"Inflation Targeting" – neither new nor effective

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Introduction:

Since 1990, the "standard of the art" in Monetary Policy has been "Inflation Targeting". Those policies have been regarded as capable of keeping inflation low under fiat money and fluctuating-exchange-rate arrangements while allowing the "flexibility" to manage monetary policy required to support politically the "independence" of central banks, namely easing credit as an attempt to promote stable growth with a minimum possible unemployment.

It is the contention presented in this paper that neither "Inflation Targeting" policies are something "new", nor these policies have been effective in preventing the boom and bust cycles produced by loose (flexible, if you will) monetary management, being them directly responsible for the current financial crisis for allowing gross speculation with investment assets not "perceived" by the general price indexes utilized to gauge those policies.

In order to discuss these ideas, in part 2 we will deal with the concept of Inflation Target policies, presenting a brief historical overview, its key elements and how to classify them in accordance with the traditional modes of rules and discretion. Next, in part 3 a review of the performance of monetary policies in selected developed countries is offered to illustrate some of the arguments presented. In part 4 some elements of the monetary history in the US are brought in support of this paper's main contention mentioned above and presented in the concluding part 5.

The formulation of "Inflation Targeting" policies:

On August 15, 1971, the United States under the Nixon administration defaulted on the Bretton Woods Treaty and severed the tenuous link still existing between the US Dollar and

gold by closing the "Gold Window" under which US Dollars were redeemable by Central Banks of signatory countries at the fixed rate of US$ 35.00 per ounce. A new short lived parity was established, but in 1973 the fixed-exchange-rate monetary regime in force since the end of WW II came to an end. Central banks around the world scrambled for a new "anchor".

In a world left only with fluctuating fiat money, the only possible "anchor" to the value of a currency was a "nominal" one to be implemented at a national level.

Precursors to Inflation Targeting. The Deutsche Bundesbank and the Swiss Central Bank as early as 1974 and the American Federal Reserve System (FED) and the Bank of Canada during 1975 started to "state" a "growth" target that they were aiming at (Bernanke *et al*, 2001: 43). At the beginning, the effort of central banks was to make known by society the growth in the monetary aggregates and with them, the "expected" changes in prices as mechanically derived from the Quantitative Theory of Money.

Pressures to make changes to the goals in terms of expansion of the money supply were felt soon. Real and political factors contributed to force central banks out of their stated goals for monetary expansion and therefore compromising their credibility. At times, with relative low inflation but small rate of growth, some further monetary expansion seemed to be possible and pressure to promote that mounted; at other times, a more stringent monetary policy was pursued by the monetary authorities to keep inflation low, frustrating the expectative (if from no one else, from the treasury) that the stated monetary expansion would happen. In sum, the claim for "discretion" was a constant.

It was only in 1990 when the New Zealand Central Bank adopted an explicit inflation target with reference no more to the expansion of monetary aggregates but to an aimed price level measured by a price index that "inflation targeting" policy in a narrow sense officially began (Bernanke *et al*, 2001: 86).

What is Inflation Targeting? But, what is Inflation Targeting? In their book "Inflation

Targeting – Lessons from the International Experience" Dr. Bernanke and his co-authors offer the following definition:

> - "*Inflation targeting is 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 acknowledgement that low, stable inflation is monetary policy's primary log-run goal*" (2001: 4).

Since the 30's most of the debate about monetary policies tries to classify them as strategies based on either "rules" or "discretion", being the Gold Standard, for instance, a "rule". A discretionary approach happens when a central bank makes no public commitment about its actions. Dr. Bernanke describes inflation target as a "framework" in order not to pin it at either a "rule" or as a "discretionary" kind of policy.

In other words, under the "framework" of an inflation target, the central bank is free to take any measure it sees fit, so far and so long as the price level at the end of a certain period of time comes close to the previously stated price level "goal" as measured by the chosen price index. Under the inflation target framework, the central bank claims to be able to pursue other political goals without falling into the discredited monetary "activism" of the bad old days before the "Great Moderation".

Key elements of Inflation Targeting policies. To summarize, inflation target policy is composed by two key elements, a high level of discretion about the use of the tools available to the central bank, and a "formal" commitment to keep inflation low. The first component is thought by the central bankers to show the "strength" of their institutions and therefore, along with the second element, to convey the idea that the monetary authorities are committed to a low level of inflation and have the power to make it come about.

