NORTH-HOLLAND

North American Journal of
Economics and Finance 13 (2002) 99–112

THE NORTH AMERICAN
JOURNAL OF
ECONOMICS
AND FINANCE

Inflation targeting: New Zealand's experience over 14 years☆

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Received 18 January 2002; received in revised form 31 January 2002; accepted 11 February 2002

Abstract

The usually-cited reasons for adopting inflation targeting were certainly present in New Zealand when that country became the first to adopt inflation targeting in the late 1980s. The paper describes the advantages of having the inflation target agreed by government and central bank, the relatively undemanding pre-conditions for inflation targeting and the considerable evolution in the approach to policy which took place in New Zealand in the 1990s. There is also a brief discussion of the pros and cons of having a single decision-maker, and of the similarities in practice between central banks with a single mandate and those with a dual mandate.
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JEL classification: E42; E52; E58

Keywords: Inflation targeting; New Zealand; Monetary policy

1. Introduction

New Zealand was the first country in the world to adopt a formal inflation target, in the sense that we understand the term today, in the late 1980s. The purpose of this paper is not to address the theory of inflation targeting so much as to talk about some of the lessons we have learnt from experience over almost 14 years. In doing so, I adopt the definition of inflation targeting put forth by Bernanke et al. (1999):

☆ A speech delivered at the annual meetings of the North American Economics and Finance Association and the American Economics Association in Atlanta, Georgia in January 2002.

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1062-9408/02/$ – see front matter © 2002 Elsevier Science Inc. All rights reserved.
PII: S1062-9408(02)00060-8

> a framework for monetary policy characterized by the public announcement of official quantitative targets (or target ranges) for the inflation rate over one or more time horizons, and by explicit acknowledgment that low, stable inflation is monetary policy's primary long-run goal. Among other important features of inflation targeting are vigorous efforts to communicate with the public about the plans and objectives of the monetary authorities, and, in many cases, mechanisms that strengthen the central bank's accountability for attaining those objectives.[1]

The paper proceeds as follows. Section 2 reviews the New Zealand experience and derives some key lessons. Section 3 deals with implementation of inflation targeting, while Section 4 discusses selection of the target. Sections 5 and 6 examine the pros and cons of single versus committee decision-making and single versus dual mandates, respectively. Section 7 concludes.

2. Inflation targeting in New Zealand

Countries usually adopt inflation targeting for one or more of the following reasons:

- A desire to find some credible anchor for monetary policy, often after a period of high inflation and/or the loss of a previous anchor (perhaps an exchange-rate target which proved impossible to maintain or a money aggregate target which proved both difficult to achieve and was less closely connected to the inflation rate than hoped for).
- A desire to give the central bank instrument independence, but to balance that with some clearer specification of what the central bank should seek to achieve with that instrument independence—in other words, to make it possible to balance independence with accountability.
- A desire to reduce the social and economic costs of disinflation by reducing the inflation expectations of both financial markets and agents in the real economy.

In New Zealand's experience, the adoption of inflation targeting undoubtedly helped to provide an anchor for monetary policy. Certainly, there had been important progress in reducing inflation between the mid-1980s and the time a specific target was first discussed in April 1988, but in the year to March that year, CPI inflation was still 9%, and predictions by the Reserve Bank that inflation would fall below 4% within 2 years were widely ridiculed.

By 1991, inflation was under 2%, and inflation has averaged around 2% over the last 10 years. Of course, many other countries have also achieved low rates of inflation over the last decade, so it is impossible to be dogmatic about the extent to which inflation targeting helped in the case of New Zealand. But in my own judgment, the single focus which inflation targeting required of the central bank was a material factor in focusing the Bank on that objective. Beyond the first year or two, we did not spend a lot of time debating what the optimal inflation rate might be. In terms of making the decisions about monetary policy, that was irrelevant because the target had been agreed upon. The only debate was about what degree of monetary policy pressure was needed to achieve that objective.

In the 1970s and 1980s, during most of which period New Zealand did not have an inflation target, New Zealand's inflation was not only markedly higher than it was in the 1990s, it was also higher than inflation in other OECD countries. Inflation targeting helped us to achieve a

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