USAID

FROM THE AMERICAN PEOPLE

EG Technical Briefings
Volume III No. 2 February 2006

Inflation Targeting: An Overview

Background: With the recent appointment and confirmation of economist Ben Bernanke to the Chairmanship of the Federal Reserve Board of Governors, the issue of inflation targeting has taken on new significance in U.S. monetary policy discussions. A supporter of inflation targeting in previous publications and speeches, Bernanke testified in his confirmation hearings before Congress that he would support quantifying long-run price stability objectives and having the Federal Open Market Committee (FOMC) state explicitly the numerical inflation rate or range of inflation rates it considers to be consistent with the goal of long-term price stability, a practice currently employed by many of the world's central banks. But, he promised to take no precipitate action on this: further studies at the Fed, extensive discussion and consultations, and development of a consensus that taking such a step would further enhance the ability of the FOMC to satisfy its dual mandate of achieving both stable prices and maximum employment would be needed first.

The U.S. is only the most recent of a number of countries to consider adopting inflation targeting: New Zealand pioneered inflation targeting in 1990, after which an increasing number of developed countries adopted it, including the U.K., Canada, Australia, and the countries constituting the Eurozone. Developing countries too are showing increasing interest in this policy approach. As of January, 2006, Turkey became the 11th developing country to adopt the strategy as its primary means of addressing price-level stability, and the 23rd country to adopt it overall (Cevik, 2006). This brief outlines the advantages and disadvantages of inflation targeting, and some of the issues involved.

Definition: According to Mishkin (AER; 2000), a formal inflation targeting regime can be defined as a complete policy framework composed of five core elements, namely: (1) regular announcement by the central bank of a medium-term numerical target or range for inflation; (2) clear "institutional commitment" to subordinate any other monetary policy goals to price-level stability; (3) utilization of a variety of economic indicators (e.g. not just monetary aggregates or exchange rates) when making monetary policy decisions; (4) increased central bank transparency for the public on monetary policy objectives, plans, and actions; and (5) clear central bank accountability for attaining policy objectives.

Policy Alternatives to Inflation Targeting: Central banks in recent years have generally chosen one of three approaches to monetary policy: conducting their operations to achieve an exchange rate or target, a money quantity target, or an inflation rate target. Exchange rate targeting fixes the exchange rate between the local currency and a particular foreign currency or basket of selected currencies through central bank intervention in the foreign exchange market. Success depends on the credibility of the central bank's promise to maintain the pre-announced exchange rate or path. In targeting the money supply, a central bank gears its monetary policy actions to making the money supply follow a steady pre-determined path consistent with avoiding monetary disturbances to the economy. Success depends on the stability of the real demand for money and the reliability of the linkages between the variables the central bank can set or influence, and the money supply. Many developing countries have experienced high and variable inflation. The real demand for money is volatile, making

Technical Briefings is published by USAID/EGAT Office of Economic Growth in Washington, DC. This publication aims to share technical and analytical information with USAID field missions, especially with economic, private sector, and agricultural development officers. Any views, interpretations, and conclusions expressed in ***Technical Briefings*** are those of the author (s) alone and do not represent any official views of USAID or the U.S. Government. If you have feedback, suggestions or ideas about Technical Briefings, please contact Jim Elliott (jelliott@usaid.gov) Suggestions for subjects are always welcome. This Technical Brief was authored by Andrew Batchelor who is in EGAT/EG with the DIS project.

it hard for the central bank to predict the impact of its monetary policy actions on the money supply. A central bank cannot target both the exchange rate and the money supply at the same time. Either it must gear its actions primarily to making the money supply follow a preset path and let the exchange rate float, or it must gear its actions to supporting the exchange rate at its target level with little regard for what is happening to the domestic money supply, price level, inflation rate, or real exchange rate.

Advantages and Disadvantages of Inflation Targeting: Choosing the third monetary policy approach, targeting inflation, frees the central bank from having to achieve either a money supply or an exchange rate target. Inflation targeting, flexibly implemented, enables the central bank to focus on inflation without ignoring conditions in the domestic economy and to apply countercyclical measures as needed. Public understanding of inflation targeting is easily achieved, which in turn promotes transparency of central bank objectives and accountability for its actions. By cooling inflationary expectations, inflation targeting helps to lower inflation rates, eventually achieving a low and stable inflation rate or still better a price level stable in the long term (i.e. a zero inflation rate) and corresponding to this, public expectations of long run price-level stability.

However, some disadvantages can be associated with inflation targeting. If policies are not flexible, a temporary shock could lead a single-minded central bank to engineer a severe economic slowdown. The rate of inflation may respond to monetary policy actions only after a long time lag. If high inflation rates exist when an inflation targeting regime is instituted, inflation forecast errors are likely to result, inflation targets may be missed, and the credibility of the central bank as target-setter may be questioned. Thus, countries adopting inflation targeting are likely to do so not all at once but only gradually, in steps, first making periodic announcement about the likely rate of inflation, and then, eventually committing themselves to achieving the announced target rate of inflation. Third, inflation targeting can be undermined by fiscal excess—but so equally can exchange rate targeting or money supply targeting. Finally, dollarization—a phenomenon marked by partial or full adoption of a foreign currency as a unit of account for economic transactions—may pose a problem. Due to its implications for banks' and businesses' balance sheets, the central bank of a country with a highly dollarized economy cannot ignore the exchange rate, and thus may not make price-level stability its top priority.

Empirical Evidence: Empirical evidence to date supports the hypothesis that inflation targeting helps to lower inflation rates. Corbo and Schmidt-Hebbel (2001) estimate that in 18 inflation targeting countries, from the three years prior to policy adoption to one year after adoption, inflation rates dropped by an average of seven percent. They find that inflation rate targeters have also been quite successful in attaining their inflation objectives, deviating on average from their pre-announced targets or ranges by only 1.04 percentage points per year from 1990 to 2000, and on average achieving convergence to their announced long-term inflation targets in just eight quarters from the time of policy adoption. Thus, inflation targeting may be regarded as likely to be beneficial to a country adopting it. Evaluation of the success of inflation targeting adherents will go on, with countries in both the developed and developing world taking notice.

References:

Cevik, Serhan, "Turkey: Loving IT." Morgan Stanley Global Economic Forum, January 16, 2006.

Corbo, Vittorio and Klaus Schmidt-Hebbel, 2001. "Inflation Targeting in Latin America." Central Bank of Chile Working Paper, Number 105.

Mishkin, Frederic, 2000. "Inflation Targeting in Emerging-Market Countries." *The American Economic Review*, Volume 90, Number 2, pages 105-109.