The Birth of Inflation Targeting: A New Era in Monetary Policy

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Hello everyone, I'm **Susanna Grigoryan**, an **Economist at the Central Bank of Armenia** and a **Level One student at the Global Forecasting School**. In this video, we'll explore how the modern era of monetary policy began — the birth of **inflation targeting**, a framework that transformed central banking worldwide and continues to shape our work today.

By the late 1980s, both advanced and small open economies had learned two hard lessons from the 1970s. First, **monetary targeting** was no longer a reliable guide for policy in an era of rapid financial innovation and unstable money demand. Second, **credibility** — the ability to anchor inflation expectations through strong institutions — had become the most valuable asset in monetary policy.

Escaping high and volatile inflation required a new framework — one built on three pillars: a **clear nominal anchor**, **operational independence**, and **transparent communication**, so that the public could understand and evaluate policy trade-offs.

New Zealand led the way. Its **1989 Reserve Bank Act** gave the central bank operational independence and a single objective: **price stability**. This objective was implemented through a **Policy Targets Agreement**, or PTA, which made the Governor directly accountable for achieving the target. This innovation marked the birth of **modern inflation targeting** — and a new mindset for making policy decisions under uncertainty.

While New Zealand was the first to adopt explicit inflation targeting, the **Bank of Canada** had already developed the analytical foundation that made such frameworks credible in practice. When the **Reserve Bank of New Zealand** sought to strengthen its process, it adopted **model-based analysis** and structured decision-making tools pioneered in Canada through the **Quarterly Projection Model**, or QPM. In essence, New Zealand created the first **legal and institutional** inflation-targeting regime, while Canada built the **analytical process** that became the global standard.

New Zealand's experience can be seen as a journey — what we call **the New Zealand Arc**.

- In **Stage One**, from 1989 to 1992, the focus was **credible disinflation**: the PTA anchored expectations and quickly brought inflation down.
- In **Stage Two**, beginning in the mid-1990s, the framework evolved into **flexible inflation targeting**, recognizing short-run trade-offs between inflation and output.
- In **Stage Three**, during the late 1990s, the RBNZ refined its **tools and communication** — publishing the forward policy-rate path and replacing the **Monetary Conditions Index** with the **Official Cash Rate**.
- And in **Stage Four**, from the 2000s onward, the RBNZ emphasized **transparency and macroprudential integration**, uniting price stability and financial stability within a coherent communication strategy.

Meanwhile, the **Bank of Canada's framework** was quietly shaping how central banks thought about policy around the world. Its **Quarterly Projection Model** embedded rational expectations, loss functions, and endogenous credibility — linking economic projections directly to policy-rate decisions. This made policy responses to shocks both systematic and transparent.

Two features of the Canadian approach soon became global norms: first, **publishing endogenous interest-rate paths**, and second, using **transparency** as an active tool of policy transmission. The RBNZ and many others later adopted these practices, showing how **institutional credibility** and **analytical credibility** reinforce each other.

Inflation targeting also rests on two deep intellectual roots.

The first is the **Long-Run Natural Rate Hypothesis**. Economists **Milton Friedman** and **Edmund Phelps** showed that only policies anchored in expectations can stabilize both inflation and output. When that principle was ignored, it led to the **Great Inflation** of the 1970s. Later, **Freedman and Laxton (2009)** explained how the **Bank of Canada** embedded this insight into its framework to ensure lasting credibility and macroeconomic stability.

The second root is the **Time-Inconsistency Problem**, identified by **Kydland and Prescott (1977)** and **Barro and Gordon (1983)**. They showed that purely discretionary policy leads to an inflation bias — the temptation to boost output in the short run at the cost of higher inflation in the long run. New Zealand's **1989 Act** addressed this directly by holding the Governor accountable for inflation outcomes. Later, several **Latin**

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American economies adopted similar institutional reforms to rebuild credibility where years of instability had eroded public trust.

Together, these two intellectual foundations demonstrate that **inflation targeting must combine model-based discipline with institutional integrity**. New Zealand emphasized institutional credibility, while Canada developed analytical credibility.

Successful frameworks — including **Armenia's Prudent Risk Management Approach** — integrate both. That brings us to **Armenia**. Our **FPAS Mark II** framework builds directly on these two traditions. Its **least-regrets approach** combines rules-based discipline with model-based flexibility. Anchored expectations, transparent communication, and continuous learning are central to sustaining credibility and managing uncertainty.

In many ways, FPAS Mark II reflects the lessons of this global journey — from the failures of monetary targeting to the creation of credible, forward-looking frameworks grounded in analysis and accountability.

The **new era** of monetary policy was not just about new tools; it was about a new mindset. Credibility, transparency, and analytical rigor became the foundation for modern central banking. And here in Armenia, those same principles continue to guide us as we strengthen our **Prudent Risk Management Approach** to meet the challenges of an ever-changing world.

Thank you for watching, and I look forward to seeing you in the next episode of the **CBA Academy**.

See you there.

Literature & Further Reading

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