

Economist.com**Articles by subject: Topics: Economics****ECONOMICS FOCUS****Economics focus****On target?**

Aug 30th 2001

From The Economist print edition

Inflation targeting is all the rage, but this approach to monetary policy does not provide all the answers

CENTRAL bankers are dedicated followers of fashion. This year, countries as diverse as Iceland and Turkey are joining the in-crowd by adopting inflation targets. Since New Zealand pioneered the practice in 1990, it has become ever more popular. By the end of last year, a further 18 countries, from both the developed and developing world—ranging from Britain and Canada to Chile and South Africa—had followed suit.



A new study* of the first decade of inflation targeting shows why the bandwagon is rolling. The regime has proved “a very successful new monetary framework”, conclude Frederic Mishkin and Klaus Schmidt-Hebbel. It has helped countries to bring inflation down to levels that would not otherwise have been reached, they argue. In emerging economies, the reduction in inflation has involved a smaller sacrifice in terms of lost output than other policy regimes. In both developed and developing countries, output over time has become less volatile.

But wait: inflation targeting was launched into calm seas. With largely benign economic conditions during the 1990s, sceptics say, the new regime has not really been tested. Not so, respond the two authors. Many countries with inflation targets are small, open economies that suffered big currency devaluations after the Asian crisis of 1997-98. Yet, unlike earlier shocks, this one did not cause inflation to surge.

To a large extent, the virtues of inflation targeting lie in the absence of the vices of other regimes. Unlike exchange-rate commitments, inflation targets are not vulnerable to speculative attacks on the currency. Unlike monetary targets, inflation is a final rather than intermediate goal. That would not matter for monetary targets if there were a direct link between money-supply growth and inflation. Yet this relationship has proved treacherous, mainly because of instability in the demand for money.

By contrast, an explicit inflation target anchors price expectations in a far more straightforward way—by combining a clear, rules-based regime with some tactical discretion by the central bank over how to hit the target. As with the best conjuring tricks, there is some sleight of hand here: inflation targeting depends on credibility. If the central bank can convince the public and the markets that it is utterly committed to its goal, people’s expectations will change. Once price-setters and wage-bargainers believe that the central bank means business, monetary policy gains extra clout.

In principle, the same trick should work if the economy is suffering from deflation rather than high inflation. Some Japanese politicians have joined economists in urging the Bank of Japan to adopt an inflation target. They think that the reform would help to loosen the grip of a deflationary mindset. If the Japanese expected prices to rise again, that would enhance the effectiveness of the Bank's monetary policy in overcoming deflation. A look at Sweden's experience with a price-level target in the 1930s suggests that it succeeded in raising inflationary expectations despite fears of deflation.

The spread of inflation targeting has gone hand-in-hand with greater independence for central banks. Credibility, again. The more independent central banks are, the more they are trusted by investors. That allows them to get the financial markets to do more heavy lifting. If the central bank cuts short-term interest rates, investors will no longer counteract the monetary easing by demanding higher rates on long-term bonds, in expectation of rising inflation. But as part of the deal, central banks have had to lift traditional veils of secrecy, to become more open in their operations and better at signalling their intentions to the markets.

Inflation-targeting regimes have a further virtue: they create a framework in which a central bank can be both independent and democratically accountable. The government can set the goal for inflation while leaving to the operationally independent central bank the task of how to meet that objective. This division of responsibility can reinforce, not diminish, the central bank's authority.

The end of monetary history?

Listen to some advocates of inflation targeting, and you might imagine that they have discovered the holy grail of monetary policy. In fact, the jury is still out on the effectiveness of a regime that has not yet been tested by inflationary shocks like those of the 1970s and 1980s. So far, inflation targeting has locked in low inflation rather than brought about major disinflation. In this respect, Turkey's experience will be a valuable test case, for the annual rate of inflation is forecast to be almost 60% when the new system comes into force later this year.

Furthermore, however desirable it is to secure low inflation, narrowly defined, this cannot be the sole objective of monetary policy. After all, dangerous imbalances can build up in the economy even when inflation as conventionally measured is at bay. There is a strong case for the central bank to take more explicit account of asset prices or of misaligned exchange rates rather than focus only on retail-price inflation.

The point is that there is more to monetary policy than trying to achieve a single policy objective. The solution to this problem of multiple goals is to allow the central bank more discretion. However, that could start to undermine the credibility that underpins a largely rules-based regime. For all its virtues, inflation targeting does not resolve all the problems surrounding monetary policy.

* ["One decade of inflation targeting in the world"](#), by Frederic Mishkin and Klaus Schmidt-Hebbel. National Bureau of Economic Research working paper, July 2001.