CHAPTER 1

Introduction

The Golden Age of Inflation Targeting

High inflation in the advanced economies in the 1970s and in emerging economies in the 1980s and 1990s was instrumental in shaping modern thinking about the practice of central banking. The tenets of the resulting framework are familiar and, to a large extent, uncontroversial. First, there is no permanent tradeoff between inflation and unemployment—a sustained higher level of inflation does not lead to higher growth and a sustained lower level of unemployment. Second, high and volatile inflation depresses growth and distorts the allocation of resources. Third, inflation disproportionately harms the poorest segments of society, which lack instruments for protecting themselves from its disruptive effects. For all of these reasons, price stability is the cornerstone of monetary policy.

The actions needed to achieve price stability, such as the maintenance of high interest rates, can be politically unpopular, among other reasons because they slow growth. It follows that the pursuit of price stability can be made more credible and thus more effective by granting independence or at least operational autonomy to the central bank. Otherwise, central banks may be subject to political pressure to attach greater weight to other objectives, making it harder for them to contain inflationary expectations and deliver desirable outcomes.

By the early 2000s, a growing number of central banks, in advanced countries and emerging markets alike, had converged on a policy framework, *flexible inflation targeting,* that seemed capable of achieving these desiderata and delivering macroeconomic stability at the national and international levels. In the conventional view, there are four explanations for this happy outcome:

- Flexible inflation targeting, under which the central bank aims to stabilize inflation around its target but also minimize the output gap, delivers low inflation at the national level, thereby avoiding the need for large nominal exchange-rate adjustments and the kind of overshooting that characterized the 1980s.[1]

- Flexible inflation targeting, by allowing for exchange rate variability, facilitates international adjustment. Countries experiencing demand shocks can cushion them

[1] Although neither the Fed nor the ECB had formally endorsed inflation targeting (IT), both were aiming at price stability, which made their policies similar to those of the central banks on a strict IT regime.