The second element may be understood in at least two different ways: - (a) strictly speaking about inflation targeting in the narrow sense, the formal commitment to keep inflation low may be stated in a piece of legislation, in an operational agreement between the government

and the independent monetary authorities, made public through the publication of some official document by the monetary authorities or simply made public through the press; the other possible meaning for this second element may be (b) the one in which the monetary authorities, without any legal or informal mandate, or even making public their goal, operationally, they act driven towards the achievement of an inflation goal, and it may be known only by few top officials.

Saying differently, the knowledge by the market that the central bank has the power (a) to expand or contract the money supply, (b) to raise or to low interest rates, (c) to impose exchange controls, (d) to alter the level of compulsory reserves, (e) to alter the classes of assets and the conditions under which they will grant access to discount facilities, and in most cases, the power (f) to impose new bank regulations, along with their stated goal of keeping the inflation low would create, so believe the advocates of such policies, the "psychological" conditions to actually achieve the inflation goal. Furthermore, the element of discretion offers to the central bank the capacity to pursue "other" political objectives deemed necessary by the circumstances without compromising the achievement of the stated goal so long as the "psychological" conditions remain under control.

Rules vs. Discretion. Proponents of inflation targeting policies argue that history shows that "rules" are no protection against changes in monetary policy. Since changing circumstances "require" flexibility, even the Gold Standard offers no protection against political decisions to suspend payments in gold in case of war, for instance.

Therefore, so the argument goes, all monetary policies are "discretionary" to a certain degree; and the best you can get is a "framework" such as the one provided by the adoption of a "nominal" anchor.

If we consider that there are no more commodity monies, no more fixed-exchange-rate mechanisms, the *Friedmanesque* proposal for a legally (constitutionally) defined rate of expansion for the money supply never gained acceptance anywhere because it was considered "too rigid" as the experience of stating monetary expansion goals since 1974

has proved; we are left only with discretionary regimes, and among them, the inflation target framework is the only one in sight carrying some limitations to monetary expansion.

Monetary Policy since 1990:

Since the precursory adoption of an inflation targeting policy in New Zeeland and the adoption of a similar policy by Canada one year later, it has gradually become the policy of choice worldwide due to its seemingly success.

With different grades of formality and public commitment, the establishment of price level goals by the monetary authorities without any other commitment about how that goal would be achieved has become the common practice around the globe.

Track record of Inflation Targeting policies. The historically low levels of inflation achieved under the inflation targeting framework wherever it has been adopted, according with their proponents, seem to prove that it is the solution for price stability under fiat money and fluctuating exchange rates. And the statistical record gives credit to that assessment, at least until the beginning of the current financial crisis.

In order to analyze the validity of the proponents of inflation targeting policies' claims, the table 1 below with the Consumer Price Indexes of selected developed countries is presented.

Table 1

Consumer Price Indexes selected developed countries 1970-2007:

Period	USA	Canada	Japan	France	Germany	Italy	Sweden	Swiss	UK
1970	5.9	3.3	7.6	5.9	3.4	5.0	7.0	3.6	6.4
1971	4.2	2.9	6.4	5.5	5.2	4.9	7.4	6.6	9.5
1972	3.3	4.9	4.8	6.2	5.5	5.7	6.0	6.7	7.1
1973	6.3	7.6	11.7	7.3	7.0	10.8	6.7	8.8	9.2
1974	11.0	10.9	23.2	13.7	7.0	19.1	9.9	9.8	16.0

