A Stable International Monetary System Emerges: Inflation Targeting as Bretton Woods, Reversed

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September, 2007
Motivation

• Many Currency Crises through end of 20\textsuperscript{th} century
  - Fewer Now

• International Financial Crises: Are they a Relic of an Archaic “System” that is Disappearing?
The New Development: Countries with Inflation Targets

- 14 (of 30) OECD countries have inflation targets (IT)
  - Population > 430 million
  - 12 OECD (+3 more) in EMU, closet inflation targeter
    - 2 more (Denmark, Slovakia) waiting to join
  - US another closet IT; Japan soon?
- 10 developing countries (> 750 mn) also target inflation

- Arguably most important, successful monetary framework
  - Spreading quickly
The International Financial System

• Collective interaction of national monetary policies is international monetary system
  o Ex: Bretton Woods was fixed exchange rate policy
  o Now fixed exchange rates are rare; but floating is not a well-defined monetary policy

• What are the consequences of IT for international financial regime?
Definition of Inflation Targeting

Mishkin’s 5 IT components:

1. Numerical, public medium-term inflation target
2. Price stability as primary goal of monetary policy
3. Information-inclusive strategy to set instrument(s)
4. High transparency of monetary policy strategy
5. High accountability of central bank for IT
### Inflation Targeting Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Default Start Date</th>
<th>Country</th>
<th>Start Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>March, 1993</td>
<td>Mexico</td>
<td>January, 1999</td>
</tr>
<tr>
<td>Brazil</td>
<td>June, 1999</td>
<td>New Zealand</td>
<td>March, 1990</td>
</tr>
<tr>
<td>Chile</td>
<td>January, 1991</td>
<td>Peru</td>
<td>January, 2002</td>
</tr>
<tr>
<td>Colombia</td>
<td>September, 1999</td>
<td>Philippines</td>
<td>January, 2002</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>January, 1998</td>
<td>South Africa</td>
<td>February, 2000</td>
</tr>
<tr>
<td>Finland*</td>
<td>February, 1993</td>
<td>Spain*</td>
<td>January, 1995</td>
</tr>
<tr>
<td>Hungary</td>
<td>June, 2001</td>
<td>Sweden</td>
<td>January, 1993</td>
</tr>
<tr>
<td>Iceland</td>
<td>March, 2001</td>
<td>Switzerland</td>
<td>January, 2000</td>
</tr>
<tr>
<td>Israel</td>
<td>January, 1992</td>
<td>Thailand</td>
<td>May, 2000</td>
</tr>
<tr>
<td>Korea</td>
<td>April, 1998</td>
<td>United Kingdom</td>
<td>October, 1992</td>
</tr>
</tbody>
</table>

* joined EMU, January 1999

### Recent Adopters:

<table>
<thead>
<tr>
<th>Country</th>
<th>Start Date</th>
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</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>July, 2005</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>January, 2005</td>
</tr>
<tr>
<td>Romania</td>
<td>August, 2005</td>
</tr>
<tr>
<td>Turkey</td>
<td>January, 2006</td>
</tr>
</tbody>
</table>
Countries Tend to Adopt IT after Exchange Rate Crises

- Brazil, Czech Republic, Finland, Indonesia, Korea, Mexico, Philippines, Sweden, Thailand, Turkey, United Kingdom

Only 3 Crisis Countries have not switched to IT (yet):

- Argentina, Malaysia, Russia
Inflation Targeting Entails Floating Exchange Rate

• Formal intermediate target is inflation forecast (not exchange rate/money growth rate)

• Many IT countries float freely
Floats Are Sometimes Managed, at least initially

• Some intervention by Australia, LDCs … usually to hit IT, not maintain fix (though some initial dual targets)

• But exchange rate losing importance as indicator or target of monetary policy for IT countries (e.g., Chile, Israel, NZ)
Durability of IT Regimes

• 27 countries had IT by mid-2007
  o Only 2 have left (Finland, Spain joined EMU)
  o Neither under duress

• Big contrast to alternative monetary regimes, especially fixed exchange rate regimes
Exchange Rate Regimes Typically Short

