

Monetary and Inflation Targeting

FIN 204 Lecture 14.1.

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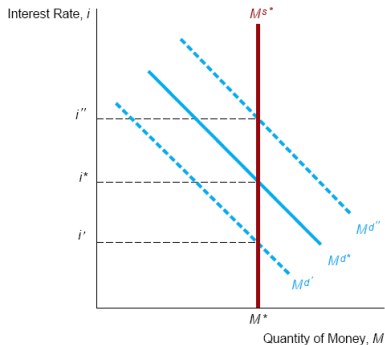
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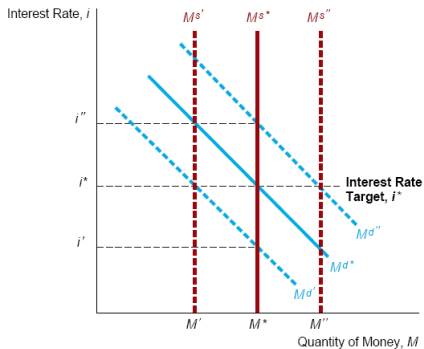
- 1 Monetary Targeting: Essence and Examples
- 2 Inflation Targeting: Essence and Examples
- 3 Advantages and Disadvantages of Inflation Targeting

Conflicts Between Intermediate Targets

Choosing a monetary aggregate target



Choosing an interest rate target



Monetary Targeting: Examples, 1973-1990

- ① **Canada:** chooses M1; abandons after several years due to unwanted exchange rate fluctuations + measurement problems of their M1 target
- ② **UK:** chooses M3; abandons after several years due to measurement problems of M3 + loss of correlation between M3 and output
- ③ **Japan:** does NOT commit to monetary targeting; monitors closely M2 growth; targets interest rates like the FED
- ④ **Germany:** chooses M0; does NOT follow closely the Monetarists' rules; a success story of controlling inflation because of an inflation target (2%).

Inflation targeting

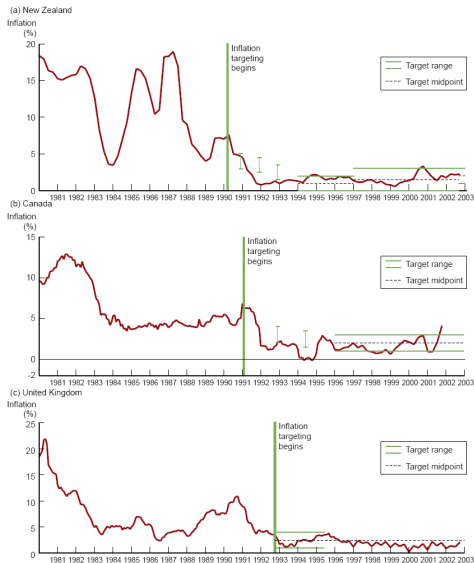
Inflation targeting: A MP rule in which the CB commits to an explicitly stated medium-term inflation rate (typically, 1-3%) which serves as a nominal anchor

Examples:

- ➊ **New Zealand, 1990:** The pioneer of inflation targeting, a success story of controlling inflation with benefits on the production side
- ➋ **Canada, 1991**
- ➌ **UK, 1992**

In all cases, after a short recession due to restrictive monetary policy, the economy was on its positive growth path again.

Inflation Targeting: The Evidence



Advantages and Disadvantages of Inflation Targeting

Advantages

- domestic policy focus
- the big *if* of targeting monetary aggregates does not apply
- easy to understand and communicate
- reduces political pressure on the CB
- increases predictability, stabilizes expectations

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Disadvantages

- not directly controllable
- effects from policy not seen immediately
- can drive the economy into recession