

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

**Dr. Meir Sokoler**

**Former Deputy Governor, Bank of Israel**

Central Bank of Nigeria

Seminar on Monetary Policy and Inflation Targeting

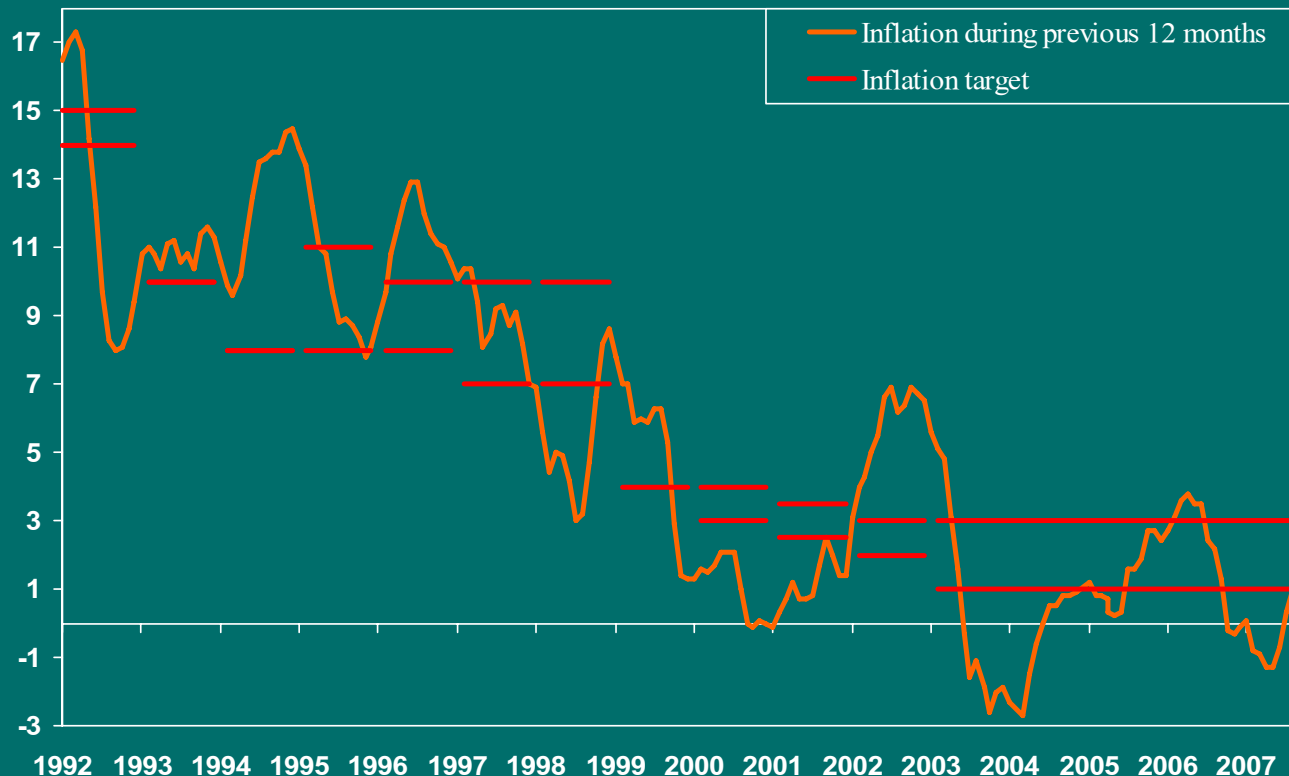
CBN, Abuja, 19 January 2008

# 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

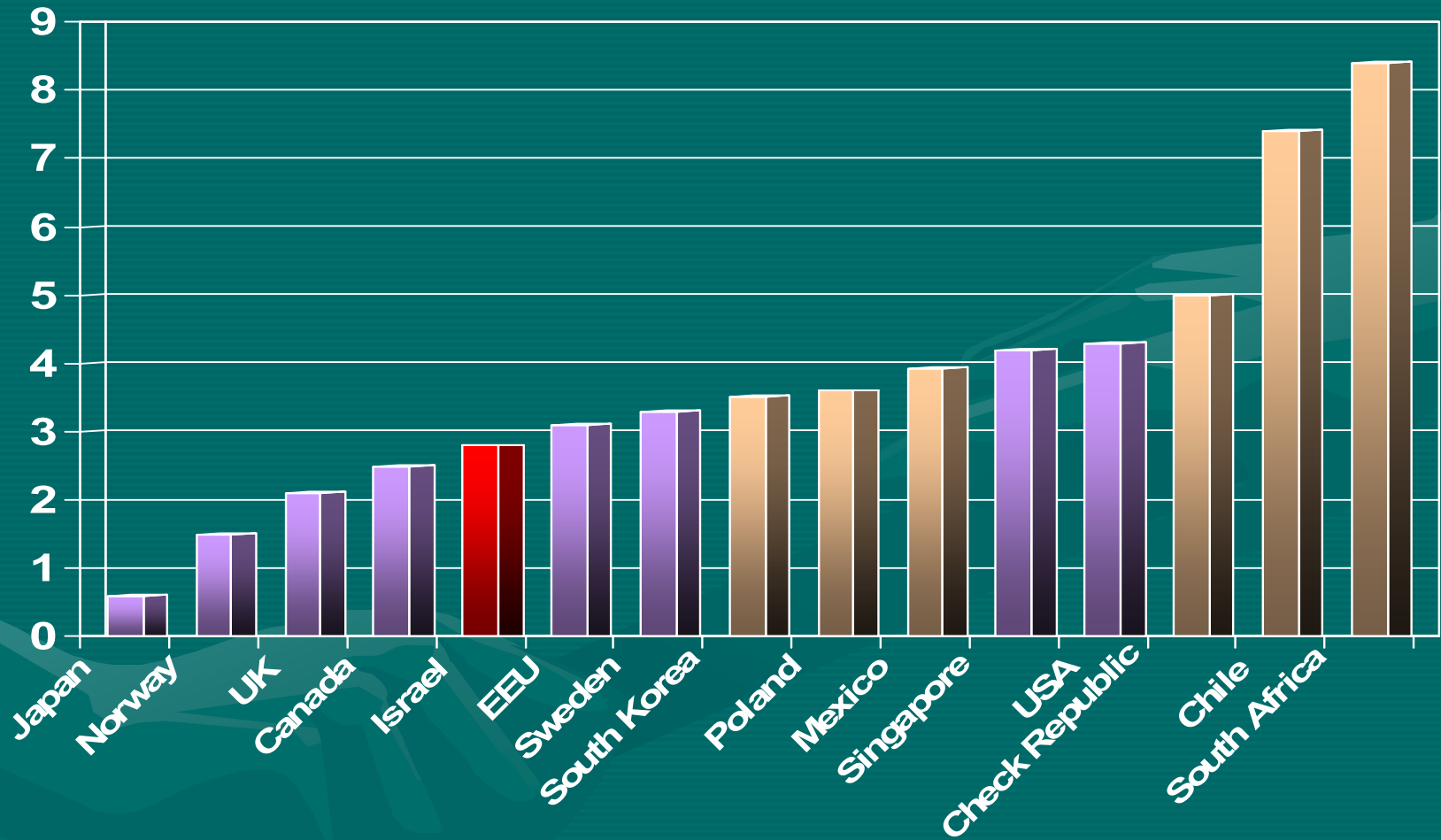