- Example: Jamaica switched exchange rate regimes 11 times in 15 years (1990-2004)

- Only 5 non-IT countries have had no changes since 1990
  - Morocco targets M1 growth, with peg against secret multilateral basket, and many capital controls
  - Syria pegs with controls, multiple exchange rates
  - HK has successful currency board
  - US and Japan have “no explicit nominal anchor, monitor various indicators to conducting policy”
Exchange Rate Regimes are *not* durable for Countries without Inflation Targets

- Average Time Between Exchange Rate Regime Change is around 6 years
- So IT is far more durable than Exchange Rate Regimes!
  - This durability a big Contrast with Previous Systems
Many Contrasts with Bretton Woods System

<table>
<thead>
<tr>
<th></th>
<th>Bretton Woods</th>
<th>Inflation Targeting</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regime Durability</td>
<td>Low</td>
</tr>
<tr>
<td>2</td>
<td>Exchange Rate Regime</td>
<td>Fixed</td>
</tr>
<tr>
<td>3</td>
<td>Focus of Monetary Policy</td>
<td>Partly International</td>
</tr>
<tr>
<td>4</td>
<td>Intermediate Target</td>
<td>Exchange Rate</td>
</tr>
<tr>
<td>5</td>
<td>Capital Mobility</td>
<td>Controlled</td>
</tr>
<tr>
<td>6</td>
<td>Current Acc. Imbalances</td>
<td>Limited</td>
</tr>
<tr>
<td>7</td>
<td>System Design</td>
<td>Planned</td>
</tr>
<tr>
<td>8</td>
<td>International Cooperation</td>
<td>Necessary</td>
</tr>
<tr>
<td>9</td>
<td>Role of IMF</td>
<td>Key in principle</td>
</tr>
<tr>
<td>10</td>
<td>Role of Gold</td>
<td>Key in principle</td>
</tr>
<tr>
<td>11</td>
<td>Role of US as Center</td>
<td>Key in practice</td>
</tr>
<tr>
<td>12</td>
<td>Key Members</td>
<td>Large, Northern</td>
</tr>
<tr>
<td>13</td>
<td>Central Banks</td>
<td>Dependent, Unaccountable</td>
</tr>
<tr>
<td>14</td>
<td>Transparency</td>
<td>Low</td>
</tr>
<tr>
<td>15</td>
<td>Alignment with Academics</td>
<td>Worrisome</td>
</tr>
</tbody>
</table>

Essentially Bretton Woods Reversed!
Do IT Countries Have Higher Exchange Rate Volatility?

- Domestic focus of monetary policy *might* result in *higher* exchange rate volatility
  - Countries with fixed exchange rates have nominal lower exchange rate volatility (and real, in short run)
- But: lower policy volatility, more stable expectations *might* result in *lower* exchange rate volatility
In Fact, Exchange Rate Volatility is Actually *Lower* for IT Countries!

- Countries that target inflation have between 2% and 5% lower real exchange rate volatility
- Robust results
Does Inflation Targeting have Other Effects?

- No effect on International Reserves
- No effect on size of Current Account Imbalances
- “Sudden Stops” of capital inflows seem *less* likely with IT
- No Inflation Targeter has *ever* experienced a banking crisis!
Conclusion

• Few Monetary Strategies exist
  o Fixed exchange rates
  o Money growth targets
  o Hybrid/Ill-defined strategies
  o Inflation Targets; the focus
Characteristics of Inflation Targeters

• Floating exchange rates
  o Often without interventions or capital controls
  o But ER volatility actually lower than non-IT
  o No observable consequences for reserves/current accounts
    o Sudden stops less frequent
• IT is highly durable
• IT spreading quickly outside OECD (pervasive inside)
Many Aspects of Bretton Woods Completely Reversed

- Domestically-oriented monetary policy
- Aligned intermediate target (inflation forecast)
- Capital Mobility, capacity for big current accounts
- No role for center country, coordination, gold, IMF
- Big role for independent transparent central banks
- Unplanned system
- Aligned with most academic thinking
- Durable Floating!
Financial Crises are not a feature of Inflation Targeters

• Are they a thing of the past?