Timing and duration of inflation targeting regimes

24th November 2014

Abstract

Central banks in G7 countries shifted to unconventional policy measures in the aftermath of the Financial Crisis, when faced with economic slack, financial instability and fiscal trouble. This shift ended a spell of rules-based time consistent monetary policy that started in the mid-80s. I argue that substantial economic, political and financial risks put pressures on the continued support for a monetary regime. Central banks may be forced to adopt policies on the going with no option to reset those options later on. I demonstrate with duration models - on a sample of industrialised and emerging economies from 1970 to 2012 - that the policy switch to inflation targeting happened after episodes with high inflation and public debt, reflecting broad support for stability-oriented monetary (and fiscal) policy. More generally, changes in monetary regimes occur after a crisis. High inflation make central banks pursue active monetary policies, while they forsake those same policies in the wake of fiscal or financial crises.

Keywords: policy regimes, duration model, rule, fiscal policy, monetary policy, beliefs.


1 Introduction

From the mid eighties until the recent Financial Crisis, most developed economies have enjoyed a remarkably long period of economic stability. This Great Moderation owes much to benign economic circumstances, but many economists would attribute an important role to the anti-inflationary stance of monetary policy (Clarida et al., 2000; Lubik and Schorfheide, 2004). A rules-based policy, like inflation targeting, that can credibly commit to some nominal anchor and maintain such a policy over time is seen as key to macroeconomic stability. The success of such a policy is proven by curbing economic volatility, and bringing down inflation to low and stable levels (Svensson, 2010).