# Background of a Recent Successful Inflation Targeting( IT) Country -Israel

Rate of Inflation in Last 12 Months and Inflation Targets, 1992-2007



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



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

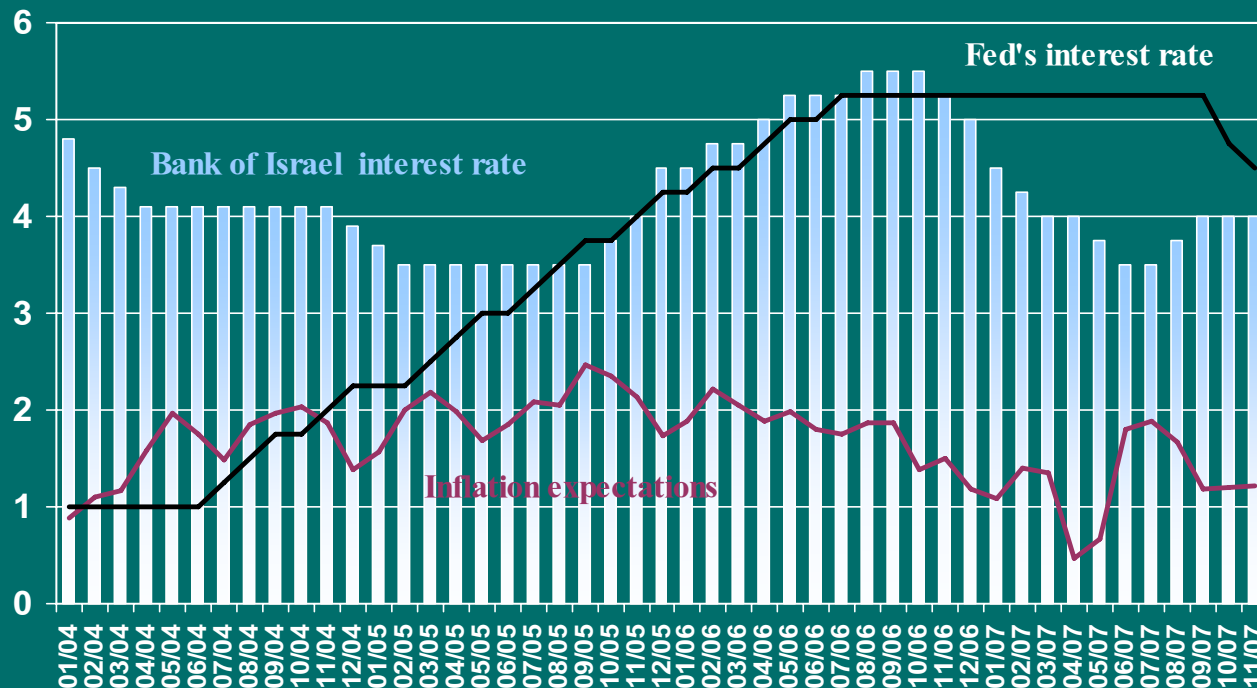
Public Sector Debt, Percentage of GDP, 2000-2007 (year-end)



