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Inflation targeting regimes

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Abstract

This paper divides the monetary frameworks of countries that use an inflation target to define their monetary framework into three different regimes: (i) full-fledged inflation targeting, (ii) implicit price stability anchor, and (iii) inflation targeting lite. The regimes are differentiated by the clarity and credibility of the commitment to the inflation target. The revealed preference for different regimes is related empirically to cross-country structural differences in economic and financial development. Policy implications of moving from one regime to another are drawn, especially for emerging market countries aiming at full-fledged inflation targeting.

JEL classification: E52; E58; E61

Keywords: Monetary policy framework; Inflation targeting; Central bank

1. Introduction

An inflation target is being used by an increasing number of countries to define their monetary framework. These countries choose to adopt a flexible exchange rate to limit their vulnerability to an exchange rate attack and to maintain an independent monetary policy. At the same time, a monetary target is not practical owing to instability in money demand. In 2001 some 42 medium and large country central banks had some sort of a floating exchange rate arrangement, leaving their degree of commitment to an inflation target as the defining monetary objective.

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This paper classifies these countries into three separate inflation targeting regimes to gain insights into the appropriate design of monetary policy conditional on a country's circumstances. The regimes are defined by the clarity and credibility of the central bank's commitment to the inflation target. Clarity is gauged by the public announcement of the inflation target and by the institutional arrangements in support of accountability to the target. Credibility is proxied by the actual inflation outturn and by market ratings of long-term local currency government debt. The three regimes are marked by qualitatively different—and intuitive—combinations of self-reported combinations of commitment and discretion.

Countries in the first regime practice *full-fledged inflation targeting* (FFIT), which is the best-known form of inflation targeting. FFIT countries have a medium to high level of credibility, clearly commit to their inflation target, and institutionalize this commitment in the form of a transparent monetary framework that fosters accountability of the central bank to the target. New Zealand was the first country to adopt FFIT, and by 2001 some seven industrial and eleven emerging market countries were practicing this regime.

Implicit price stability anchor (IPSA)[1] countries have so much credibility that they can maintain low and stable inflation without full transparency and accountability with respect to an inflation target. Their record of low and stable inflation and high degree of financial stability affords them the flexibility to pursue the objective of output stabilization, as well as price stability. Five developed country central banks are classified here as practicing IPSA, including the European Central Bank and the Board of Governors of the Federal Reserve System.

Inflation targeting lite (ITL) countries announce a broad inflation objective but owing to relatively low credibility are not able to maintain inflation as the foremost policy objective. Their relatively low credibility reflects their vulnerability to large economic shocks and financial instability and a weak institutional framework. The number of ITL countries is 19 and all are emerging market countries.

The inflation targeting regimes can be viewed as reflecting a revealed preference of individual countries for different monetary frameworks conditional on their economic structure. The empirical analysis of this paper suggests that there are systematic differences in economic structure across the three regimes. In particular, GDP per capita and the level of financial development are highest for IPSA countries and lowest for the ITL countries. The different combinations of credibility and discretion across the three regimes seem to reflect these structural differences.

The analysis also offers some practical guidance for countries considering a switch from one regime to another. The main policy implications of this paper are for emerging market countries moving from ITL to FFIT. Econometric analysis suggests that these switches are facilitated by a deep and broad financial sector, which reduces systemic risks and potential policy conflicts, provides for market-based monetary policy implementation, and allows the government to raise the bulk of its funding in financial markets.

[1]In a previous draft of the paper we refer to this group as an eclectic inflation targeting (EIT) regime, Carare and Stone (2003).