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Research Report

The inflation targeting debate

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DIW Roundup

Politik im Fokus

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The Inflation Targeting Debate

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The Inflation Targeting Debate

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Inflation targeting has become one of the most prominent monetary regimes around the globe. Proponents argue that it reduces the dynamic inconsistency problem of monetary policy and thereby stabilises prices, which in turn promotes growth. Opponents, on the other hand, say that by focusing on price stability inflation targeting neglects other important policy objectives, such as financial stability, and thereby contributed to the built up of the global financial crisis. This roundup summarises the arguments made in the debate. It concludes that no consensus has emerged in the empirical literature about whether inflation targeting improves macroeconomic performance.

Inflation targeting has become a dominant framework for monetary policy over the last two decades. New Zealand was the first country to adopt it in 1990. It has been praised for its success in bringing down inflation and raising accountability on the side of policymakers ([Bernanke and Mishkin, 1997](#); [Ball, 2010](#)). Its popularity is reflected in the number of 29 countries which are operating under inflation targeting (IT) at the end of 2015 (see Table).

Inflation targeting countries and adoption dates

| Country | IT adoption date | Country | IT adoption date |
|-----------|------------------|----------------|------------------|
| Albania | January 2009 | New Zealand | January 1990 |
| Australia | April 1993 | Norway | March 2001 |
| Brazil | June 1999 | Peru | January 2002 |
| Canada | February 1991 | Philippines | January 2002 |
| Chile | September 1999 | Poland | December 1998 |
| Colombia | September 1999 | Romania | August 2005 |
| Czech Rep | December 1997 | Serbia | September 2006 |
| Ghana | May 2007 | South Africa | February 2000 |
| Guatemala | January 2005 | Sweden | January 1993 |
| Hungary | June 2001 | Thailand | May 2000 |
| Iceland | March 2001 | Turkey | January 2006 |
| Indonesia | July 2005 | United Kingdom | December 1992 |
| Israel | June 1997 | Finland | February 1993 |
| Korea | January 2001 | Slovakia | January 2005 |
| Mexico | January 2001 | | |

Sources: Roger (2009), National central banks.

Pros and cons of inflation targeting

As a prominent proponent of inflation targeting, [Svensson \(2010\)](#) describes IT as a monetary framework under which the central bank publicly announces an official numerical target or target range for the inflation rate over a specific time horizon. The monetary authority also explicitly communicates to the public that low and stable inflation is the main goal of monetary policy, bases its decisions on inflation

forecasts, and enjoys a high degree of political independence. IT is typically associated with enhanced communication standards of monetary authorities with the public and aims at increasing accountability, possibly through implicit incentives or explicit contracts for central bankers. Advocates of IT argue that these features in the conduct of monetary policy make announced inflation targets of the central bank more credible. According to their view, the main advantage over alternative monetary regimes is thus that IT addresses the dynamic consistency problem and thereby anchors inflation expectations.

Following [Walsh \(2009\)](#), better anchored expectations are associated with reduced and more stable actual inflation according to a standard forward-looking Phillips curve. Lower inflation variability, in turn, will potentially reduce the short-run tradeoff between inflation and output and thus the impact of macroeconomic shocks. A publicly announced and credible inflation target will thus also stabilise output. Finally, [Bernanke and Mishkin \(1997\)](#) put forth that low and stable inflation promotes long-run economic growth. This is because lower uncertainty about future inflation supports long-term savings and investment decisions and reduces the riskiness of nominal financial and wage contracts. Especially in emerging and developing economies, nominal stability can be an important prerequisite for foreign direct investment and thereby foster growth.

While these are the arguments of the proponents of IT, the global financial crisis has dramatically changed the perception of IT in the public and academic debate. It is questioned whether after these turbulences IT can still be considered as the appropriate framework for achieving macroeconomic stability. Specifically, it is argued that IT, by focusing predominantly on inflation, contributed to the build-up of financial instability ([Taylor, 2007](#); [Frankel, 2012](#)), led central banks to neglect other important objectives, such as employment ([Stiglitz, 2008](#)), and constrained monetary authorities in effectively dealing with deep balance sheet recessions ([Borio, 2014](#)).

No consensus in the academic literature

The opposing views about the costs and benefits of IT made in the public debate carry over to the academic literature. Since the first introduction of IT, many studies have analysed whether this monetary regime affects the economic performance of a country, but no consensus has emerged. [Walsh \(2009\)](#) and [Ball \(2010\)](#) provide excellent recent overviews of the literature. According to their summaries, the existing studies mostly find no effects of IT in developed economies, while there is some evidence of a positive effect of IT on macroeconomic outcomes in developing countries.

Focusing on advanced economies, [Ball and Sheridan \(2004\)](#) in a seminal contribution find no significant differences between IT and non-IT countries, as measured by the behaviour of inflation, output, and interest rates in a sample of 20 OECD member states and based on a difference-in-difference approach that controls for regression to the mean. Similarly, [Lin and Ye \(2007\)](#) detect no effect of IT on either inflation or inflation variability in industrial countries when employing propensity score matching methods. Using OLS to study the impact of IT on disinflation periods in OECD countries, [Brito \(2010\)](#) concludes that inflation targeters were not able to bring inflation down at less cost than nontargeters. On the other hand, [Gonçalves and Carvalho \(2009\)](#) find in a sample of OECD countries that inflation targeters suffer significantly smaller output losses from disinflations than nontargeters when controlling for possible selection bias through Probit or Heckman regressions.

Studying the effects of IT in developing countries, [Lin and Ye \(2009\)](#) and [Lin \(2010\)](#) show evidence based on propensity score matching that IT does lower inflation and

inflation variability. Moreover, [De Mendonça and e Souza \(2012\)](#) show in a large panel consisting of both developing and advance countries that IT reduces inflation and inflation variability only in the former group but not in the latter. They conclude that IT is particularly well suited for developing economies that aim at enhancing the credibility of their monetary authorities.

These diverging results on the general effectiveness of IT extend to studies which focus on the performance of IT during specific time periods. While [Rose \(2014\)](#), for example, finds that IT did not substantially change how a country weathered the global financial crisis, [Carvalho Filho \(2010\)](#) and [Andersen et al. \(2015\)](#) present evidence that IT countries fared significantly better than others during this episode.

Conclusions

This roundup summarises the debate on inflation targeting. It argues that no consensus has been reached in the academic discourse about whether inflation targeting improves macroeconomic outcomes. Given the empirical importance of this monetary regime, reflected in the number of 29 countries operating under inflation targeting, more research thus seems needed.

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