A Stable International Monetary System Emerges: Inflation Targeting as Bretton Woods, Reversed

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Motivation

- Many Currency Crises through end of 20^{th} century
  - Fewer Now
- International Financial Crises: Are they a Relic of an Archaic "System" that is Disappearing?

The New Development: Countries with Inflation Targets

- 14 (of 30) OECD countries have inflation targets (IT)
  - Population > 430 million
  - 12 OECD (+3 more) in EMU, closet inflation targeter
    - 2 more (Denmark, Slovakia) waiting to join
  - US another closet IT; Japan soon?
- 10 developing countries (> 750 mn) also target inflation

- Arguably most important, successful monetary framework
  - Spreading quickly

The International Financial System

- Collective interaction of national monetary policies is international monetary system
  - Ex: Bretton Woods was fixed exchange rate policy
  - Now fixed exchange rates are rare; but floating is not a well-defined monetary policy
- What are the consequences of IT for international financial regime?

Definition of Inflation Targeting

Mishkin’s 5 IT components:

1. Numerical, public medium-term inflation target
2. Price stability as primary goal of monetary policy
3. Information-inclusive strategy to set instrument(s)
4. High transparency of monetary policy strategy
5. High accountability of central bank for IT

Inflation Targeting Countries

	Default Start Date	Mexico	January, 1999
Australia	March, 1993	**New Zealand**	March, 1990
Brazil	June, 1999	**Norway**	March, 2001
Canada	February, 1991	**Peru**	January, 2002
Chile	January, 1991	**Philippines**	January, 2002
Colombia	September, 1999	**Poland**	September, 1998
Czech Republic	January, 1998	**South Africa**	February, 2000
Finland*	February, 1993	**Spain***	January, 1995
Hungary	June, 2001	**Sweden**	January, 1993
Iceland	March, 2001	**Switzerland**	January, 2000
Israel	January, 1992	**Thailand**	May, 2000
Korea	April, 1998	**United Kingdom**	October, 1992

* joined EMU, January 1999

Recent Adopters:

Indonesia	July, 2005	**Slovak Republic**	January, 2005
Romania	August, 2005	**Turkey**	January, 2006

Countries Tend to Adopt IT after Exchange Rate Crises

- Brazil, Czech Republic, Finland, Indonesia, Korea, Mexico, Philippines, Sweden, Thailand, Turkey, United Kingdom

Only 3 Crisis Countries have not switched to IT (yet):

- Argentina, Malaysia, Russia

Inflation Targeting Entails Floating Exchange Rate

- Formal intermediate target is inflation forecast (not exchange rate/money growth rate)
- Many IT countries float freely

Floats Are Sometimes Managed, at least initially

- Some intervention by Australia, LDCs … usually to hit IT, not maintain fix (though some initial dual targets)
- But exchange rate losing importance as indicator or target of monetary policy for IT countries (e.g., Chile, Israel, NZ)

Durability of IT Regimes

- 27 countries had IT by mid-2007
  - Only 2 have left (Finland, Spain joined EMU)
  - Neither under duress
- *Big contrast to alternative monetary regimes*, especially fixed exchange rate regimes

Exchange Rate Regimes Typically Short

- Ex ample: Jamaica switched exchange rate regimes 11 times in 15 years (1990-2004)
- Only 5 non-IT countries have had no changes since 1990
  - Morocco targets M1 growth, with peg against secret multilateral basket, and many capital controls
  - Syria pegs with controls, multiple exchange rates
  - HK has successful currency board
  - US and Japan have "no explicit nominal anchor, monitor various indicators to conducting policy"

Exchange Rate Regimes are *not* durable for Countries without Inflation Targets

- Average Time Between Exchange Rate Regime Change is around 6 years
- So IT is far more durable than Exchange Rate Regimes!
  - This durability a big Contrast with Previous Systems

Many Contrasts with Bretton Woods System

		Bretton Woods	**Inflation Targeting**
1	Regime Durability	Low	High
2	Exchange Rate Regime	Fixed	Floating
3	Focus of Monetary Policy	Partly International	Wholly Domestic
4	Intermediate Target	Exchange Rate	None/Inflation Forecast
5	Capital Mobility	Controlled	Relatively unrestricted
6	Current Acc. Imbalances	Limited	High
7	System Design	Planned	Unplanned
8	International Cooperation	Necessary	Not required
9	Role of IMF	Key in principle	Small
10	Role of Gold	Key in principle	Negligible
11	Role of US as Center	Key in practice	Small
12	Key Members	Large, Northern	OECD/LDCs, often small
13	Central Banks	Dependent, Unaccountable	Independent, Accountable
14	Transparency	Low	High
15	Alignment with Academics	Worrisome	High

Essentially Bretton Woods *Reversed*!

Do IT Countries Have Higher Exchange Rate Volatility?

- Domestic focus of monetary policy *might* result in *higher* exchange rate volatility
  - Countries with fixed exchange rates have nominal lower exchange rate volatility (and real, in short run)
- But: lower policy volatility, more stable expectations *might* result in *lower* exchange rate volatility

In Fact, Exchange Rate Volatility is Actually *Lower* for IT Countries!

- Countries that target inflation have between 2% and 5% lower real exchange rate volatility
- Robust results

Does Inflation Targeting have Other Effects?

- No effect on International Reserves
- No effect on size of Current Account Imbalances
- “Sudden Stops” of capital inflows seem *less* likely with IT
- No Inflation Targeter has *ever* experienced a banking crisis!

Conclusion

- Few Monetary Strategies exist
    - Fixed exchange rates
    - Money growth targets
    - Hybrid/Ill-defined strategies
    - Inflation Targets; the focus

Characteristics of Inflation Targeters

- Floating exchange rates
  - Often without interventions or capital controls
  - But ER volatility actually *lower* than non-IT
  - *No* observable consequences for reserves/current accounts
  - Sudden stops *less* frequent
- IT is *highly* durable
- IT spreading quickly outside OECD (pervasive inside)

Many Aspects of Bretton Woods Completely Reversed

- Domestically-oriented monetary policy
- Aligned intermediate target (inflation forecast)
- Capital Mobility, capacity for big current accounts
- No role for center country, coordination, gold, IMF
- Big role for independent transparent central banks
- Unplanned system
- Aligned with most academic thinking
- Durable Floating!

Financial Crises are not a feature of Inflation Targeters

- Are they a thing of the past?