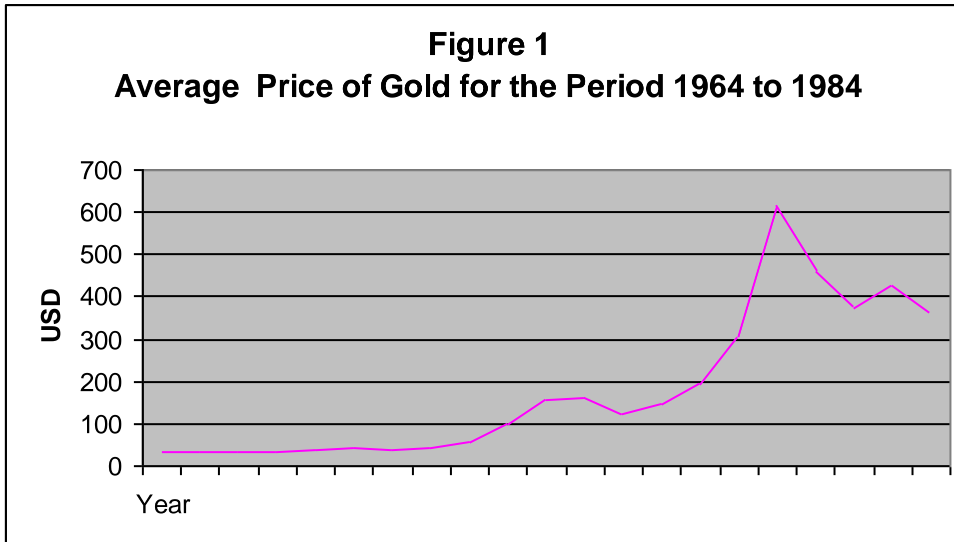
1975	9.1	10.7	11.7	11.8	5.9	17.1	9.8	6.7	24.3
1976	5.8	7.6	9.4	9.6	4.3	16.7	10.3	1.7	16.7
1977	6.5	8.0	8.2	9.4	3.7	18.5	11.4	1.3	15.8
1978	7.6	9.0	4.2	9.0	2.7	12.0	10.0	1.1	8.6
1979	11.3	9.1	3.7	10.8	4.1	14.8	7.2	3.7	12.6
1980	13.5	10.2	7.8	13.0	5.5	21.3	13.7	4.0	16.9
1981	10.4	12.4	4.9	13.3	6.3	19.5	12.1	6.5	12.2
1982	4.0	10.7	2.8	12.0	5.3	16.5	8.6	5.7	8.5
1983	5.3	5.9	1.9	9.5	3.3	14.6	8.9	3.0	5.2
1984	4.4	4.4	2.3	7.7	2.4	10.9	8.0	2.9	4.5
1985	3.5	4.0	2.0	5.8	2.1	9.1	7.4	3.5	5.2
1986	1.9	4.2	0.6	2.5	-0.1	5.8	4.2	0.8	3.6
1987	3.7	4.4	0.1	3.3	0.2	4.8	4.2	1.4	4.1
1988	4.1	4.0	0.7	2.7	1.3	5.1	5.8	1.9	4.6
1989	4.8	5.0	2.3	3.5	2.8	6.3	6.4	3.1	5.9
1990	5.4	4.8	3.1	3.4	2.7	6.5	10.5	5.4	8.2
1991	4.2	5.6	3.3	3.2	3.5	6.3	9.3	5.9	6.8
1992	3.0	1.5	1.7	2.4	5.1	5.3	2.3	4.0	4,7
1993	3.0	1.8	1.2	2.1	4.5	4.6	4.7	3.3	3.0
1994	2.6	0.2	0.7	1.7	2.7	4.1	2.2	0.9	2.4
1995	2.8	2.2	-0.1	1.8	1.8	5.3	2.5	1.8	3.5
1996	3.0	1.5	0.1	2.0	1.4	4.0	0.5	0.8	2.4
1997	2.3	1.7	1.9	1.2	1.9	2.0	0.7	0.5	3.1
1998	1.6	1.0	0.6	0.7	1.0	2.0	-0.3	0.0	3.4
1999	2.2	1.8	-0.3	0.5	0.6	1.7	0.5	0.9	1.5
2000	3.3	2.7	-0.8	1.7	1.4	2.5	0.9	1.5	3.0
2001	2.8	2.5	-0.7	1.7	1.9	2.7	2.4	1.0	1.8
2002	1.6	2.2	-0.9	1.9	1.5	2.5	2.2	0.6	1.7
2003	2.3	2.8	-0.3	2.1	1.0	2.7	1.9	0.6	2.9
2004	2.7	1.8	0.0	2.1	1.7	2.2	0.4	0.8	3.0