A prudent fiscal policy reduced early the threat of fiscal dominance

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

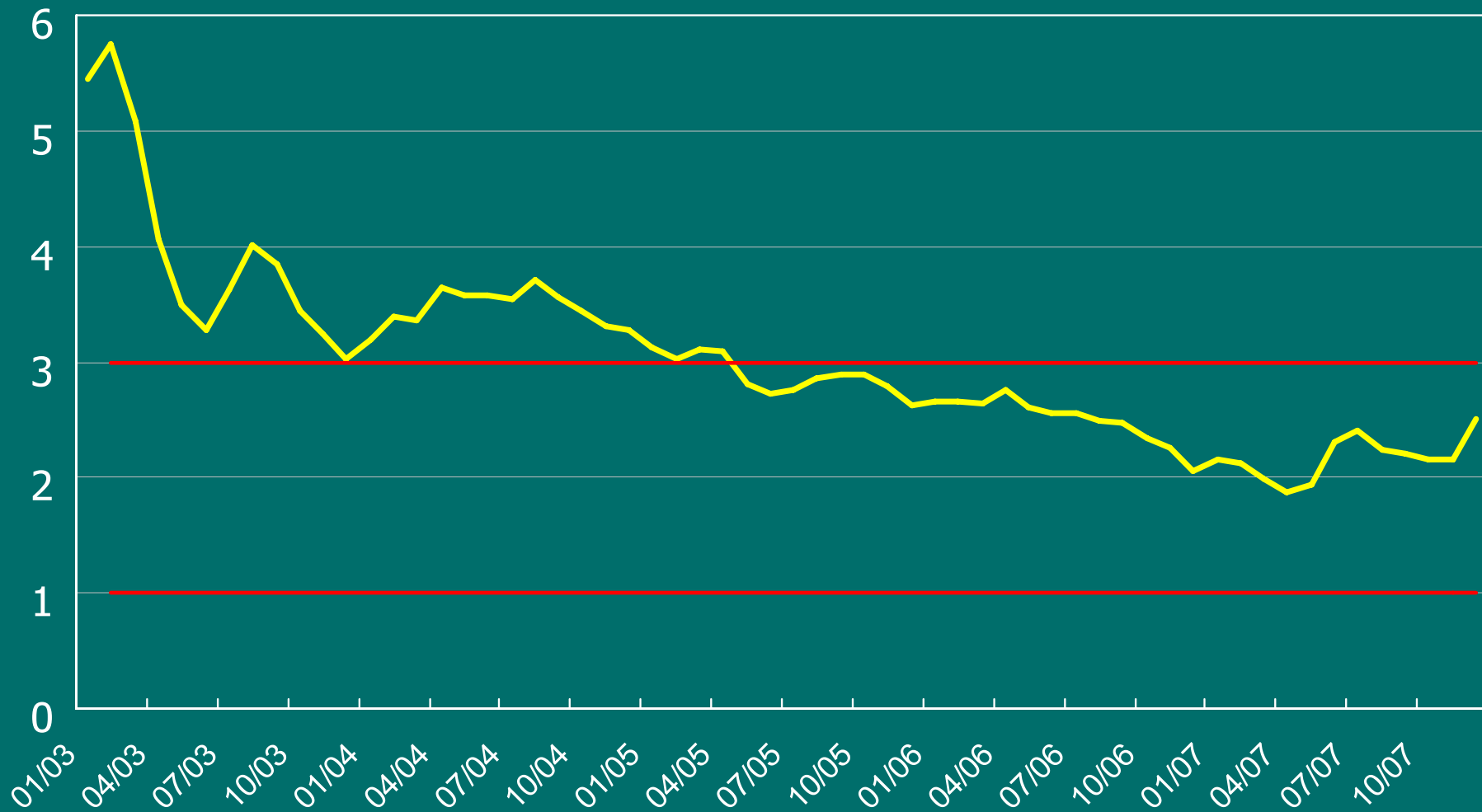
Bank of Israel Interest Rate, Inflation Expectations\*, and the Fed's interest Rate, 2004-2007



