Inflation Targeting as a Framework for Monetary Policy:
Lessons from Country Experiences
(The Israeli Experience)

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Main Topics

• Background of a Recent Successful Inflation Targeting (IT) Country - Israel

• The Advantages of the IT regime

• Some Important Precondition for IT to have a Chance of Success in Nigeria
Inflation was reduced to low single levels and since 2002 kept within the target of 1%-3%
Inflation in Israel During the Last 12 Months in Comparison to Selected Countries

- Japan
- Norway
- UK
- Canada
- Israel
- EEU
- Sweden
- South Korea
- Poland
- Mexico
- Singapore
- USA
- Check Republic
- Chile
- South Africa

Developed Economies
Emerging Economies
Background of a Recent Successful Inflation Targeting (IT) Country - Israel

Public Sector Debt, Percentage of GDP, 2000-2007 (year-end)

A prudent fiscal policy reduced early the threat of fiscal dominance.
Inflation expectations are stable within the target range and the BOI key rate is at present lower than the FED’S
The Average of the Forward Rates of Inflation for 8th -10th Year
Background of a Recent Successful Inflation Targeting (IT) Country - Israel

Openness of the Israeli Economy (percentage of GDP, 1995-2007*)

The goods and capital accounts underwent a liberalization process and the economy is currently totally open.
Background of a Recent Successful Inflation Targeting (IT) Country - Israel

Current Account of Balance of Payments as Percentage of GDP, 1995-2007* (Annual)

-5.1 -5.0 -3.1 -0.9 -1.4 -0.8 -1.1 -0.8 1.2 2.4 3.3 5.6 4.8


* First half of 2007.
* Foreign Currency Department forecast

• SOURCE: Balance of Payments, Central Bureau of Statistics.
The Advantages of the IT regime

Brings up the question of what is the appropriate division of labor between fiscal and monetary policy.

*Percent of GDP; excluding credit extended. Until 1996, domestic deficit; from 1997, total deficit.
*The data from 2000 refer to the deficit excluding the Bank of Israel’s profits.
The Advantages of the IT regime

- Serves as a useful communication device between the central bank and businesses and individuals.
- Helps to sharpen analysis of the transmission mechanism and improves the decision making process of the central bank.
The Monetary Policy Transmission Mechanism

Policy Rate → Lending/Deposits

Lending/Deposits → Term Structure Rates – Nominal & Real

Term Structure Rates → Aggregate Demand

Aggregate Demand → Inflation Expectations

Inflation Expectations → Inflation

Inflation → Foreign Prices

Foreign Prices → Inflation

Inflation → World Economic Conditions

World Economic Conditions → Inflation

Inflation → Exogenous Capital Flows

Exogenous Capital Flows → Inflation

Inflation → Fiscal Policy

Fiscal Policy → Aggregate Demand

Aggregate Demand → Exchangerate

Exchangerate → Lending/Deposits

Lending/Deposits → Policy Rate

Policy Rate → Exchangerate

Exchangerate → Inflation

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The Advantages of the IT regime

- Helps to develop transparency, credibility and accountability.

Despite many events that could shake financial stability and cause loss of credibility inflation expectations have been relatively stable.
The Advantages of the IT regime

- Forces decision makers (politicians) to reveal their view on short-run versus long-run trade-offs

**Expected Rate of Unemployment and Inflation**

\[ Y_{gap} = -1.542 + 0.799 \times Z(1,5) + 0.159 \times edp(1,5) \]

\(-0.9\) \quad (4.2) \quad (1.1)

\[ R^2 = 0.394 \quad DW = 1.549 \quad S = 2.693 \quad T = 30 \quad (1991.2-1998.3) \]
The Advantages of the IT regime

- Raises sharply the issue of the appropriate exchange rate regime.
  - The rate of interest consistent with inflation targeting is inconsistent with the rate necessary to keep the exchange rate within the band.
  - Heavy sterilized FX intervention proves unsuccessful and leads to perverse results.

![Interest Rate Spread and NIS-Dollar Exchange Rate Graph](image-url)
The Advantages of the IT regime

Israel’s experience with various FX regimes is valuable to other countries.

For over a decade the Bank of Israel (BOI) has not intervened directly at all in the FX market. Thus Israel’s FX regime has in effect been for the last decade a clean float one.

In addition, for over five years now, both the trade and capital account are fully liberalized.
The Advantages of the IT regime

- A stimulus for the current process of modernizing the central bank law.
Some Important Precondition for IT to have a Chance of Success in Nigeria

- Create the proper legal and institutional structure - price stability has priority, instrument and financial independence to for CBN
Some Important Precondition for IT to have a Chance of Success in Nigeria

Improve the Data Infrastructure

- The calculation of the by the National Institute of Statistics (NIS) should be of the highest standards, highest integrity and be perceived as such
- The figures should be relevant and meaningful to the public
- Timeliness of data on real economic activity is important for proper diagnosis and policy actions
- Collect and analyze forward looking type data from financial markets and surveys
Some Important Precondition for IT to have a Chance of Success in Nigeria

- Enhance the efficiency of the monetary transmission mechanism by deepening financial market along implementing persistently the FSS 2020 program
Thank You