The future of monetary policy after the Great Financial Crisis (GFC) is currently a popular topic. A book entitled „Advancing the frontiers of monetary policy“ would seem to fit into this category of „visionary“ writing. It would certainly come as no surprise that the IMF as the major international official financial and monetary institution would pull together over a dozen among its top experts to offer their take on this issue. But the focus of this volume is different, in that it analyses the evolution of the practice of monetary policy making since the early 1990s, based on relevant theoretical concepts and empirical insights, through the lense of inflation forecast targeting.

After an introduction and summary, the book is structured in three parts. A first block summarizes state-of-the-art mainstream monetary policy thinking. It comes as no surprise that the authors start from the premise that inflation forecast targeting is the strategy to be pursued by central banks - both in developed and low income countries - these days, as it ensures “clarity of purpose and execution” of monetary policy. In explaining inflation forecast targeting, the authors appropriately emphasize the central importance of managing expectations effectively, in order to affect medium and longer parts of the yield curve. In this context, the authors also explain the central role of carefully developed forecasting tools and
procedures, databases, and a well-organised production process for quantitative economic analyses. These are very practical and important considerations; they also provide a rationale why central banks, maybe more than other policy institutions, have developed a rather "scientific" approach to monetary policy.

The book then addresses how to devise efficient operational monetary policy implementation. The relevant chapter provides a very illustrative and up-to-date overview of four alternative approaches to governing operational frameworks based on short-term interest rates – two types of systems where the central bank aims to keep market rates around the middle of an interest rate corridor and two types of systems where the central banks provides a floor for money market rates. While before the GFC, monetary policy operations focused on the management of reserve balances and short-term money market rates, since the crisis many central banks have turned to using outright asset purchases ("quantitative easing") and to communicating actively on future monetary policy actions ("forward guidance") in order to also actively influence medium to longer term interest rates and thus to provide monetary easing. The book does not discuss the future role of outright purchases and the appropriate size of central banks' balance sheets further but develops the role of communication in a separate chapter.

The GFC has also highlighted the question of the relationship between monetary and financial stability, to which the book devotes a very useful chapter. While recognizing that, e.g. to safeguard an effective transmission of monetary policy impulses to the economy, monetary policy makers should pay due attention to financial stability and extend their analytical toolboxes in this direction, the authors subscribe to the mainstream view that it is for separate macro-prudential instruments to specifically address financial stability. Derived from a useful cost and benefit analysis, and in line with most monetary policy thinkers, the authors do not advocate a separate financial stability objective for central banks. However, developing the need for refining central banks’ analytical toolboxes further, another chapter considers how to incorporate financial conditions into the policy formulation process. There, the authors present a model and simulations which investigate the influence of financial conditions on output and output volatility. They find that optimal monetary policy, in addition to inflation and output, should take financial vulnerability into account; their result applies to the pre-GFC and GFC period, in both developed and developing countries. Still, while recognizing that, for instance, the Bank for International Settlements is quite critical of the narrow focus of inflation forecast targeting because of the risks arising from credit and asset price bubbles, the authors in the end subscribe to the mainstream separation principle between monetary policy and financial stability policy.

This first block of the book is concluded by a chapter on transparency and communication. There, the authors argue, in line with recent developments among inflation forecast targeting central banks, that central bank should also publish their conditional expected path of future policy rates (including indications of how this path might be changed in reply to changed future economic developments). They emphasize the communication challenges that would arise if the central bank's objective(s) were widened to explicitly include financial stability. While the authors appropriately attribute the
increased importance of central bank communication to the rise of inflation (forecast) targeting, the important role of the GFC and the need to prevent inflation expectations from gliding downwards might have been highlighted more. Also, the comprehensive nature of forward guidance, which goes far beyond guidance on short-term policy rates, is noteworthy. The ECB’s emphasis of “SAPI” (Sustainable Adjustment Path of Inflation) in the context of its forward guidance could have been embedded into the book’s overall theme of inflation expectations management and targeting.