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

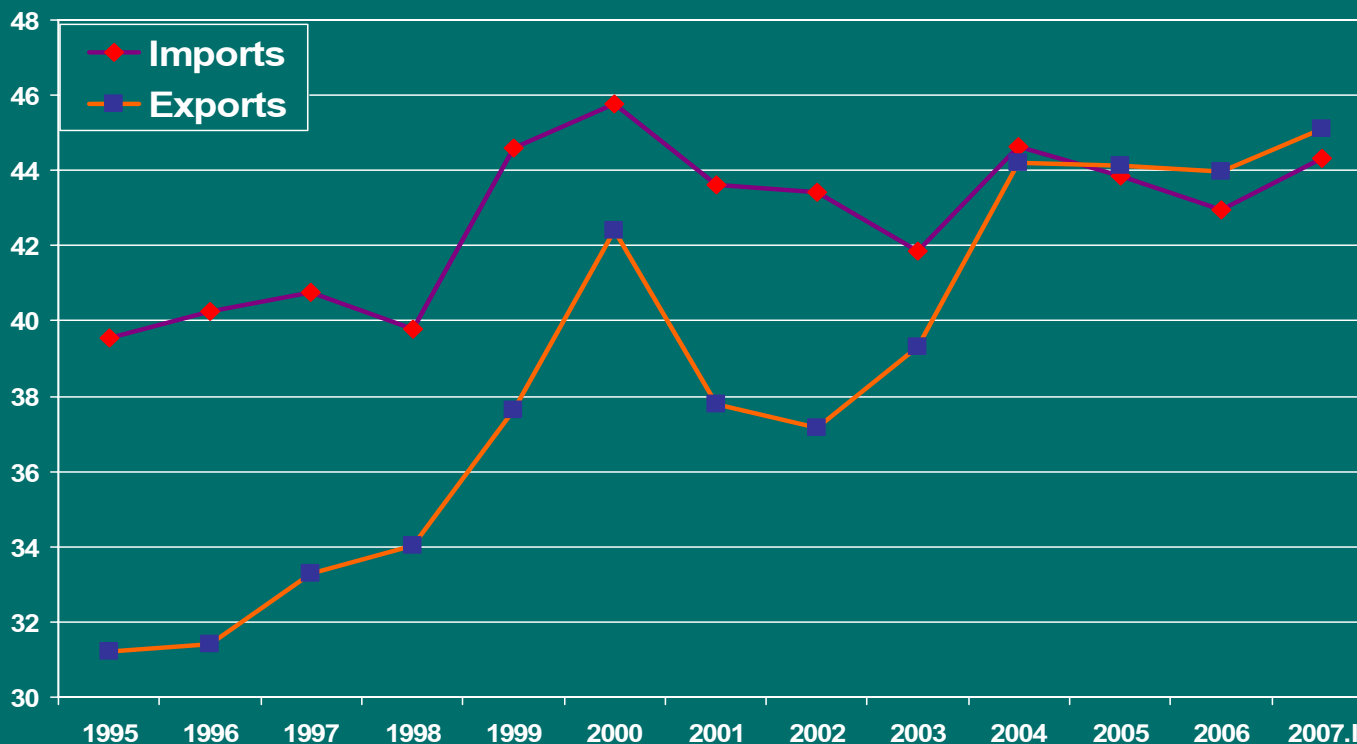
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# Background of a Recent Successful Inflation Targeting( IT) Country -Israel

%

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



\*First half of 2007.

\*Goods and Services.

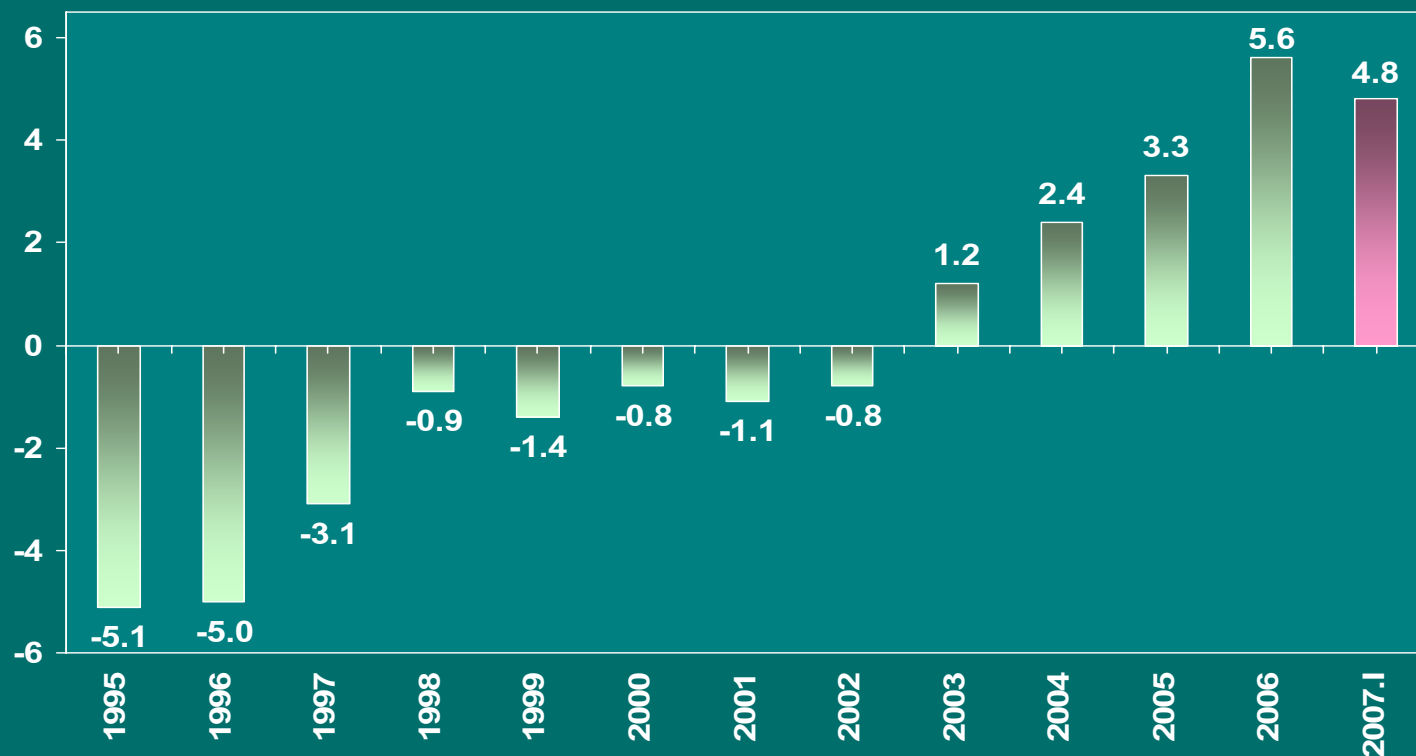
Source: National accounts, CBS.

