising consumption and investment, and therefore growth.

Inflation targets are often set quite slow, at around 2% or 3%. The short-run Philips Curve tells us that there is a trade-off between inflation and unemployment. Therefore we could expect higher unemployment if a country adopts a relatively low inflationary target.

If a credible (trustworthy) central bank adopts an inflation target then people expect there to a certain level of inflation in the future, which allows them to negotiate more appropriate wage increases and to write better contracts.

Countries that adopt inflation targets usually have lower inflation than countries that do not have a target. This helps to tackle all of the negative consequences of inflation.

It can be difficult to know which measure of inflation to target, because different measures put different weights on different items. Central banks usually choose to target consumer price indices rather than industrial price indices.

The ‘punishment’ for a central bank failing to achieve its inflation target is often fairly weak e.g. in the UK, the Governor of the Bank of England simply has to write an open (i.e. published) letter to the Chancellor to explain the reasons why the target has been missed.

For many developed countries, inflation targeting has failed to prevent destructive asset-price bubbles, because the inflation target has been in relation to consumer prices.

A policy of inflation targeting can prevent a central bank from responding quickly to new, unforeseen events e.g. the European Central Bank (ECB) was accused of being slow to react to the Financial Crisis of 2007 onwards, only adopting a Quantitative Easing policy to boost growth in 2015.

Inflation targeting can anchor inflationary expectations – if people expect low inflation, then they will request only low wage increases, therefore reducing cost-push inflationary pressure. So, expectations of low inflation can cause low inflation.

Inflation targeting can improve the transparency of the central bank’s activity, and improve its communication with the general public.

Monetary policy can take up to around two years to have its full effect on inflation. Therefore targets need to be met in the medium term, rather than the short-term.

Inflation targeting prevents interest rates being used for political advantage i.e. lowered in the run up to an election in order to win votes.

The policy of inflation targeting is generally easy-to-understand by the general public.

It can be difficult to forecast inflation in a globalised world i.e. it is much easier to import inflation from countries from whom we buy exports.