2005	3.4	2.2	-0.3	1.8	1.5	2.0	0.5	1.1	2.8
2006	3.2	2.0	0.3	1.6	1.6	2.1	1.4	1.1	3.2
2007	2.8	2.2	0.0	1.5	2.3	1.8	2.2	0.7	4.3

The final years under the Bretton Woods Treaty. Until February 1973 the international monetary arrangements were the ones established in 1944 by the Treaty of Bretton Woods with fixed exchange rates pegging all currencies of the signing countries to a US Dollar, until 1971, convertible (only by their correspondent central banks) in gold at a fixed parity of US$ 35.00 per dollar. However, the charter above shows that the average inflation level in the selected developed countries for the period 1970-1972 was well above 5% per year. Those arrangements were clearly unsustainable in the long run. The weakened link to the Gold Standard provided by the Bretton Woods treaty until August 1971 proved to be insufficient to check inflationary expansions of the money supply among the Western developed countries and the abandonment of those arrangements became inevitable.

In search of a new "anchor" for the value of monies. The American *default* on their obligations of redeeming US Dollar in Gold had huge and last long impact. From 1973 until 1983, we saw on table 1 an increase in prices. That was the period of failed attempts to control inflation establishing targets for the growth of monetary aggregates. The figure 1 below shows the price of gold in US Dollars for the period 1964 to 1984. It shows that until 1968 it was perceived by world markets that the promise by the American government to redeem US Dollars at the agreed parity of US$ 35 per once was credible. From 1968 to 1971, when the pledge was finally broken, the increases in the gold prices showed that the confidence in that promise had somewhat diminished. Under the Smithsonian Agreement of December 1971, an attempt to fix exchange rates at a devaluated US Dollar without a link to actual gold faced skepticism and the gold in 1971 closed at the record price of US$ 44.20 per ounce. In February 1973, the Bretton Woods exchange market formally closed, reopening in March 1973 in a floating regime.

Average Price of Gold for the Period 1964 to 1984:



The years of Recovering Credibility. 1984 is the first year in which the data shows the results of more conservative policies adopted in developed countries. The galloping inflation during the Carter Administration led Mr. Paul Volker to the head of the FED. Mr. Volker implemented a monetary policy of quantitative control of monetary aggregates that eventually curbed the increases in consumer prices. Similar policies were adopted in Europe since 1979 with the creation of the European Monetary System. But in order to impose an effective control on the growth of monetary aggregates, these policies have resulted, as a byproduct, in a short but significant recession.

New Inflationary Pressures and the adoption of Inflation Target policies. Conservative monetary policies became fashionable then. However, three historical events may explain the increase the general price levels until 1991. The first of them was the Black Monday in October 1987 when the stock market in the US plunged and the recently appointed FED Chairman, Mr. Alan Greenspan, took charge of the problem flooding the market with dollars. The second one was the fall of the Berlin Wall in 1988 with the required effort made by developed countries to integrate the Eastern European countries into the new world order. And the third one was the invasion of Kuwait and the first war in the Persian Gulf with the correspondent shock in the world oil supply.

No doubt the massive inflationary expansion determined by those events resulted in the increases in prices shown on table 1. But they were eventually counterweighted by the productivity gains generated by the enlargement of the division of labor with: (a) the integration of China and the countries behind the iron curtain in the world markets, (b) liberalization of trade worldwide with the creation of the World Trade Organization (WTO), (c) the benefits in terms of lower barriers for the trade of goods, labor, services, finances in an expanded Euro-zone with the final adoption of the Euro ten years ago, and last but not least, (d) the advances in Information Technology.

A 20-year period of prosperity had begun. Foreign trade was the motor in the real economy behind the miracle; and economic expansion and increasing tax revenues lessened the political cost of adopting relative more conservative fiscal policies in developed countries, and that was done.

With a regained credibility in their fiscal management, governments started to adopt, explicit or tacitly, the inflation target framework.

The US is one of these countries where, to this day, inflation targets are not formally adopted; nevertheless American monetary policy is guided primarily with a focus on the inflation rate. About the monetary policy in 1996, in the seventh year of the most consistent bull market in record, in his memoirs Mr. Greenspan argues that the FED "has no explicit mandate under the law to try to contain a stock market bubble" and that it was established that "price stability is (the) central (FED's concern) to (promote) long-term economic growth" (Greenspan, 2007: 178).