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)



\* First half of 2007.

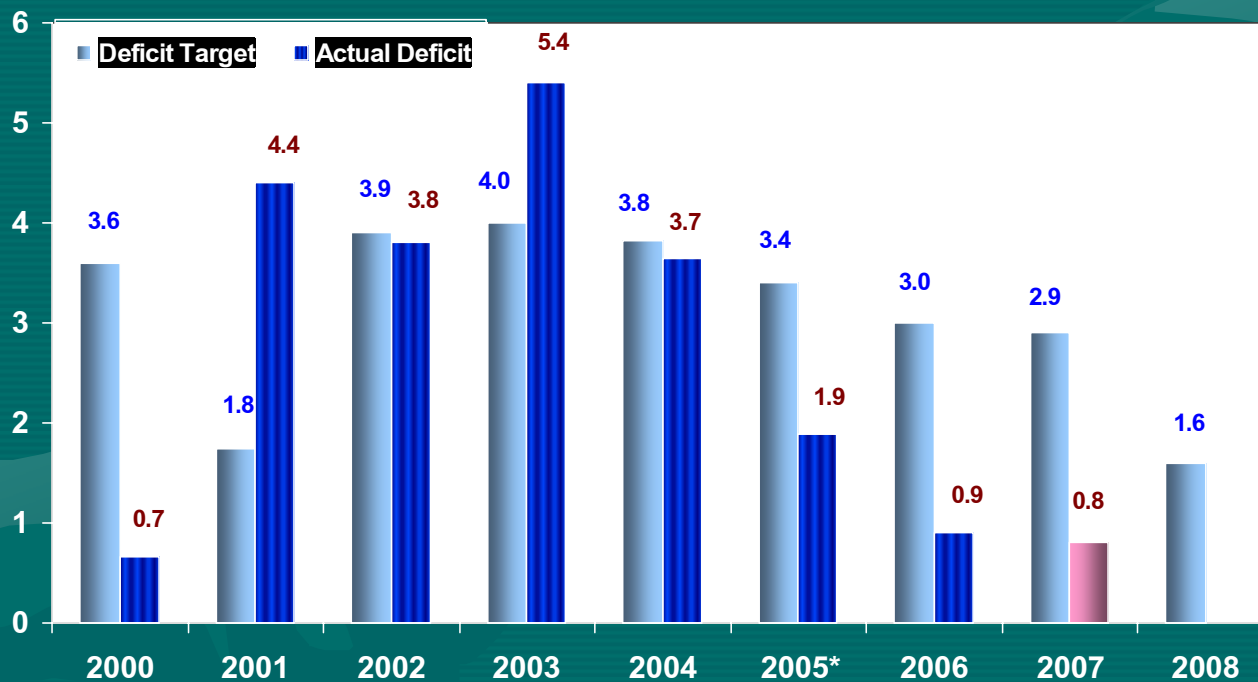
\* Foreign Currency Department forecast

•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.

Budget Deficit\* (percentage of GDP, 2000-2007)



\*Percent of GDP; excluding credit extended. Until 1996, domestic deficit; from 1997, total deficit.

