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Choice of inflation targeting: Some international evidence



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ABSTRACT

Inflation targeting has attracted attention to researchers and policy makers since the first attempt in New Zealand in 1990. This paper discusses a country's choice of inflation targeting by examining its driving forces with the dataset of 82 countries. The empirical result shows that countries' decision of adoption of inflation targeting depends highly on their development stage. For high-income or developed countries, the significant motive of monetary authority to choose inflation targeting is the desire to keep or enhance anti-inflation credibility, and inflation targeting could be a natural option under more floats with the absence of nominal exchange rate anchor. On the other hand, low-income or developing countries with the large size of public debts are not likely to choose inflation targeting, so that fiscal fragility would discourage monetary authority to adopt restrictive monetary policy under inflation targeting.

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1. Introduction

Inflation targeting is a monetary policy framework to maintain prices or inflation rates at a target level or within a specific range by controlling policy rate and other monetary policy measures. Inflation targeting has attracted attention to researchers and policy makers since the first attempt in New Zealand in 1990. It is currently in use by central banks in many countries around the world (see [Bernanke, Laubach, Mishkin, & Posen, 1999](#), for various case studies and empirical evidences). One important aspect is that the adoption of inflation targeting can be seen in not only developed countries but also emerging or developing countries. Indeed, as of 2013, inflation targeting is officially adopted by 28 countries, among which there are 15 OECD countries and 13 non-OECD countries. Given this fact, this study attempts to discuss a country's choice of inflation targeting by empirically identifying the specific characteristics encouraging a country to choose the framework of inflation targeting. Since monetary authorities or central banks, particularly in developing countries, have the responsibility to assure price stability, our analysis could provide some important guidance for conducting monetary policy effectively.

Many studies have investigated how inflation targeting affects macroeconomic variables, including output, interest rate, inflation, and exchange rate pass-through and volatility, although some results are still unsettled due mainly to short history of inflation targeting (see e.g., [Ball & Sheridan, 2003](#); [Brito & Bystedt, 2010](#); [De Mendonca, 2007](#); [Genc, Lee, Rodriguez, & Lutz, 2007](#); [Goncalves & Carvalho, 2009](#); [Goncalves & Salles, 2008](#); [Lee, 2011](#); [Levin, Natalucci, & Piger, 2004](#); [Lin & Ye, 2007](#); [Lin & Ye, 2009](#); [Odria, Castillo, & Rodriguez, 2012](#); [Vega & Winkelried, 2005](#); [Willard, 2012](#)). Among them, some studies, including [Goncalves and Salles \(2008\)](#), suggest the positive aspects that inflation targeting could reduce inflation rate and its fluctuation together with improved policy credibility. On the other hand, several works, such as [Ball and Sheridan \(2003\)](#) and [Brito and Bystedt \(2010\)](#), reveal the skepticism on the effects of inflation targeting on macroeconomic performance.

In contrast to works on the effect of inflation targeting, a relatively small number of studies have existed on the driving forces to adopt inflation targeting as a monetary policy measure. [Amato and Gerlach \(2002\)](#) discuss the roles of several preconditions for inflation targeting in transition and emerging economies, including central bank's independence, fiscal policy, and flexibility in interest rates and exchange rates. Following the method of [Ball and Sheridan \(2003\)](#) and the argument of [Eijffinger and de Haan \(1996\)](#) on monetary independence, the empirical works of [Goncalves and Carvalho \(2008\)](#), [Goncalves and Carvalho \(2009\)](#) over OECD countries present that the low level of debts, the high inflation, and flexible exchange rate are likely to inspire the choice of inflation targeting. As the most relevant work to our study, [Hu \(2006\)](#) examines a country's choice of inflation targeting with the panel data set of 66 countries, including developed and developing countries, and finds that several economic and institutional conditions, such as sound fiscal position, financial depth, exchange rate flexibility, and monetary autonomy of central bank, would encourage monetary authority to choose this policy framework.

This study also examines factors encouraging monetary authorities to choose inflation targeting by applying probit models, following the methodology employed by [Ball and Sheridan \(2003\)](#), [Goncalves and Carvalho \(2008, 2009\)](#), and [Goncalves and Salles \(2008\)](#). Our sample covers 82 countries, among which 23 countries adopted inflation targeting up to 2010. Differently from the previous studies such as [Hu \(2006\)](#), this study attempts to identify the differences in determinants of the adoption of inflation targeting between developed and developing countries by dividing our full sample into two groups of developed (high-income) and developing (low-income) countries. Our analysis enables us to discuss some important policy guidance for monetary authorities, particularly in developing countries, which are often struggling against less monetary credibility associated with higher inflation bias, large public indebtedness, and unstable political conditions.

The main results show some clear differences in the driving forces to adopt inflation targeting between developed and developing countries, which have not been identified in the past empirical studies. First, high inflation rates encourage monetary authorities of developed countries to shift their policy toward inflation targeting, while their effect on the choice of inflation targeting is insignificant in developing countries. The desire to keep or enhance anti-inflation credibility could be identified as the significant motive of monetary authority to adopt inflation targeting for developed countries, but not

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