Describe the strategy of inflation targeting economics essay

ASSIGN BUSTER

In recent years, policymakers realized the weight of the inflation cost on the economy and started to pay more attention to the price stability goal. The latter is increasingly considered as the most important goal of monetary policy. Inflation has detrimental effects that could lead to a low economic growth, making the future hard to anticipate (Mishkin, 2007).

The need to adopt monetary policies that can subsequently overcome the inflation issue had emerged in many countries. Central Banks had different options of strategies to implement in order to achieve long-term price stability including the inflation targeting and the monetary targeting also known as money growth targeting. In the first case, Central Banks target an explicit value of inflation while in the second case, they aim to reach a certain level of growth of a monetary aggregate.

An increasing number of countries have chosen the inflation targeting to achieve price stability (Genberg, 2002). Some of them have moved away from monetary targeting to inflation targeting. A question arises: why are the Central Banks using inflation targeting over money-growth targeting?

To address this question, this paper will confront these two monetary policies and try to understand the reasons of the decline of monetary targeting in favour of inflation targeting.

MONEY-GROWTH TARGETING

Definition

The money-growth targeting refers to one of the monetary policy strategies' where central banks targets an objective of an annual growth rate of a monetary aggregate (M1, M2…) in order to maintain price stability. A set of

variables called intermediate targets such as money supply are used in order to have an impact on the level of inflation. These variables have to satisfy three conditions that are: measurability, controllability and ability to predictably affect the goal that is price stability. For instance, the Central Bank can announce that it will attain 5% growth rate of M2. This is an indirect way to control the final target of inflation (Mishkin, 2007). Money-growth policy was adopted in 1975 by the US Federal reserve to answer the request of Congress about setting monetary targets. Germany, United Kingdom, France and many other countries also implemented the money-growth policy in late 1970s.

Examples of countries that adopted money-growth targeting

In the 1970s, many countries chose this monetary targeting policy; some of them such as Germany succeed in its implementation whereas others such as the United States failed to reach their growth target range.

The German success relied on two main elements: first, the flexibility of their policy rule that targeted a money aggregate but allowed it to fluctuate within a tight interval; and second, the good communication by the Bundesbank to the public.

Conversely, the United States failed in implementing this monetary policy mainly because of a poor monetary control and a priority given to interest-rate movements to control inflation (Mishkin, 2007).

Many cases of failure of money-growth targeting led Central Banks to change their monetary policy in favour of inflation targeting.

INFLATION TARGETING STRATEGY

Definition of inflation-targeting

Inflation targeting was firstly adopted by New Zealand in 1990, then many countries followed such as the United Kingdom in 1992 (Mishkin, 2007).

It is a monetary policy strategy that aims to sustain an explicit target level of inflation to achieve long run price stability.

It is based on five key elements:

publication of the numerical targets for inflation

“ institutional commitment” to sustain price stability as a principal goal

information-inclusive strategy with many variables that are used for deciding the setting of monetary policy instruments

communication to guarantee the transparency

accountability of the Central Bank for hitting its inflation target (Mishkin, 2000).

Although these five key elements are common to many countries, the way they are interpreted and applied should be country-specific. Indeed, even if countries have similar goals, they are different in their level of sensitivity to shocks and in the way they transmit mechanisms. Thus, they may imply different reactions to the same event (Genberg, 2002).

The successful case of Chile

The Chilean example illustrates a case where implementing the inflation-targeting was successful. In 1990, the inflation rate of that country was almost 30%. The Central Bank decided to adopt this new strategy by targeting a certain level of inflation (more than 20%) for the following 12 months. Year after year, the Chilean Central Bank reduced the inflation objectives until reaching 3. 5% at the end of the decade. The Consumer Price Index inflation followed the tendency of the inflation target as it decreased from almost 30% in 1990 to 3% in the end of 1999 as we can see in the graph below. Thus, targeted inflation rates were remarkably achieved (Valdés, 2007).

