VOX
Research-based policy analysis and commentary from leading economists

Are international financial crises a relic of the past? Inflation targeting as a monetary vaccine

Andrew K. Rose

31 May 2007

A new world financial 'non-system' is emerging consisting of nations with independent central banks that target inflation who let their exchange rates float, usually without controls on capital flows and often without intervention.

The 1990s were plagued by international financial crises. Countries rich and poor, and large and small saw their currency attacked by speculators and their fixed exchange rate policies thrown into the dust-bin of history. The UK in 1992, Mexico in 1994, Thailand in 1997, Russia in 1998, Brazil in 1999 …the list is long. Yet since the collapse of Argentina in 2001, the international financial system has been an oasis of stability. Some believe this is merely good luck, and that the bad old days will return. They are wrong.

Countries have few choices for their monetary strategy. Historically a large number of countries chose to hitch their monetary policy to a fixed exchange rate. In a world of massive international capital flows, exchange rate fixing subordinates domestic goals of monetary policy – low inflation, full employment and the like – to the exchange rate target. Since this subordination of domestic concerns automatically faces the central bank with conflicting interests, most fixed exchange rates did not stayed fixed for long.

In reaction, the past decades have seen many nations experimenting with other strategies – money growth targets, monetary unions and boards, ill-defined or hybrid strategies. Since 1990, a new monetary strategy emerged from the Antipodes; inflation targeting. Inflation targeting requires that the central bank has a numerical inflation target to hit in the medium run in a transparent and accountable fashion, and this should be as the most important objective of monetary policy.

Inflation targeting has met with unprecedented popularity in the stodgy world of central banking; fourteen of the thirty OECD countries have already adopted inflation targeting! But even this understates its importance. Twelve OECD countries are in EMU, which is almost a formal inflation targeter, and may become one soon; more are waiting in the wings to join EMU. The United States has also been an implicit inflation targeting country for years, and may become an explicit one soon. There is much speculation that Japan may adopt inflation targeting when its deflationary days are definitively over. So the entire OECD may soon be using the same monetary strategy. And inflation targeting is not simply a policy of rich countries. Ten developing countries with 750 million people have also adopted inflation targeting – often after losing the fight to maintain a fixed exchange rate. In all, inflation targeting is the formal basis of monetary policy for well over a billion people in countries that constitute over a quarter of the global economy, and the informal framework accounts for much more.

Inflation targeters let their exchange rates float, usually without controls on capital flows and often without intervention. Because the goal of monetary policy is aligned with national interests, inflation targeting seems remarkably durable, especially by way of contrast with the alternatives. No country has ever been forced to abandon an inflation-targeting regime. But the domestic focus of inflation targeting does not seem to have observable international costs. As research discussed in this Policy Insight shows, countries that target inflation experience lower exchange rate volatility and fewer "sudden stops" of capital flows than their counterparts.

As a result of its manifest success, inflation targeting has continued to spread; it now includes a number of developing countries as well as a large chunk of the OECD. The system of domestically-oriented monetary policy with floating exchange rates and capital mobility was not formally planned. It does not have a central role for the United States, gold, or the International Monetary Fund. Neither exchange rates nor capital flows are controlled. In short, it is the diametric opposite of the post-war system; Bretton Woods, reversed, if you will.

CEPR Policy Insight No. 1, June 2007

URL: http://www.cepr.org/pubs/PolicyInsights/CEPR_Policy_Insight_001.asp
Topics: Monetary policy
Tags: inflation targeting, monetary policy, international financial crises