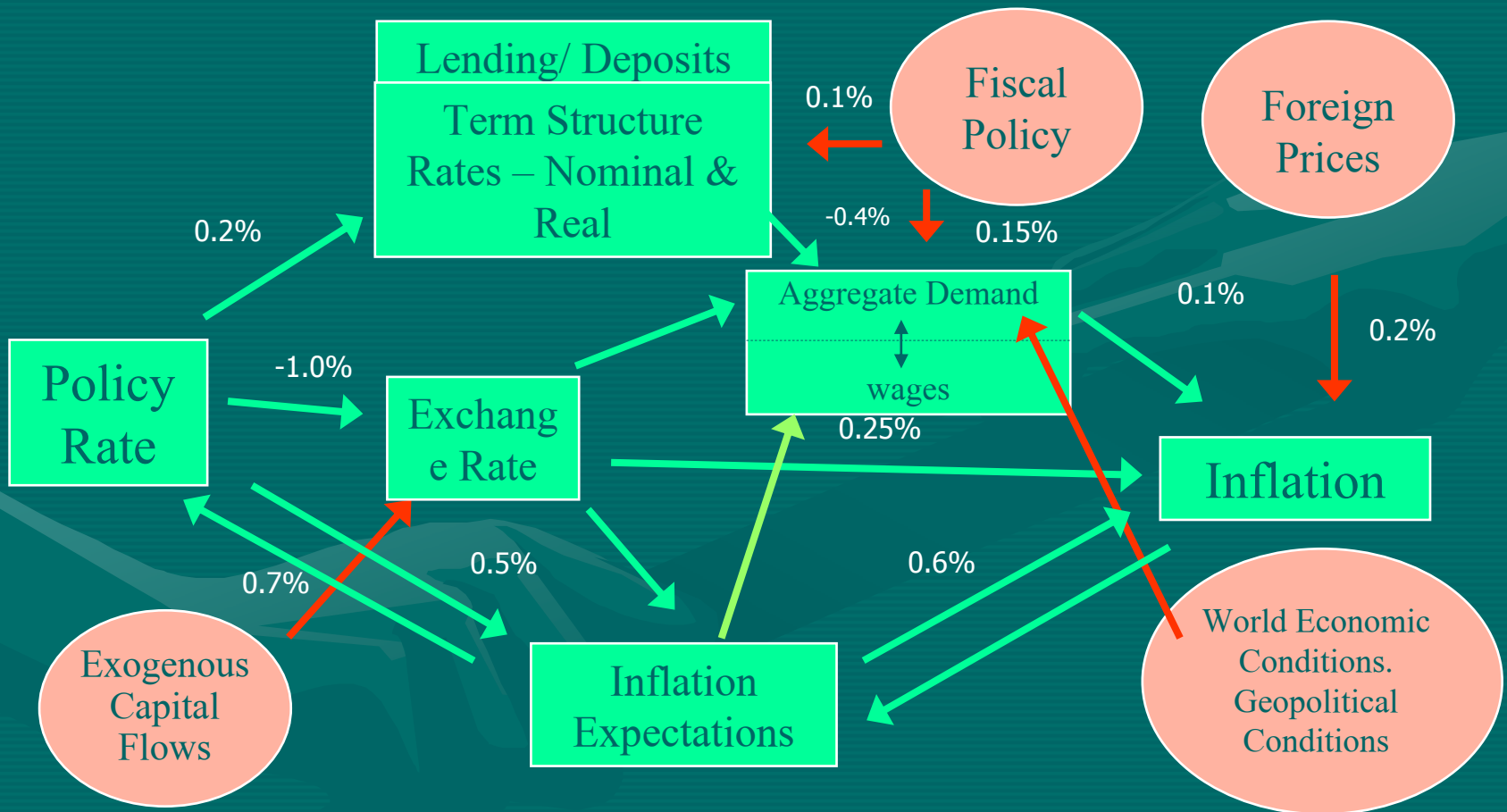
\*The data from 2000 refer to the deficit excluding the Bank of Israel's profits.

# 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



# The Advantages of the IT regime

- Helps to develop transparency, credibility and accountability.

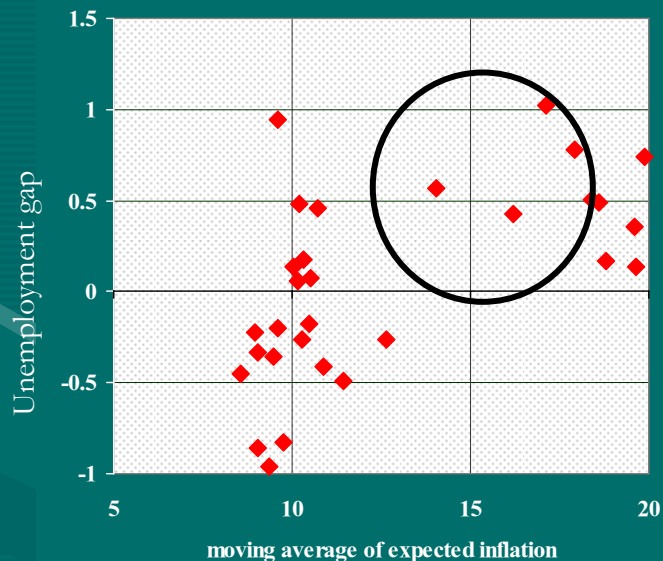


Despite many events that could shake financial stability and cause loss of credibility inflation expectations have been relatively stable.