The second part of the book offers four country case studies: Canada, the Czech Republic, India, and the United States. The choice of countries is clever: each of the countries can be viewed as being representative for a whole group of similar other countries, with Canada representing a developed small open economy with an independent, inflation targeting central bank (indeed, together with the Reserve Bank of New Zealand, one of the pioneers of inflation targeting). The Czech Republic stands for transition economies with floating exchange rates and an independent monetary policy. India is the low-income country in the group, with the typical challenge of stabilizing inflation. And the Fed stands for a central bank of a large developed economic area, with the specificity of a dual mandate but which de facto pursues an inflation forecast targeting strategy. The common bracket to these four countries is that they all pursue inflation targeting strategies.

It is notable that the case study section omits a the euro and the ECB. This may seem surprising since many monetary economists and practitioners – despite the ECB’s different language (“price stability definition”, more recently also „inflation aim“, „two pillar strategy“) - would also subsume the ECB’s monetary policy strategy under the header of (flexible) inflation (forecast) targeting, given the prominent publication of a medium-term price stability definition (or, in the ECB President’s recent communication, “inflation aim”), the importance of published euro area forecasts, and the strong focus on forward guidance, including on the future path of interest rates.

The final part of the book promises “A widened perspective for inflation forecast targeting”. In fact, it focuses on two aspects: first, specificities and challenges for inflation targeting in low income countries, which include, according to the authors, the prevalence of supply shocks, highly uncertain monetary transmission, an underdeveloped financial sector, and lacking or low-quality economic data. While one might conclude that such an environment is simply not suitable for such an elaborate, scientific and data-driven process as inflation targeting, the authors quite interestingly argue the other way round, namely to use inflation targeting as a framework to develop the analytical tools for their policy-making – and maybe, one might carry the idea further, as a catalyst to work on improvements of framework conditions for such a policy. Given there is a dedicated chapter on low income countries, one might have expected the authors to also address the topic of international spill-overs from big central banks’ monetary policy actions through exchange rate and various other channels, including global financial flows and fragilities. Emerging market central bankers do face the need for instruments to cope with such spillovers in the absence of international monetary policy coordination (see Gnan et al, 2018). Probably, space reasons prompted the decision to omit this
subject, since the IMF certainly has expertise and views on this issue.

A final chapter entitled “A robust and adaptable nominal anchor” offers a summary and conclusions, arguing that (flexible) inflation forecast targeting continues to be the state of the art in monetary policy making. In particular, contrary to alternative regimes, according to the authors, this strategy has proven robust under varying economic circumstances over time and across countries. In this chapter, the authors briefly touch upon some central and urgent questions that monetary policy makers face currently and in the years to come: a potentially much lower natural rate of interest, less distance from the zero or effective lower bound on interest rates, and the potential for negative feedback loops between consumer prices, real economic developments and financial instability in crisis situations. Yet, they refrain from offering solutions, instead referring to the need for concerted policy action in such circumstances. Such an endeavour is known to be difficult to put into practice. At the same time, the authors judge the effectiveness of unconventional monetary policies such as quantitative easing to be quite small. So, in the end, it remains unclear for the reader how monetary policy should cope with potential future deep recessions, financial crises and periods of deflationary threat.

For whom is this book, who is the target audience? The book successfully combines the relevant academic literature and policy-oriented advice and conclusions on state-of-the-art inflation forecast targeting. The origin of the authors undoubtedly helped to achieve this very useful outcome. The style is accessible, formal mathematical sections are quite limited. Practitioners will welcome this, while academic readers will certainly not perceive a lack of intellectual rigour. The content of the book is comprehensive yet concise. It describes the state of the art of inflation forecast targeting-based monetary policy making, while avoiding a critical and broad-ranging discussion about what monetary policy strategies and frameworks might - or should - look like five years from now. Supposedly, being an IMF publication, one typical target audience could be central bank officials in charge of reforming or improving monetary policy frameworks in their countries. In a sense, the volume reads like a „Handbook for monetary policy decision-makers“. But the book is of far more general usefulness. It is a good read for both policy practitioners, financial analysts, academics and students of monetary economics. Indeed, it could very usefully be added to reading lists of monetary economics courses. It should not be missing in any university, central bank or other library that aims to cover monetary economics. Highly recommended.

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References: