

Rieth, Malte

**Research Report**

## The inflation targeting debate

DIW Roundup: Politik im Fokus, No. 107

**Provided in Cooperation with:**

German Institute for Economic Research (DIW Berlin)

Suggested Citation: Rieth, Malte (2017) : The inflation targeting debate, DIW Roundup: Politik im Fokus, No. 107, Deutsches Institut für Wirtschaftsforschung (DIW), Berlin

This Version is available at:

<http://hdl.handle.net/10419/155338>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*

## DIW Roundup

Politik im Fokus

Deutsches Institut für Wirtschaftsforschung

2017

# The Inflation Targeting Debate

Malte Rieth

# The Inflation Targeting Debate

Malte Rieth | [mrieth@diw.de](mailto:mrieth@diw.de) | Department of Macroeconomics at DIW Berlin

January 9, 2017

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 advanced 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.

## References

- Andersen, T. B., N. Malchow-Møller and J. Nordvig (2015). 'Inflation targeting and macroeconomic performance since the Great Recession', *Oxford Economic Papers*, vol. 67(3), pp. 598-613. Retrieved from <http://oep.oxfordjournals.org/content/67/3/598.short>
- Ball, L. (2010). 'The Performance of Alternative Monetary Regimes', *Handbook of Monetary Economics*, vol. 3, pp. 1303-1343. Retrieved from <http://www.nber.org/papers/w16124>
- Ball, L. M. and N. Sheridan (2004). 'Does inflation targeting matter?', *The Inflation-Targeting Debate*, pp. 249-282: University of Chicago Press. Retrieved from <http://www.nber.org/chapters/c9561.pdf>
- Bernanke, B. S. and F. S. Mishkin (1997). 'Inflation Targeting: A New Framework for Monetary Policy?', *Journal of Economic Perspectives*, vol. 11(2), pp. 97-116. Retrieved from, <http://www.nber.org/papers/w5893>
- Borio, C. (2014). 'Monetary policy and financial stability: what role in prevention and recovery?', BIS Working Papers. [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2390174](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2390174)
- Brito, R. D. (2010). 'Inflation targeting does not matter: another look at OECD sacrifice ratios', *Journal of Money, Credit and Banking*, vol. 42(8), pp. 1679-1688. Retrieved from <http://onlinelibrary.wiley.com/doi/10.1111/j.1538-4616.2010.00359.x/full>
- Carvalho Filho, I. E. (2010). 'Inflation targeting and the crisis: An empirical assessment', IMF Working Papers, pp. 1-22. Retrieved from [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1562413](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1562413)
- De Mendonça, H. F. and G. J. d. G. e Souza (2012). 'Is inflation targeting a good remedy to control inflation?', *Journal of Development economics*, vol. 98(2), pp. 178-191. Retrieved from <http://www.sciencedirect.com/science/article/pii/S030438781100068X>
- Frankel, J. (2012). 'The death of inflation targeting', *VoxEU.org*, vol. 19. Retrieved from [http://voxeu.org/article/inflation-targeting-dead-long-live-nominal-gdp-targeting?quicktabs\\_tabbed\\_recent\\_articles\\_block=1](http://voxeu.org/article/inflation-targeting-dead-long-live-nominal-gdp-targeting?quicktabs_tabbed_recent_articles_block=1)
- Gonçalves, C. E. S. and A. Carvalho (2009). 'Inflation targeting matters: evidence from OECD economies' sacrifice ratios', *Journal of Money, Credit and Banking*, vol. 41(1), pp. 233-243. Retrieved from <http://onlinelibrary.wiley.com/doi/10.1111/j.1538-4616.2008.00195.x/full>
- Lin, S. (2010). 'On the international effects of inflation targeting', *The Review of Economics and Statistics*, vol. 92(1), pp. 195-199. Retrieved from <http://www.mitpressjournals.org/doi/abs/10.1162/rest.2009.11553>
- Lin, S. and H. Ye (2007). 'Does inflation targeting really make a difference? Evaluating the treatment effect of inflation targeting in seven industrial countries', *Journal of Monetary Economics*, vol. 54(8), pp. 2521-2533. Retrieved from <http://www.sciencedirect.com/science/article/pii/S0304393207000682>
- Lin, S. and H. Ye (2009). 'Does inflation targeting make a difference in developing countries?', *Journal of Development economics*, vol. 89(1), pp. 118-123. Retrieved from <http://www.sciencedirect.com/science/article/pii/S0304387808000576>

Rose, A. K. (2014). 'Surprising similarities: recent monetary regimes of small economies', *Journal of International Money and Finance*, vol. 49, pp. 5-27. Retrieved from <http://www.sciencedirect.com/science/article/pii/S0261560614000813>

Stiglitz, J. E. (2008). 'The failure of inflation targeting', *Project Syndicate*, vol. 13. Retrieved from <https://www.economics.utoronto.ca/gindart/Stiglitz%20-%20The%20Failure%20of%20Inflation%20Targeting.pdf>

Svensson, L. E. (2010). 'Inflation Targeting', *Handbook of Monetary Economics*, vol. 3, pp. 1237-1302.

[http://link.springer.com/chapter/10.1057/9780230280854\\_16](http://link.springer.com/chapter/10.1057/9780230280854_16)

Taylor, J. B. (2007). "' Housing and Monetary Policy" in *Housing, Housing Finance and Monetary Policy* Federal Reserve Bank of Kansas City'. Retrieved from <http://www.nber.org/papers/w13682.pdf>

Walsh, C. E. (2009). 'Inflation targeting: what have we learned?', *International Finance*, vol. 12(2), pp. 195-233. Retrieved from <http://onlinelibrary.wiley.com/doi/10.1111/j.1468-2362.2009.01236.x/full>

## **Imprint**

DIW Berlin – Deutsches Institut  
für Wirtschaftsforschung  
Mohrenstraße 58, 10117 Berlin

Tel. +49 (30) 897 89-0  
Fax +49 (30) 897 89-200  
<http://www.diw.de>

ISSN 2198-3925

All rights reserved.  
© 2017 DIW Berlin

Reprint and further distribution  
–including extracts–  
with complete reference and  
consignment of a specimen  
copy to DIW Berlin's  
Communications Department  
([kundenservice@diw.berlin](mailto:kundenservice@diw.berlin)) only.