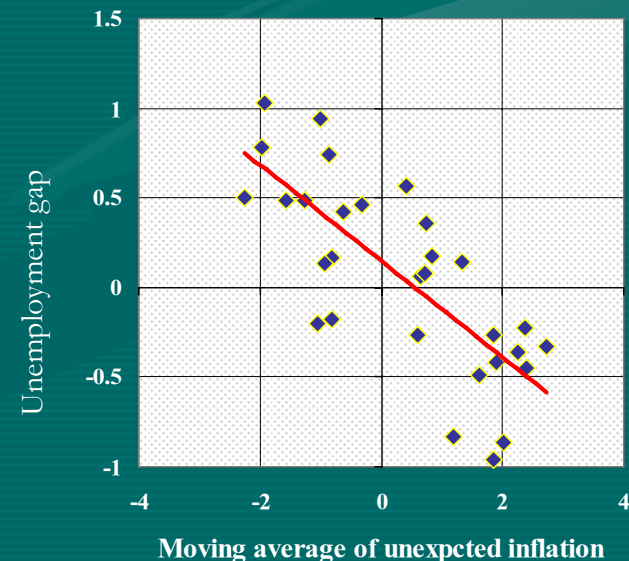
# The Advantages of the IT regime

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

Expected Rate of Unemployment and Inflation



Unexpected Rate of Unemployment and Inflation



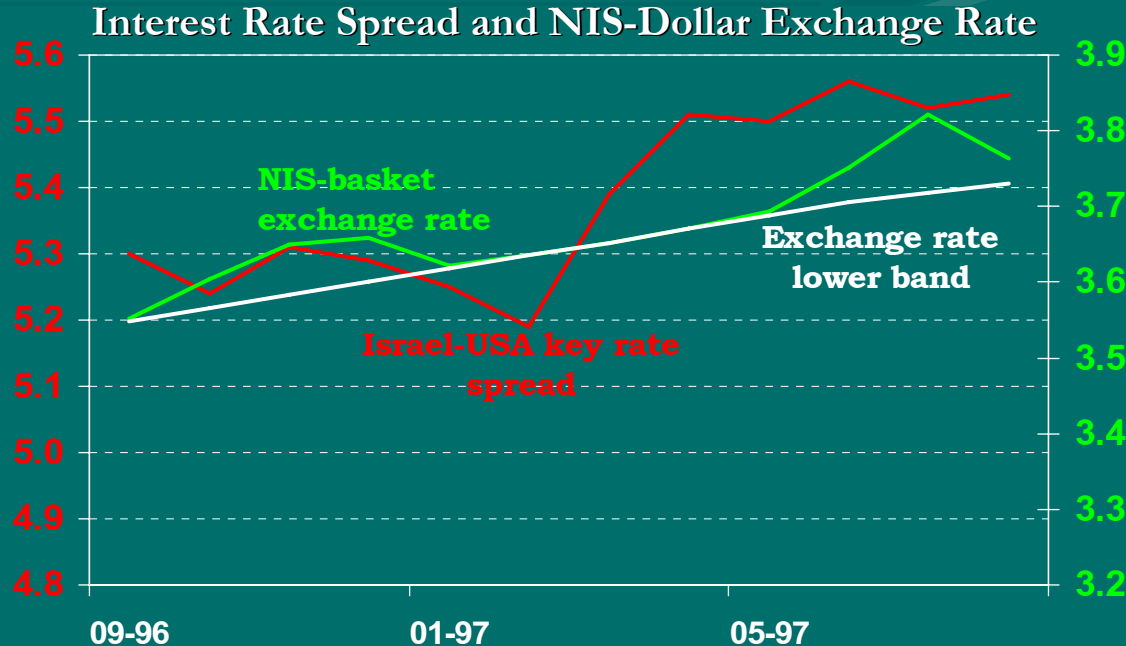
$$Y_{gap} = -1.542 + 0.799 * Z(1,5) + 0.159 * edp(1,5)$$

(-0.9)      (4.2)                      (1.1)

$R^2=0.394$     $DW=1.549$     $S=2.693$     $T=30$  (1991.2-1998.3)

