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The Move Toward Inflation Targeting in Other Countries

As Tom Melzer pointed out in his Feditorial on page 2, monetary policy in the United States currently has multiple objectives. The Federal Reserve is directed by law to "promote effectively the goals of maximum employment, stable prices and moderate, long-term interest rates." Unfortunately, in the short run, these objectives sometimes seem to conflict with one another. Many economists think that the best way to achieve them all is to maintain stable prices, which ultimately fosters high employment and strong growth.

With this in mind, a number of countries, including New Zealand, the United Kingdom, Canada, Sweden and Finland, have recently directed their central banks to make inflation control, or price stability, their main objective. Other countries, like France, Italy and Switzerland, have moved toward less formal "quantified inflation objectives." Although the details differ from country to country, the common structure among these policy initiatives is telling.

An integral part of each plan is that the central bank firmly commits itself to price stability and reduced uncertainty about the objectives of monetary policy by announcing a downward target path for inflation, as well as a long-term low target range—typically zero to 2 percent. The plans may also include contingencies for permitting a suspension of the inflation targets—a temporary increase in inflation—in the face of extreme events, like an oil price shock. The thought here is that long-term inflation credibility will actually be enhanced by explicitly allowing flexibility in the case of unusual circumstances.

Another measure, adopted in New Zealand, the United Kingdom and other countries to increase the credibility of these plans, is increased central bank independence. Independent central banks are typically able to look beyond the next six to 12 months in making decisions about controlling inflation, but remain accountable to the public and the legislature to achieve the democratically decided goals of monetary policy—stable prices. In New Zealand, for example, the governor of the central bank may be dismissed if he fails to meet the inflation objective. As research indicates, countries that have achieved the best records in controlling inflation are typically those with independent central banks, like Germany, Switzerland and the United States. Where day-to-day monetary decisions are decided by political institutions, inflation rates are usually higher.

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To accompany inflation targeting, countries often adopt budgetary reforms because irresponsible fiscal policy can ultimately trump even the best monetary policy. If the government's expenditures are out of control, it may force the central bank to print money to pay these bills. Hence, fiscal reforms can help lend credibility to a policy of inflation control.

So far, inflation targeting has been quite successful in bringing down inflation in these countries. Although the reduction in inflation has typically been accompanied by some slowdown in output, the fall in inflation has led to a fall in interest rates and, later, a recovery of output and employment. Recently, New Zealand, Canada and the United Kingdom have enjoyed lower rates of underlying inflation and higher output growth than the average OECD country. New Zealand, which has taken the boldest steps toward inflation targeting and financial reform of any country in the world, is currently enjoying the best of both worlds, with underlying inflation below 2 percent and very strong output growth.

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