



## Inflation targeting and financial stability: Does the quality of institutions matter?☆



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### ABSTRACT

Inflation targeting (IT) has recently been seen as one of the main causes of the authorities' unresponsiveness to the build up of financial imbalances during the recent financial crisis. We take data from banks from 66 countries for the period of 1998–2014 and compare how institutional quality as perceived by the national population impacts financial stability in countries that adopted IT with those that did not. We find that, while banks from IT countries with high quality of institutions do not have their stability significantly enhanced by this policy (the “paradox of credibility”), countries with average levels of quality of institutions seem to benefit from it. In addition, in the estimations, IT and financial stability are negatively associated in countries with low levels of institutional quality, which is consistent with the fact that governments must have at least some trust of their population in order to conduct effective economic policies. This inverted U-shaped relationship between IT and financial stability as function of the institutional quality reflects the two opposing views in the literature regarding this topic.

### 1. Introduction

The quality of institutions gains significant importance during financial crisis (Klomp and de Haan, 2014). Countries with high quality of institutions should be able to formulate policies to deal more effectively with adverse shocks than countries that suffer from low institutional quality. Recent discussion triggered by the financial crisis has pointed inflation targeting (IT) as one important reason for the failure of the government authorities to respond to developing financial imbalances and rising financial instability for several reasons. First, by focusing in achieving the inflation target, governments may have overlooked the situation in the financial market (Blanchard et al., 2010). Second, low and stable inflation coupled with a credible anti-inflationary policy can make it harder for financial imbalances,

such as asset bubbles, to show up in inflation indexes. In fact, Amato and Shin (2003) argue that in a model in which agents have imperfect information on the state of the economy (such as inflation), but in which they fully believe in a public signal issued by the government (i.e. high credible signal), agents beliefs might be distorted, since they might put more weight into this public signal than in actual fundamentals. In this case, inflation levels would lose its informativeness about economic (demand and cost) conditions and thus financial imbalances might develop. Therefore, governments can be a victim of their own success, phenomenon of which the literature terms as the “paradox of credibility” (Borio and Lowe, 2002; Borio, 2005, 2006; Montes and Peixoto, 2014). Third, a commitment to low inflation levels makes the economic policy too loose during normal times. Thus, the policy rate approaches the zero lower-bound, reducing the margin for any adjustment on the

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**Table 1**  
Countries, Regions, Legal Origins and Adoption of Inflation Target.

| Country        | Region    | Legal Origin | IT? | Adoption | Country            | Region        | Legal Origin | IT? | Adoption     |
|----------------|-----------|--------------|-----|----------|--------------------|---------------|--------------|-----|--------------|
| Ghana          | Africa/ME | English      | Yes | 2007     | Hungary            | Eurasia       | German       | Yes | 2001         |
| Israel         | Africa/ME | English      | Yes | 1997     | Poland             | Eurasia       | German       | Yes | 1998         |
| Kenya          | Africa/ME | English      |     |          | Poland             | Eurasia       | German       | Yes |              |
| Kenya          | Africa/ME | English      |     |          | Slovakia           | Eurasia       | German       | Yes | 2005 to 2008 |
| Nigeria        | Africa/ME | English      |     |          | Slovenia           | Eurasia       | German       |     |              |
| South africa   | Africa/ME | English      | Yes | 2000     | Bolivia            | Latin America | French       |     |              |
| Tanzania       | Africa/ME | English      |     |          | Brazil             | Latin America | French       | Yes | 1999         |
| Egypt          | Africa/ME | French       |     |          | Colombia           | Latin America | French       | Yes | 1999         |
| Jordan         | Africa/ME | French       |     |          | Costa rica         | Latin America | French       |     |              |
| Mauritius      | Africa/ME | French       |     |          | Dominican republic | Latin America | French       |     |              |
| Tunisia        | Africa/ME | French       |     |          | Ecuador            | Latin America | French       |     |              |
| Turkey         | Africa/ME | French       | Yes | 2006     | El Salvador        | Latin America | French       |     |              |
| Australia      | East Asia | English      | Yes | 1993     | Guatemala          | Latin America | French       | Yes | 2005         |
| Bangladesh     | East Asia | English      |     |          | Guatemala          | Latin America | French       |     |              |
| Bangladesh     | East Asia | English      |     |          | Mexico             | Latin America | French       | Yes | 2001         |
| Hong kong      | East Asia | English      |     |          | Panama             | Latin America | French       |     |              |
| India          | East Asia | English      |     |          | Paraguay           | Latin America | French       |     |              |
| Malaysia       | East Asia | English      |     |          | Peru               | Latin America | French       | Yes | 2002         |
| Nepal          | East Asia | English      |     |          | Canada             | North America | English      | Yes | 1991         |
| Pakistan       | East Asia | English      |     |          | United states      | North America | English      |     |              |
| Thailand       | East Asia | English      | Yes | 2000     | Ireland            | West Europe   | English      |     |              |
| Indonesia      | East Asia | French       | Yes | 2005     | United kingdom     | West Europe   | English      | Yes | 1992         |
| Philippines    | East Asia | French       | Yes | 2002     | Belgium            | West Europe   | French       |     |              |
| China          | East Asia | German       |     |          | France             | West Europe   | French       |     |              |
| Japan          | East Asia | German       |     |          | Italy              | West Europe   | French       |     |              |
| Korea          | East Asia | German       | Yes | 2001     | Luxembourg         | West Europe   | French       |     |              |
| Armenia        | Eurasia   | French       |     |          | Portugal           | West Europe   | French       |     |              |
| Kazakhstan     | Eurasia   | French       |     |          | Spain              | West Europe   | French       | Yes | 1993 to 1998 |
| Moldova        | Eurasia   | French       |     |          | Austria            | West Europe   | German       |     |              |
| Romania        | Eurasia   | French       | Yes | 2005     | Denmark            | West Europe   | German       |     |              |
| Russia         | Eurasia   | French       |     |          | Finland            | West Europe   | German       | Yes | 1995 to 1998 |
| Ukraine        | Eurasia   | French       |     |          | Germany            | West Europe   | German       |     |              |
| Bulgaria       | Eurasia   | German       |     |          | Latvia             | West Europe   | German       |     |              |
| Croatia        | Eurasia   | German       |     |          | Sweden             | West Europe   | German       | Yes | 1993         |
| Czech republic | Eurasia   | German       | Yes | 1997     | Switzerland        | West Europe   | German       |     |              |
| Croatia        | Eurasia   | German       |     |          |                    |               |              |     |              |