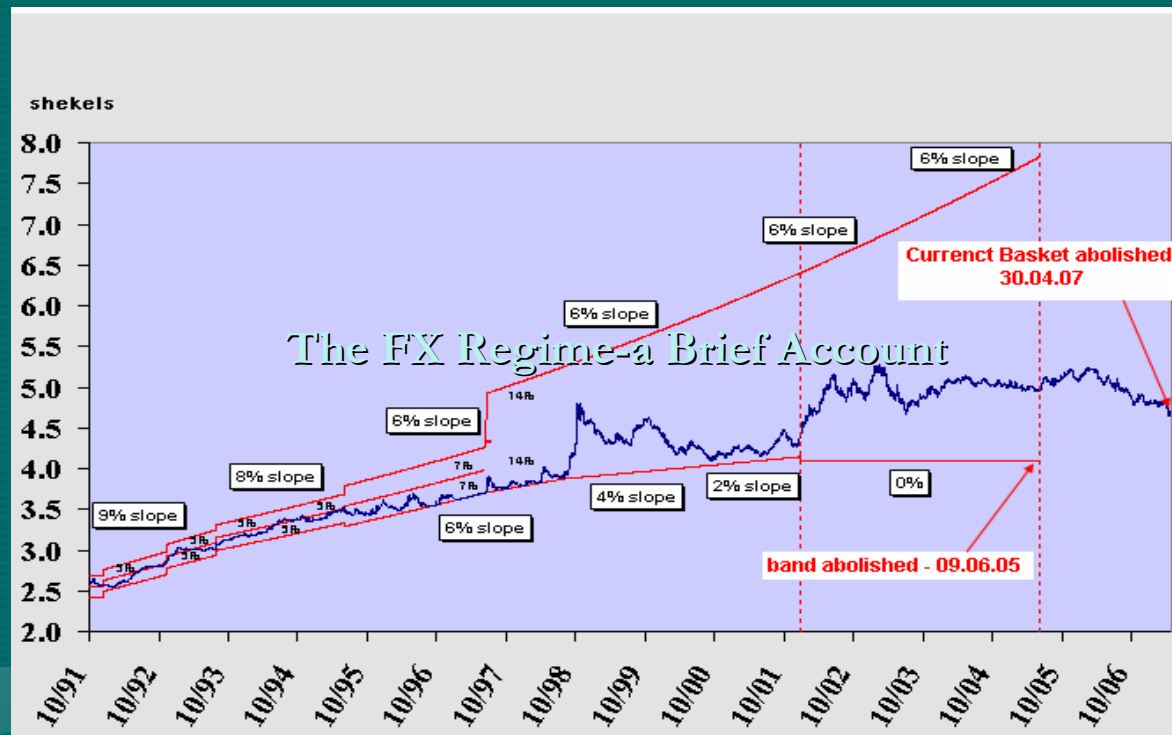
# The Advantages of the IT regime

- 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.



# The Advantages of the IT regime

## The FX Regime-a Brief Account



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

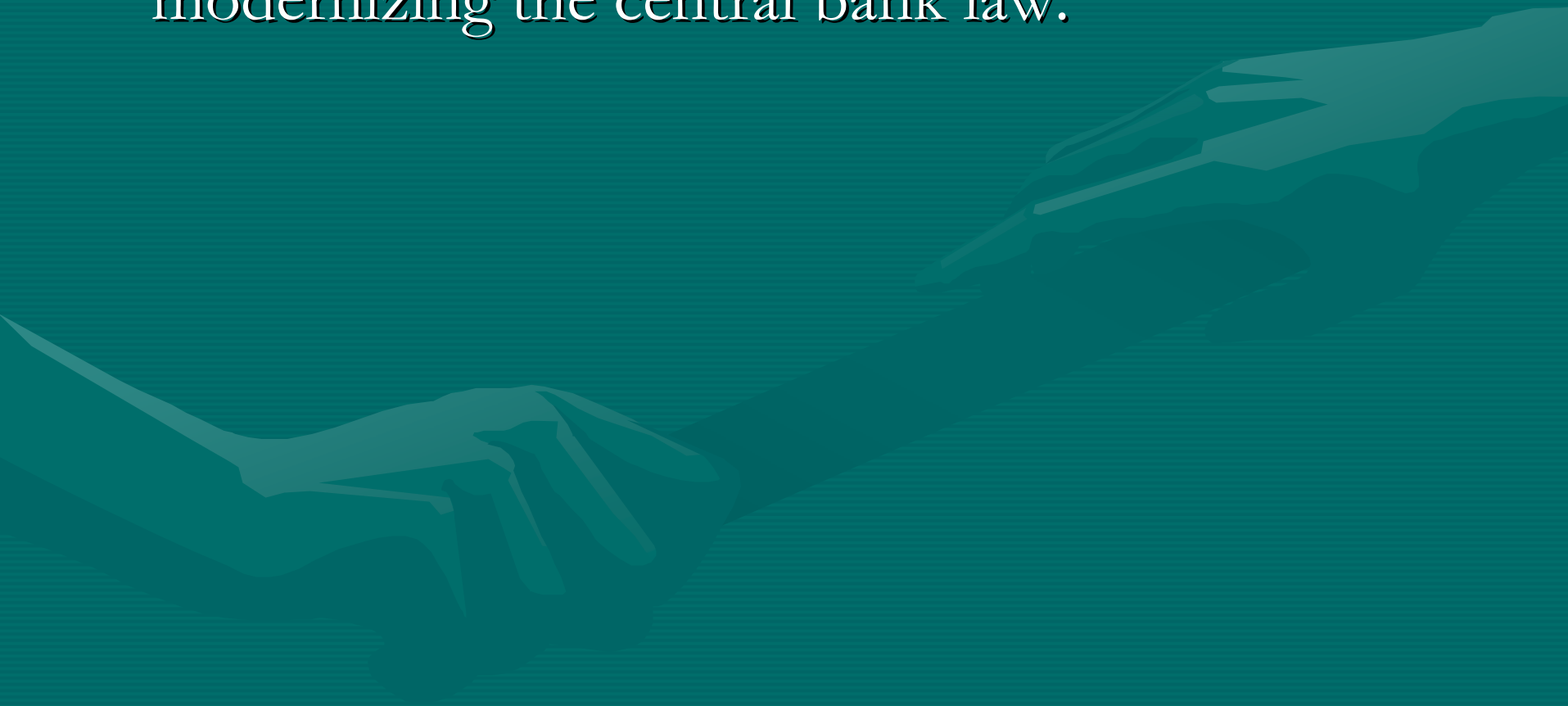
For over a decade the Bank of Israel (BOI) has not intervened directly at all in the FX market. Thus Israel's FX regime has in effect been for the last decade a clean float one.

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**

