NORTH-HOLLAND

North American Journal of
Economics and Finance 13 (2002) 93–97

THE NORTH AMERICAN
JOURNAL OF
ECONOMICS
AND FINANCE

Central banks and inflation targeting in perspective

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Received 19 April 2002; received in revised form 24 May 2002; accepted 24 May 2002

Abstract

Beginning over a decade ago, a number of central banks have adopted the technique of “inflation targeting” in an effort to improve their performance. Under this approach, an agreement between a nation’s government and its central bank commits the latter to achieve a quantitative inflation target by a certain date. Typically, the target is specified as a low – but positive – rate of inflation. In 1990, New Zealand became the first industrialized country to institute a formula regime of inflation targeting. Next in line were Canada (1991), the United Kingdom and Israel (1992), and Australia and Sweden (1993). Switzerland took the step in 1999. Finland and Spain adopted inflation targeting prior to joining the European Monetary Union. The European Central Bank – while not describing its basic mode of operation as inflation targeting – behaves as though this were the case. The U.S. Federal Reserve has debated inflation targeting but has refrained from adopting it. Instead, it boasts that it has achieved its noticeable success through relying on its traditional instruments. This article provides an over-view of papers on inflation targeting in New Zealand, Canada, and Chile, and summarizes the discussion in the United States. In New Zealand, inflation was brought down sharply, and the approach created an expectations environment that made the policy credible. In Canada, the decline in actual inflation was also striking, and expectations of forecasters, businesses, and organized labor soon began to decrease in parallel with the target. Inflation targeting in Chile (dating back to 1990), cut the rate of inflation markedly and strengthened the credibility of monetary policy.
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Keywords: Central Banking; Inflation targeting

1. Introduction

Over the years, monetary economists, both in academia and in central banks, have made numerous suggestions with respect to the best way for authorities to operate in pursuit of

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PII: S1062-9408(02)00078-5

their monetary policy objectives. Along the way, some of these recommendations have been adopted. They include fixing exchange rates, stabilization of the money supply, smoothing the rate of growth of nominal income, and setting short-term interest rates through an instrument rule. In one form or another, most of these procedures have been tried by one or more central banks, but with uneven results.

Beginning just over a decade ago, a new mode of operation became quite popular. This technique was labeled “inflation targeting.” Under it, an agreement between a nation’s government and its central bank commits the latter to achieve a quantitative inflation target by a certain date. Typically, the target is specified as a low—but positive—rate of inflation, although allowances are made for a margin of error and for unexpected price shocks.

In 1990, New Zealand became the first industrialized country to institute a formal regime of inflation targeting. Next in line were Canada (1991), the United Kingdom and Israel (1992), and Australia and Sweden (1993). Switzerland took the step in 1999. Both Finland and Spain adopted inflation targeting prior to joining the European Monetary Union. The European Central Bank (ECB)—while not describing its basic mode of operation as inflation targeting—behaves as though this were the case. Its charter (the Maastricht Treaty) set the achievement of price stability as the Bank’s primary goal, and the ECB does set explicit numeric targets for inflation.

Finally, a number of developing countries (including Brazil, Chile, Turkey, and South Africa) adopted inflation targeting as a principal guidepost for the operation of their central banks. In fact, during the decade of the 1990s, the trend to inflation targeting accelerated. At the last count, more than 30 countries had instituted inflation targeting regimes.

However, one leading country is not among them: the United States is conspicuous by its absence. Although there has been much debate over the Federal Reserve’s decision not to institute inflation targeting, the United States Congress has always refused to amend the Federal Reserve Act to require it.

The papers included in this section, taken together, provide a variety of insights into the motivations behind inflation targeting regimes, the way they have worked in practice, the necessity to modify them, and the reasons for the results reported. The papers cover inflation targeting in New Zealand, Canada, and Chile and examine the state of affairs in the United States, which has not adopted inflation targeting, but whose experts have given considerable thought to that approach.

2. Inflation targeting in New Zealand

In the paper entitled “Inflation targeting: New Zealand’s experience over 14 years,” Donald T. Brash, Governor of the Reserve Bank of New Zealand, describes the origins and evolution of that approach in his country and assesses the character and magnitude of the contribution it has made in the central bank’s campaign to check inflation.

Inflation targeting was adopted by the Reserve Bank of New Zealand in response to a mandate from the National Government to provide an anchor for monetary policy. The desire to change inflation expectations was an important part of the motivation behind the adoption of an inflation target. As a first step in adopting the new policy, Parliament voted to make price

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