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A stable international monetary system emerges: Inflation targeting is Bretton Woods, reversed

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Abstract

A stable international monetary system has emerged since the early 1990s. A large number of industrial and a growing number of developing countries now have domestic inflation targets administered by independent and transparent central banks. These countries place few restrictions on capital mobility and allow their exchange rates to float. The domestic focus of monetary policy in these countries does not have any obvious international cost. Inflation targeters have lower exchange rate volatility and less frequent "sudden stops" of capital flows than similar countries that do not target inflation. Inflation targeting countries also do not have current accounts or international reserves that look different from other countries. This system was not planned and does not rely on international coordination. There is no role for a center country, the IMF, or gold. It is durable; in contrast to other monetary regimes, no country has been forced to abandon an inflation-targeting regime. Succinctly, it is the diametric opposite of the post-war system; Bretton Woods, reversed.

JEL classification: F02; F33

Keywords: Fixed; Financial; Exchange; Rate; Capital; Controls; Durable; Regime

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1. Motivation and introduction

All countries choose their monetary policy. Collectively, the interaction of these policies constitutes the international monetary system. For instance, during the "Bretton Woods" regime after WWII, countries fixed their exchange rates to the American dollar. A fixed exchange rate is a well-defined monetary policy that is still used by a number of countries. In the presence of capital mobility, it subordinates monetary policy to the objective of exchange rate stability at the expense of other domestic interests. Because of this conflict, most fixed exchange rates do not stay fixed for long. But when countries float their exchange rates, they have to choose another monetary regime; floating is not a coherent monetary policy. Some countries have tried to pursue money growth targets, often without success. Others have hybrid strategies involving multiple or moving targets; some countries do not even have clearly defined monetary policies.

Fourteen of the 30 OECD countries currently have a monetary policy that explicitly targets inflation. These countries have a combined population exceeding 430 million, and produce over an eighth of global output, so inflation targeting is an important monetary policy. But even these impressive numbers understate the importance of inflation targeting (hereafter "IT"). Twelve OECD countries are in EMU, which is almost a formal inflation targeter (Wyplosz, 2006), and may become one soon; another pair (Denmark and the Slovak Republic) are waiting to join EMU.[2] The United States has been an implicit IT country for years (Goodfriend, 2003), and may become an explicit one soon. There is speculation that Japan may adopt IT when its deflationary days are definitively over. So the entire OECD may soon be using the same monetary strategy.

But inflation targeting is not simply a policy of rich countries. As of June 2006, 10 developing countries with 750 million people have also adopted IT. Altogether, countries that formally target inflation currently constitute over a quarter of the global economy. And IT is not only important, but likely to grow in significance as the remaining OECD and more developing countries adopt it.

This paper examines the implications of this widespread policy for the international monetary system.

1.1. Targeting inflation, floating exchange rates

Mishkin (2004) lists five components to an inflation targeting regime:

1. The public announcement of medium-term numerical targets for inflation,
2. an institutional commitment to price stability as the primary goal of monetary policy,
3. an information-inclusive strategy to set policy instruments,
4. increased transparency of the monetary policy strategy, and
5. increased accountability of central bank for attaining its inflation objectives.

While inflation targeting has been defined in different ways, most are similar. Table A1 lists IT countries, along with the dates that the IT regime began. It is not always clear precisely when

[2] In *Monetary Programme of the NBS until the Year 2008* the National Bank of Slovakia defines its monetary policy as (p. 2): "Simultaneously, the NBS defines the conduct of its monetary policy as inflation targeting in the conditions of ERM II." (bold in original); http://www.nbs.sk/MPOL/MPROG/2008A.PDF.