Strict and Flexible Inflation Forecast Targets: An Empirical Investigation

Glenn Otto
University of New South Wales, Australia

and

Graham Voss
University of Victoria, Canada
Hong Kong Institute for Monetary Research

May 2009

Summary

We examine whether models of inflation targeting are consistent with the observed behaviour of the central banks of Australia, Canada, and the United States. Strict inflation targeting restricts the conditionally expected path of inflation such that there should be no predictable deviations of inflation from the inflation target. Flexible inflation targeting, in contrast, restricts the conditionally expected path of a linear combination of target variables, typically inflation and the output gap, such that there should be no predictable deviations of the inflation and output combination from the relevant target. In this latter case, the linear combination of target variables captures how the central bank balances its concerns about inflation and economic activity.

We estimate the conditions implied by both strict and flexible inflation targets, providing a description of monetary policy for each central bank under different maintained hypotheses. We then test whether these estimated conditions satisfy the predictions of the forecast targeting models. The overall objective is to examine the extent to which and the manner in which these central banks successfully balance inflation and output objectives over the near term.

For all three countries, we obtain reasonable parameter estimates for the various models we consider. Our preferred specification for each country is a flexible inflation target, balancing inflation and changes in the output gap, over the two and four quarter horizon. Although the parameter estimates are reasonable, and remarkably similar across countries, for Australia and the United States there are predictable deviations from forecasted targets, which is not consistent with models of inflation targeting. In contrast, the results for Canada lend considerable support to simple models of flexible inflation forecast targeting.