interest policy rates should any economic downturn arise. We contribute to the literature by evaluating the relationship between IT and financial instability while controlling for quality of institutions.

Notwithstanding this criticism, a traditional view (the [Schwartz, 1995](#) hypothesis) argues that periods of unstable price levels can lead to incorrect inferences about the future real returns of investments. This may result in flawed lending/borrowing decisions, increasing loan defaults, compromising the banking system's loan portfolio, and increasing bankruptcies. Inflation targeting improves the predictability of economic policy and reduces the degree of uncertainty about the price level over the long run (the price stability channel). [Bordo and Wheelock \(1998\)](#) argue that among the several financial crises that occurred during the XIX and XX centuries, the most severe financially distressing events occurred after unexpected and substantial disinflation.

Empirical papers that test how the quality of government institutions and inflation targeting in different countries impact financial stability are surprisingly rare.<sup>1</sup> Using bank-level data from 66 countries over the period of 1998–2014, and measures of quality of government institutions as perceived by the national population, our paper provides empirical evidence that attempts to bridge this gap in the literature. We employ two measures of quality of institutions: the Corruption Perception Index of the Transparency International, and the Government Effectiveness Index of World Bank's Governance Indicators (WGI). We interact these variables with dummies that flag whether a specific country adopted IT, as

<sup>1</sup> Among the papers that are close to our approach, we highlight ([Fouejieu, 2017](#)), [Kim and Mehrotra \(2017\)](#), and [Hove et al. \(2017\)](#). However, they do not explore the non-linearity between the quality of institutions and the adoption of an IT regime as we propose in this paper.

defined by the International Monetary Fund<sup>2</sup> in a triple DiD approach. Banks in IT countries (treated) are compared with those in non-IT countries (control) for different levels of quality of institutions. Our benchmark specification controls for time-invariant bank characteristics, and both bank- and country-level controls.

Among the advantages of our proxies to institutional quality are the fact that they are publicly available and are calculated by international trusted institutions. This avoids subjective data mining issues and improves the accountability of the paper. Moreover, these measures are related to the agents' trust in government's communication about their economic policies. We argue that the population of a non-corrupt country put more trust in their government than the population of a highly corrupt country. Thus, we can test whether the IT impact on financial stability depends on the quality of national governments. Intuitively, there must be a lower bound for the trust in the authorities in order for any economic policy to be effective. In addition, we can also test if there is also an upper bound, i.e. when the institutional quality is so high that the benefit to financial stability might not be significant anymore as [Amato and Shin \(2003\)](#) highlight. Finally, we minimize endogeneity concerns because government authorities cannot change these measures in the short term. In addition, since governments cannot easily manipulate agents' perception on corruption nor institutional quality, we

<sup>2</sup> According to [Mishkin \(2004\)](#) and [Heenan et al. \(2006\)](#), inflation targeting consists of four elements: (i) an explicit CB mandate to pursue price stability as the primary objective of monetary policy and accountability for performance in achieving the objective; (ii) explicit quantitative targets for inflation; (iii) policy actions based on a forward-looking assessment of inflation pressures that considers a wide range of information; and (iv) increased transparency of monetary policy strategy and implementation.

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