Inflation Targeting and Optimal Monetary Policy

Abstract

Since the early 1990s, an increasing number of countries have adopted explicit inflation targets as the defining principle that should guide the conduct of monetary policy. This development is often credited with having brought about substantial reductions in both the level and variability of inflation in the inflation-targeting countries, and is sometimes argued to have improved the stability of the real economy as well. Inflation-forecast targeting, as a systematic decision procedure for the conduct of monetary policy, was developed at central banks like the Reserve Bank of New Zealand, the Bank of Canada, the Bank of England, and the Bank of Sweden on a trial-and-error basis, with little guidance from the academic literature on monetary policy rules. But the growing popularity of inflation targeting has more recently led to an active literature that seeks to assess the desirability of such an approach from the standpoint of theoretical monetary economics. This literature finds that an optimal policy regime — one that could have been designed on *a priori* grounds to achieve the highest possible degree of social welfare — might well be implemented through procedures that share important features of the inflation-forecast targeting that is currently practiced at central banks like those just mentioned. At the same time, the normative literature finds that one ought, in principle, to be able to do better through appropriate refinement of the practices developed at these banks. Here I survey some of the most important conclusions of this literature. I shall begin by reviewing some of the respects in which inflation targeting as currently implemented represents a step toward what the theory of optimal monetary policy would recommend. In the final section of the paper, I then summarize some of the more important respects in which an optimal policy regime would go beyond current practice. Finally, as a concrete illustration of some of the general remarks that have been made about the form of an optimal policy rule, in an appendix I briefly discuss the quantitative character of optimal policy in the context of the small econometric model for the U.S. presented in Giannoni and Woodford (2003).