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European Economic Review 46 (2002) 781–790

EUROPEAN ECONOMIC REVIEW

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# Inflation targeting in emerging market and transition economies: Lessons after a decade☆

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**Abstract**

Starting in the early 1990s, several emerging market and transition economies adopted inflation targeting (IT). In this paper we discuss a number of issues that arise in this context: (a) the definition of IT, (b) the role of preconditions for IT, (c) the use of intermediate exchange rate targets, and (d) the specification of inflation targets. Our overall conclusion is that, suitably modified, IT is a useful policy strategy for EMEs. 

*JEL classification:* E42; E50; E58

*Keywords:* Inflation targeting; Central banks; Monetary policy

## 1. Introduction

The announcement of explicit inflation targeting (IT) by a number of countries during the last decade constitutes arguably the most important change in the framework of monetary policy since the collapse of the Bretton Woods system in the early 1970s. While New Zealand and Canada led the adoption of such a framework, it is not always recognised that some emerging market and transition economies (EMEs) launched at the same time policy strategies containing many of the elements of the IT regimes used in more advanced economies. For instance, the Bank of Chile adopted numerical targets for inflation as early as 1990, and the Bank of Israel in 1991. Other EMEs that have

☆ The views expressed in this paper are solely those of the authors and do not represent the views of the BIS or the HKMA.

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0014-2921/02/$ - see front matter 
PII: S0014-2921(01)00213-6

switched to a monetary policy framework anchored around a numerical objective for inflation include the Czech Republic and Korea (1998), Poland, Brazil, and Colombia (1999) and South Africa and Thailand (2000). [1]

In this paper we summarise what can be learned from the experiences of the EMEs that have adopted inflation targeting regimes since the early 1990s. We emphasise that EMEs are diverse in terms of economic structure, the development of their financial markets and the capacity of the central banks to conduct independent policy. While IT has been introduced by relatively advanced EMEs (Schaechter et al., 2000), it seems likely that this framework will also be adopted by a number of EMEs with intermediate income levels. The discussion below focuses on issues of importance for this group of countries.

The paper is organised as follows. Section 2 reviews the nature of IT regimes. Section 3 discusses the importance of preconditions for the adoption of IT, which play an important role in the literature. Section 4 considers a number of issues that arise when adopting IT in an EME. Section 5 concludes.

## 2. What is inflation targeting?

An immediate question that arises when discussing IT regimes in EMEs concerns the definition of IT. A number of authors have proposed formal criteria that can be used to discriminate between this and other policy strategies. While the proposals vary somewhat between authors, those suggested by Mishkin (2000) and Mishkin and Savastano (2000) are representative of those found elsewhere in the literature. The criteria are: A public announcement of a numerical target for inflation; a commitment to price stability as the overriding goal of policy; the use of an information-inclusive strategy (defined as one in which the central bank does not solely rely on information from e.g. monetary aggregates or exchange rates to set policy); and the adoption of high levels of transparency and accountability.

Although there is little doubt that these criteria capture the spirit of IT, they are not very helpful in formally defining this policy framework. First, several central banks, including the Swiss National Bank and the European Central Bank, that do not consider themselves as targeting inflation would arguably satisfy these criteria. Moreover, the Bundesbank would almost surely have argued that these criteria admirably capture the spirit of the monetary targeting strategy it used until the introduction of EMU. Second, several criteria are unclear. For instance, what is a “high” level of transparency? The degree of transparency thought essential for IT increased drastically in the 1990s. Third, and more importantly, the IT frameworks in use have typically been refined considerably over time, suggesting that the definition of IT has evolved as well.

While one might argue that some slippage in any definition is unavoidable, the use of overly stringent criteria sends a strong signal to central banks that there are

[1] As discussed further below, it is difficult to formally determine whether a monetary policy framework should be classified as IT or not. This is particularly so among EMEs, which have tended to initially adopt relatively simple IT regimes. Moreover, some (including Chile and Israel) adopted IT before it was recognised as a separate policy framework.