



Low-inflation-targeting monetary policy and differential unemployment rate: Is monetary policy to be blamed for the financial crisis? – Evidence from major OECD countries

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ABSTRACT

Since the mid-1990s, monetary policy discussion has been centered around whether targeting inflation rate too low was responsible for the differential unemployment rate observed between major OECD countries and the US. In late 2000s with the financial crisis, critiques have argued that these economies had fallen into liquidity trap sooner because of the policy mistake of adhering to the 2% inflation target when the policy rate was already too close to zero. As the argument goes, since there was not enough room left to maneuver, central bankers were powerless in their attempt to revive the economy when aggregate demand collapsed. Using SVAR methodology, this paper formally investigates whether unanticipated deviation of OECD short-term rates from the fund rate can indeed explain differential unemployment rate with the US. It also discusses whether low-inflation targeting monetary policy is to be blamed for the financial crisis. The results show that interest rate differential shocks have no effects on unemployment in the very short-run. However, in the long-run, the cost for deviating drastically from US monetary policy is indeed higher and persistent unemployment at home, on average 30, 102, and 186 basis-points after 10, 15, and 20 quarters, respectively for the period 1989q1–2009q4. This cost is on average higher for inflation- than non-inflation targeting countries. These findings suggest that the fear of unemployment was partly the reason central bankers kept interest rate low since commodity prices were falling as a result of globalization while the economies were returning to normal partly due to positive supply shocks. Since Canada had its interest rate well aligned with the fund rate prior to the crisis while the inflation target was 2%, but did not suffer as much because sound mortgage rules and financial regulation were in place, the view that higher inflation target might have produced a different outcome does not seem to rest on firm grounds. Therefore, this paper lends support to the view that lax mortgage rules and financial deregulations in the US were the main factors responsible for the crisis.

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1. Introduction

The objective of this paper is to determine whether unanticipated deviations of OECD countries' short-term interest rates from the United States (US) rate can explain differences in their unemployment rates with the US, and whether low-inflation targeting monetary policy could be blamed for the recent financial crisis. The countries selected for comparison are France, Germany, Italy, Japan (which are known as non-

inflation targeters – non-IT), Canada, United Kingdom (UK), Australia, and New Zealand (which are known as inflation targeters – IT).² Cognizant that central bankers in the latter group of countries influence short-term interest rates through a policy rate to keep inflation at a certain level or within a certain range while the US and others did not have such a target (Collins and Siklos, 2004), at least explicitly, we therefore ask whether the stance on inflation matters when it comes to the repercussions of large differential interest rate with the US.

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² See Hu (2006) for a comprehensive list of inflation and non-inflation targeters, and Collins and Siklos (2004) for a comparison between Australia, Canada, and New Zealand that explicitly targets inflation, and the U.S. that does not explicitly target inflation. Their results show that there are broad similarities in monetary policies despite the apparent differences. It is worth noting that our distinction between IT and non-IT is only valid for the period prior to EMU for European countries.

It has been a little over a decade since Akerlof, Dickens, and Perry (hereafter ADP) (1996), based on the original work of Tobin (1972), have challenged the wisdom of monetary neutrality embodied in the long-run vertical Phillips curve and its empirical counterpart; the non-accelerating inflation rate of unemployment, NAIRU, by showing that low rates of inflation may cause high and persistent rates of unemployment when nominal wages are downward rigid. Their findings therefore suggest that low inflation-targeting monetary policy can be destabilizing for countries if central bankers take as *article of faith* that there is no trade-off between inflation and unemployment in the long-run. This contribution is particularly of importance for OECD countries where labor unions are strong and inflation is targeted at low levels.