The adoption of the inflation target framework perfectly coincides with the beginning of the 20-year expansion mentioned above. Up to a point in which the inflation target framework has been credited by the prosperity experienced until 2007. Claims have been made that it is the "perfect" balance between rules and discretion in monetary policy.

What remains to be assessed is to what extent the current crisis proved that inflation

targeting policy is the best strategy possible for monetary policy, since it gives room for the monetary authorities to react to the crisis with every instrument at their disposal; or it proved to be no more than a new dress for the recurrent mistake of credit expansion that in the end caused the crisis.

In order to assess that, it is worthwhile revisiting the monetary policies of the early 20's.

The Monetary Policy of the 20's:

It is commonly believed that the years between the Great War and the Depression were years in which the monetary excesses provoked by the war financing were interrupted in Europe and in the US, that resuming redemption in gold was a signal of a regained monetary stability under the venerable Gold Standard and that the wild speculation with equities during the 20's was main due to the lack of regulation in the stock markets.

The available data, however, tells us a different story: - From June 30, 1921 to June 30, 1929 the total money supply of the United States in billion of dollars rose from 45.30 to 73.26. It means an increase of 28 billion dollars during those eight years, or 61.8% (Rothbard, 2008: 92).

Many mechanisms were used to expand the money supply given the limitations of the Gold-Exchange Standard then in force; the currency in circulation, for instance, stayed fairly constant around $ 3.7 billion during the period. The truth of the matter is that the entire monetary expansion happened on money-substitutes, i.e. through credit expansion.

But does not the Gold Standard have a inbuilt mechanism to self-correct imbalances preventing inflationary expansions? It seems that not all monetary regimes based on a Gold Standard are the same. It was already noted in nineteenth-century England that the operation of an external drain of specie would only work in order to keep the monetary system "neutral", i.e., neither promoting nor reducing the business cycle under a hypothetical purely metallic currency as described by Hume in "Of the Balance of Trade"

(Hume, 1987: 308); under the gold-exchange system with a central bank, the anti-inflationary effects of a specie drain mechanism were not immediately perceived, if ever (White, 1995:115).

Prof. Murray Rothbard on the Monetary Policy of the 1920's in the USA: In "America's Great Depression", Prof. Rothbard demonstrates that that was the case in the 1920's utilizing the concept of "Total Dollar Claims" to represent the total money supply on top of gold reserves. The data retrieved from the Banking and Monetary Statistics published by the FED in 1943 is shown on the table below (Rothbard, 2008: 94).

Total Dollars and Total Gold Reserves in billions of Dollars:

	Total Dollar Claims	Total Gold Reserve	Total Uncovered Dollars
June, 1921	44.7	2.6	42.1
June, 1929	71.8	3.0	68.8

Actually, as shown above, the regime of Gold-exchange Standard of the 20's, in which governments no more accepted to redeem their currency in gold domestically and redemption by foreigners, although formally available, was politically constrained, posed no real limits to monetary expansion.

Intellectual roots of Inflation Targeting may be found in the 1920's. Prof. Rothbard considers Yale Professor Irving Fisher as the major theoretician of the inflationists in the years of the Great Depression, as someone "*who mechanistically had believed that since the price level was not rising in the 1920's, there was no inflation to worry about and no coming crash*" (Rothbard, 2005: 303). After the crash happened Prof. Fisher urged President Roosevelt to abandon the gold standard and was rejoiced when the President finally did that. But the important lesson is what history tells us about the monetary policy before the Great Depression, and what we now know is that the only actual limits to monetary expansion at that time were already the self-limitations adopted by different central banks with eyes only on the price levels, anticipating by 60 years the strategy of

conducing monetary policy primarily aiming at a certain inflation level, and using discretion in the management of the money supply in order to achieve that goal; i.e., inflation targeting. And in face of the supposed success of FED Governor Strong in stabilizing wholesale prices during the late 1920's, Prof. Fisher was again the leader in the economic profession in welcoming the arrival of an era of continue prosperity assured by the "new" policy of managed money in America and in the world, ignorant of the fact of mounting malinvestments induced by the inflationary policies in practice during the 1920's. As stated by Prof. Murray Rothbard in "America's Great Depression":

> - "*One of the reasons that most economists in of the 1920's did not recognize the existence of an inflationary problem was the widespread adoption of a stable price level as the goal and criterion for monetary policy*" (Rothbard, 2008: 169).

