Inflation Targeting – The Holy Grail of Monetary Policy?

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Summary

Inflation targeting has become the latest fashion among central bankers, and inflation has generally been maintained at a low level in countries where it has been adopted. This paper argues that the success of inflation targeting is principally the result of having a clear unambiguous goal, price stability, for monetary policy that is determined not only by the central bank but by the political authorities more generally. With such a goal in place, and with support from other macroeconomic policies, the actual operating procedure a central bank should follow depends critically on the transmission mechanism of monetary policy and on the sources of shocks in the economy. It follows that implementation of a strategy of targeting inflation could look very different from one country to another. What would be an appropriate policy rule in an industrialized country would not necessarily be suitable in an emerging market even if the ultimate goal of the central bank were the same.

Economies evolve over time potentially altering the relationship between policy instruments and outcomes. The celebrated Goodhart's law explained the debacle of monetary targeting by referring to financial innovations weakening the link between money growth and inflation. Considering inflation targeting in this light, I argue that implementation of this strategy has to be flexible enough to incorporate changes in the link between interest rates or other policy instruments and inflation that are sure to emerge in the future. Failing such flexibility, inflation targeting will also fall victim to Goodhart's law.

Judging by the fate of previous monetary policy regimes, it would be surprising if inflation targeting will be the last word on monetary policy. Earlier strategies such as interest rate targeting, monetary targeting, and exchange rate targeting have all been found wanting in many countries, and have been replaced. Of course, these strategies are of a quite different nature from inflation targeting, since they involve a specific operating procedure for monetary policy, whereas inflation targeting represents an announcement of the ultimate goal of policy. Provided we view inflation targeting in terms only of the objective of monetary policy there is hope that it will have a lasting impact. If it is viewed also as representing a particular operating procedure there are reasons to believe it too will be replaced in due time.