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Inflation targeting at the crossroads: Evidence from post-communist economies during the crisis

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ABSTRACT

The objective of this paper is to assess if inflation targeting post-communist economies performed better, in terms of output growth, during the crisis than their non-inflation targeting counterparts. The paper also puts the issue in the context of the preconditions of inflation targeters to adopt this regime. 26 post-communist economies of Central and Eastern Europe and the Commonwealth of Independent States are analyzed during the ongoing economic crisis. Results suggest that inflation targeters of those countries performed worse than non-inflation targeters. The growth decline in inflation targeters post-communist economies has been estimated to be deeper by about four percentage points than that in non-inflation targeters. The study finds very limited role of the preconditions for growth decline. Only the lower amount of monetary financing of the budget may have contributed in inflation-targeting countries to have gone through the crisis better.

1. Introduction

Since its "invention" in the early 1990s, inflation targeting (IT) sparked a tremendous body of research. The studies evaluating macroeconomic performance under this monetary regime (Siklos, 1999; Mishkin and Schmidt-Hebbel, 2001; Kuttner and Posen, 2001; Corbo et al., 2002; Neumann and von Hagen, 2002; Angeriz and Arestis, 2007) generally conclude that after IT was introduced inflation and its persistence fell. The results on output volatility remained mixed, thus not giving support for the claim that IT is a superior strategy (Petreski, 2011a). However, these studies also found that IT countries did not perform better – in terms of inflation and output performance – than non-ITers with a similar starting point, mostly taken as an equal initial level of inflation. Consequently, much of the extant evidence fails to address the argument put forth in Friedman (2003) and Ball and Sheridan (2005) that most central banks, not just inflation targeters, enjoyed better outcomes in recent years. One reason for this is that the widespread adoption of IT happened to coincide with a period with a stable economic environment, "a period friendly to price stability" (Neumann and von Hagen, 2002, p. 129) and mild macroeconomic shocks. Hence, while IT proponents (Bernanke et al., 1999; Mishkin, 2004) strongly argued in IT's favor, IT opponents (Stiglitz, 2008; Frankel, 2012), including the FED and the ECB, continue to show skepticism toward its adoption.

The research on IT in developing, including post-communist economies, is not an exception of the general conclusion that inflation targeters performed well, but not better than non-inflation targeters (Corbo et al., 2002; Mishkin and Schmidt-Hebbel, 2001, 2006, 2007; IMF, 2005; Edwards, 2007; Conçalves and Salles, 2008; Carvalho Filho, 2010; Petreski, 2011b). However, over and above this discussion, the conduct of monetary policy in developing and post-communist economies faces several challenges. Calvo and Mendoza (2000) highlight the weak institutional environment in the post-communist

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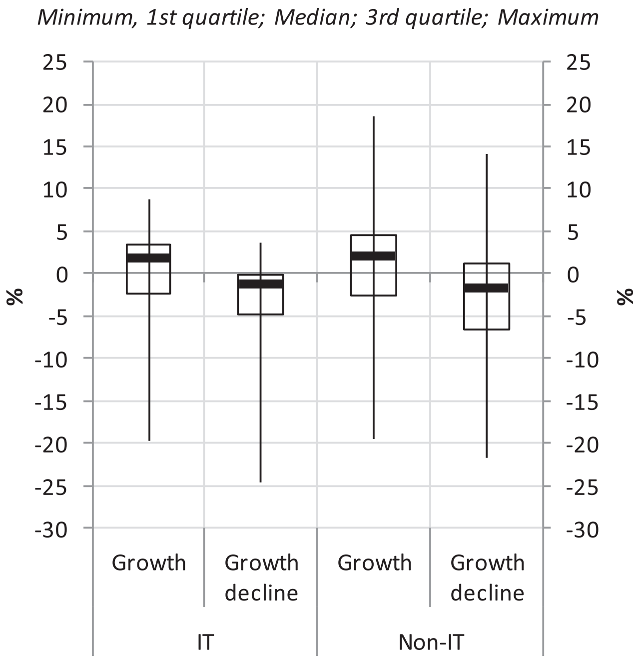

Fig. 1. Growth performance during crisis (2009–2012) under inflation targeting versus non-inflation targeting in post-communist economies. (Drafted by the author, based on IMF data).

economies: they did not have a strong record of low inflation and this could have been detrimental for successful IT. Mishkin (2004), Fraga et al. (2004) and Aizenman et al. (2011) further question the following characteristics of the post-communist process: i) the capacity of fiscal, financial and monetary institutions, including the increased probability that authorities will pursue short-run objectives without regard to the long-run damage; ii) financial and fiscal dominance; iii) the exposure to shocks and cash-inflows vulnerability of those countries that are small, open economies; and iv) the problem of high euroization. Hence, IT performance in post-communist economies has been likely shaped by those aspects as well.

Notwithstanding the ongoing debates about merits of inflation targeting, it is a stylized fact and even a warning of the pre-crisis literature (Kuttner, 2004) that it had not been tested by a situation involving large macroeconomic shock until the 2007 economic crisis came by. Until the present moment, no IT regime failed, but the question if it helped mitigating the perils of the crisis persists (Carvalho Filho, 2010). This paper opts to investigate if inflation targeting post-communist economies performed better in terms of their output growth, than their non-inflation targeting counterparts during the crisis, with special reference to their preparedness and capability to conduct this monetary framework.

The paper is organized as follows. Section 2 reviews the underlying literature on IT and presents some stylized facts about IT in post-communist economies. Section 3 puts the emphasis on the preconditions to adopt IT in post-communist economies. Section 4 presents the model, methodology and data used. Section 5 presents the results and offers a discussion. Section 6 concludes.

2. Inflation targeting at the crossroads

Inflation targeting (IT) was first introduced by New Zealand in 1990 and then followed by many developed and developing countries. Hence, many studies emerged on many aspects of IT. IT proponents, like Bernanke et al. (1999), Mishkin (2006) and Svensson (1996, 1999a,b) portrayed it as a flexible monetary framework enabling central banks to pursue countercyclical monetary policy while maintaining medium- and long-run price stability. Indeed, years under IT have been quite favorable: inflation and its persistence fell, while results on output volatility have not been worse (Siklos, 1999).

However, IT had its skeptics even from the beginning. One longstanding question is if this policy strategy could actually matter for outcomes as much as, and in the way that, its advocates said it should. For instance, a strand of the literature (Neumann and von Hagen, 2002; Friedman, 2003; Ball and Sheridan, 2005) expressed doubts that merely declaring a numerical inflation target, while reserving the right to respond to shocks, would offer any tangible advantage over conventional discretionary frameworks. The second question is whether IT's touted advantages would come at the cost of greater output instability, due to stricter adherence to a rigid policy rule (Kuttner and Posen, 2011). In other words, the concern was over the credibility-flexibility dilemma: how IT could be constraining enough to have an effect, and yet flexible enough to allow for meaningful output stabilization (Kohn, 2003; Meyer, 2004; Friedman and Kuttner, 1996). At the empirical front, literature failed to address the argument put forth in Friedman (2003) and Ball and Sheridan (2005) that most central banks, not just inflation targeters, enjoyed better outcomes in recent years. Throughout most of the period since IT was widely adopted,