Consumer Price Index Headline Inflation and Inflation Targets, 1985-1999 (%)

The success of this “ gradual disinflation” is due to the actions and the independence of the Chilean Central Bank but also thanks to two main supportive policies: the good fiscal policy avoiding large deficits and the healthy financial system encouraging regulations (Mishkin, 2000).

Why many countries shifted away from money-growth targeting to inflation targeting?

The decline of money-growth targeting

One of the major disadvantages of money-growth targeting is that the achievement of the inflation objective depends on one essential condition which is the strength of the relationship between the targeted monetary aggregate and inflation; otherwise the desired result will not be reached. If

this connection is weak, it would be difficult to use money-growth targeting to communicate, and this will alter the transparency of Central bank’s policy.

Indeed, this unpredictable and instable relationship between targeted monetary aggregate and the goal variables led several countries in the 1990s to shift from money-growth policy to the inflation targeting strategy.

In the 1980s, the financial innovations combined to the deregulation of the financial markets harmed the reliance on monetary targets by reducing money’s controllability (Granville, 2010).

Furthermore, in the same period, the gold standard system was abandoned because of the ascent of immaterial economy. The monetarism was degraded which promoted the rise of inflation targeting. Moreover, exchange rates were also used as a target from mid-80s to mid-90s but their efficient as means of stabilizing economy were suspected especially after the currency crisis of the 1990s.

Thence, inflation targeting became the most reliable substitute to these declining instruments.

Advantages and disadvantages of inflation targeting

The inflation targeting policy counts several advantages and disadvantages; this paper will focus on the main ones.

Unlike money growth targeting, the inflation targeting success is not based on the relation between inflation and money. Indeed, a Central Bank can use other variables to conduct properly this monetary policy.

Central Bank's frequent interaction with governments, which are in charge of making public announcements, drives the inflation targeting strategy to be more transparent. These settings allow the public to get a better understanding of the policy (Bernanke et al., 1999). By stating an explicit numerical target of inflation, its evolution is clearer and easily understood and followed. For example, the Chilean Central Bank maintained its credibility by announcing on each September an annual targeted inflation rate for the next year on its Report to Congress (Valdés, 2007).

Thanks to this transparency, Central Bank's accountability increases which reduces the occurrence of time incompatibility when the Central Bank applies an expansionary monetary policy in order to increase employment in the short run (Mishkin, 2007).

However, inflation targeting has major disadvantages. The first one is the delayed signalling due to the inability of inflation target to send instantaneous signals. However, this issue cannot be overcome by the money-growth targeting as the signal of the monetary aggregates is not strong.

The second disadvantage concerns the rigidity of inflation targeting because of the inflexible rules of the policy and the restricted capability of the policymakers to react to unpredictable events (Mishkin, 2007). Nevertheless, in practice, inflation targeting is flexible, as it does not impose mechanical directives. Indeed, this monetary policy enables Central Banks to adapt its implementation to different situations. For instance, during its first adoption of the inflation targeting strategy in 1991, the Chilean Central Bank decided

to rely on inflation projections rather than formal inflation targets as suggested by this monetary policy. Few years later, after achieving and reducing its inflation projections, the Central Bank started considering hard inflation targets and started being accountable for hitting them (Mishkin, 2000). According to Valdés (2007), the Chilean case shows that inflation targeting “ raises the possibility of self discovery, improvements and learning”.

Also, the fact that inflation depends on several variables makes it hard to control. Indeed, inflation integrates the impacts of these variables that are not disclosed in the short run.

Finally, inflation targeting may not guarantee fiscal order. In fact, when fiscal deficits occur, they can be financed by either devaluating or printing money. In the two cases, inflation increases.

CONCLUSION

Adopting the appropriate monetary policy is vital for the progress and the prosperity of an economy. Many cases of money-growth targeting failure led Central Banks to change their monetary policy in favour of inflation targeting.

The Chilean case represents a successful implementation of inflation targeting. Indeed, the inflation targets were remarkably reached.

However, the example of Chile does not allow us to deduce that inflation targeting may succeed for all countries. Although countries have similar goals, they may have different reactions to the same event.