In that book, Prof. Rothbard is explicit in stating that the Federal Reserve was guided not only by the desire to help the UK in their inflationist monetary policy or to help farmers, but "*by the fashionable economic theory of a stable price level as the goal of monetary manipulation*" (Rothbard, 2008: 181).

Conclusion:

The monetary policy known as "Inflation Targeting" is neither new nor effective. Seen by most economists today as the "state of the art" in monetary policy, the inflation target framework can be understood as a relabeled version of the monetary management that has gradually became possible to be exercised by central banks worldwide once the Gold Standard was diluted into the Gold-Exchange Standard.

It is not the objective of this paper to discuss the historical evolution of the Gold Standard, but suffice it to say that the golden era of the International Gold Standard with a fractional reserves' banking system structured as a pyramid with the Bank of England on the top that took form after Peel's Act of 1844 was already a regime with room for monetary

management by the central bank and that the gradual transformation of that system to a system of gold-exchange, after limited gold-exchange, after that fixed exchange rates and finally fiat money with floating exchange rates just gave more and more room for the exercise of discretionary monetary policy.

Taking the fractional reserves' system under the umbrella of the Bank of England as our departing point, inflationary credit expansion was possible, first, diminishing the prudent ratio of reserves to assets by the implicit support of the British Crown to the banking system. Later, after the Great War, already under a regime formally with a central bank, as described by Prof. Rothbard, the direct trade on money-substitutes by the FED, the Bank of England and other leading central banks was a source of inflationary credit expansion worldwide. And finally, since 1973, under fiat currency and floating exchange rates, inflationary expansion of the money supply is possible by the total discretion that central banks have today.

All along the way, the "nominal" anchor, i.e., an implicit or explicit commitment of the monetary authorities to avoiding increases in the price level as gauged commonly by a consumer price index gradually became more and more the only limitation to inflationary expansion and also the only guide to the exercise of monetary policy.

The surprising thing about policies that in essence allow discretionary expansion of the money supply so long the Consumer Price Index does not increase more than some "accepted" rate is that the shortcomings of the theoretical apparatus behind those policies are known in academic circles for about 80 years now. The inter-temporal implications of inflationary changes in the money supply, and the limitations imposed by the structure of production for monetary "management" presented by the Austrian Business Cycle Theory are concepts well known since the early 1930's; still during the Great Depression and again, during the current crisis, many economists were surprised by the effects of inflationary expansions of credit in distorting economic activity and leading to malinvestments that eventually need to be purged by a recession. As written by Prof. Murray Rothbard in "America's Great Depression:

- "*The fact that general prices were more or less stable during the 1920's told most economists that there was no inflationary threat, and therefore the events of the great depression caught them completely unaware*" (Rothbard, 2008: 169).

Inflation targeting strategies do not prevent inflationary credit expansions and therefore do not prevent cycles of boom and bust irremediably associated with them. Moreover, distortions in relative prices produced by inflationary credit expansion as described by the Austrian Business Cycle Theory are not easily perceived by price indexes, since usually they do not include assets in their composition. Massive increases in the money supply can produce sizable appreciation in certain classes of assets without barely affecting consumer prices or more generally the price level as measured by general price indexes.

Nowadays, it can be affirmed that the flexibility to engage in long term inflationary credit expansion under an inflation targeting framework can be exercised without compromising the achievement of an inflation goal as measured by most price indexes. It was true during the 1920's, it had been true since the 1990's. However, the fact is that an inflationary credit expansion distorts relative prices and provokes economic booms that eventually will go bust remains. Therefore, we may conclude that policies guided solely by targeting a certain price level as measured by an index while allowing discretion to the monetary authorities to pursue "growth" is an insufficient institutional arrangement for a society that purports to offer a good money as a fair instrument to the individuals for enhancing the division of labor, productivity and prosperity in the long run.

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