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Does inflation targeting lower inflation and spur growth?

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Abstract

Over the last few decades several countries have turned to inflation targeting as a policy choice for instilling stability into their economies. Prior studies have shown that inflation targeting has reduced inflation in those countries without significantly impacting GDP. This study seeks to improve upon these results by identifying the impact of timing on the policy decision as well as its impact as related to specific regions of the world. The focus is on developing countries across six regions. We find significant regional variation in developing countries in our sample in terms of the direction of changes in inflation following a switch to the inflation targeting policy. Moreover, although the impact of inflation targeting on real GDP is minimal overall, there is a statistically significant increase in real GDP among developing countries in certain regions only, namely, Europe, Latin America, and the Middle East.

JEL classification: E31; E32; E52; F33; O5

Keywords: Inflation; Targeting; Growth; International; Emerging economies

1. Introduction and motivation

Inflation targeting is not without its critics. It has been argued that inflation targeting has several disadvantages including the following: (1) decreased discretion by the central bank that leads to declines in output growth; (2) too much discretion that results in the inability to influence inflation expectations; (3) higher exchange rate volatility as inflation targeting ignores exchange rate levels; and (4) inability of inflation targeting to be successful in countries that do not meet strict preconditions.[1]

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[1] For further information, see, among others, Batini and Laxton (2007).

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Following the most recent methodology put into place by Brito and Bystedt (2010) and applying this methodology to a large sample of developing countries, the purpose of this study is to further explore the effectiveness of inflation targeting on inflation and output growth. We extend previous literature by using a large sample of developing countries including the addition of several recent inflation targeters. Additionally, unlike previous studies, we examine the effects of inflation targeting on different regions in order to capture regional effects following evidence from Brito and Bystedt (2006) that there are regional specific effects.

Being able to assess how inflation targeting affects different regions individually is critical to understanding the effects of inflation targeting and to design appropriate policies in individual countries and specific regions accordingly. The results have important broader policy implications. For example, international monetary institutions like the IMF, the World Bank, the European Central Bank and alike can judge whether regional inflation stability and economic growth might be achieved using an inflation targeting regime. If there are differences in the performance of inflation targeting regimes, regional meetings of the IMF and the World Bank may discuss these issues by organizing policy roundtables, leading to further stability in the global economy and cooperation between policymakers and central banks in regional countries and international institutions including the IMF and the World Bank. Then these international institutions may advice individual countries and regions accordingly by better understanding the differences in the performance of inflation targeting regime across different regions. Region specific policy tools may be used to achieve inflation stability and economic growth. For example, certain countries in a region may establish new ways of coordinating policy by establishing some new forms of economic or monetary unions or agreements toward their policy objectives such as low inflation and stable economic growth.

2. Background and literature review

Inflation targeting is defined as a monetary policy that encompasses five main elements. Those countries that inflation target do the following: (1) publicly announce a medium-term numerical target for inflation; (2) have an institutional commitment to price stability as the primary goal of monetary policy to which other goals are subordinate; (3) have an information inclusive strategy in which many variables are used for deciding the setting of policy instruments; (4) have increased transparency of monetary policy through communication with public and the markets about the plans, objectives, and decisions of monetary authorities; and (5) have increased accountability of the central bank for obtaining its inflation objectives.[2]

There are currently twenty-two countries that explicitly follow an inflation targeting policy, including fourteen developing countries and eight industrial countries, spanning the entire world.[3] Within this group of countries, there are countries of varying degrees of economic development, ranging from the most industrialized countries to those countries that are still developing. The group of inflation-targeting developing countries, furthermore, is heterogeneous and the level of economic development varies drastically from one country to the next. These developing countries vary in terms of their economic practices utilized and their level of institutional development.

The results and presumed success of inflation targeting in general is still a controversial topic and varies depending on the economic development status of the country. Much work has been

[2] For further information, see Mishkin (2004, 2008).

[3] Numbers as of 2010 from central banks' websites.