Several authors have built on the work of Akerlof et al. (1996) to either explain unemployment rate in a single country or differential unemployment rate across countries and their link with aggressive zero-inflation-targeting monetary policy. For example, Akerlof et al. (1996) have applied their own model to US and Canadian data to show there is a long-run tradeoff between unemployment rate and inflation rate. Djoudad and Sargent (1997) reached a similar conclusion based on Canadian Data. Exploring the same line of research, ADP (2000) and Fortin and Dumont (2000) have respectively present empirical results based on US and Canadian data for an efficiency wage model where agents are assumed to be near-rational, and therefore may deviate from profit- and utility-maximization under certain conditions. Lundborg and Sacklén (2006) apply the ADP model to Swedish data to investigate the relationship between low-inflation targeting and long-run unemployment. Their research shows that the data do not support the NAIRU model for the Swedish economy and suggests that an increase in inflation target from 2% to 4% would bring long-run unemployment down by several percentage points. In their view, this finding carries serious implications for the euro countries since adherence to a single inflation target by the European Central Bank (ECB) is likely to generate excess unemployment in individual member countries. On a cross-country basis, Fortin (1996, 2001) offers the relative tightness of monetary policy in Canada in comparison to that of the US as the main culprit for the high and persistent differential unemployment rate between the two countries that worsens in the 1990s with the recession, the so-called The Great Canadian Slump. Ball's (1997) work on the linkages between changes in unemployment and disinflation reveals that the cost of disinflation is high and persistent unemployment rates for OECD countries. He noted that OECD countries with larger reductions in inflation or which take longer to achieve a given reduction in inflation have also endured increases in unemployment for longer periods of time. Dickens (2001) provides further evidence of a nonlinear Phillips curve for a number of European countries based on the near-rationality hypothesis.

Disagreements, however, persist in the literature as to whether monetary policy can be destabilizing for economies that targets zero-inflation or price stability, a proposition that goes against the well-accepted consensus among economists on NAIRU (see Friedman and Macklem, 1998; Crawford and Hogan, (1998–99); Crawford, 2001; Crawford and Wright, 2001; Faruqui, 2000; Farès and Hogan, 2000; Mishkin, 2001; Parkin, 2001, to cite just a few). The key puzzling question however remains: can differences in monetary policy targets explain the differential unemployment rate between major developed countries and the US? Subsequent contributions to the literature have mostly amplified on the advantages or pitfalls of inflation targeting. The focus has been generally on inflation and output outcomes over several years (e.g. Ball and Sheridan, 2005; Batini and Laxton, 2007; Batini et al., 2005; Brito and Bystedt, 2010; Gonçalves and Salles, 2008), but not on the ensuing differential unemployment rate that may arise or the vulnerability to economic shocks, be they local, regional, or global. Beck et al. (2009) examine the size and persistence of differential inflation rates for six euro area countries and find that national factors such labor market institutions play an important role in inflation rates variation. Malikane and Semmler (2008) investigate the implications of adopting inflation targeting policy

when unemployment rate is high in a small open economy. Their finding show that the optimal Taylor rule is robust to real exchange rate, aggregate demand and productivity shocks. However, they also show that in the context where the unemployment rate is high, the robustness to demand shocks is equivalent to trapping the economy at high unemployment rate equilibrium. Altavilla and Ciccarelli (2010) study the link between inflation forecasts, monetary policy, and unemployment dynamics in the euro area and the US. Their results show that the estimated effects of shocks to interest rates on unemployment might depend on both the method used to forecast inflation and on the rule that the policymaker adheres to. Altavilla and Ciccarelli argue that the result of their paper is independent of whether they consider the euro area or the US. In the latter, interest rate shocks can have larger and more significant effects on unemployment than in the former, the reason being the higher degree of persistence in European unemployment. de Carvalho Filho (2010) has recently investigated how countries with inflation targeting fared in comparison with their non-inflation peers during the recent financial crisis. Of importance to this paper, she finds some weak evidence that inflation targeting countries did better on unemployment rates, though advanced IT countries have had relatively stronger industrial production performance and higher GDP growth rates than their non-inflation targeting peers. However, she could not find such difference for emerging countries or her full sample. Brito and Bystedt (2010) show that there is no evidence that IT in emerging economies improves economic performance as measured by the behavior of inflation and output growth. Output growth is actually lower during IT adoption.

It is worth noting that none of the above cited papers explored the direct linkages between the monetary instruments and unemployment rates. What we care about in this paper along with Akerlof et al. and Fortin is not the usual deviation from the fund rate that takes place due to financial market adjustments in prevention of capital outflows from OECD countries but rather the large unexpected deviations with excess unemployment as a consequential effect. The critical issue that is also raised in this paper is that of foreign central bank dependence on the US. These issues do not appear to have been formally investigated in the literature.

This paper tests for cointegration to uncover the interest rate linkages between each major OECD country and the US and estimates quarterly structural vector autoregression (SVAR) models with two and three endogenous variables. The bivariate models contain the differential between each country's real short-term interest rate and the US rate and the differential between each country's unemployment rate and the US unemployment rate whereas the trivariate models include the differential inflation rate between each country and the US as a third variable. The empirical results indicate that major differences with the US in terms of monetary policy did give rise to higher and persistent unemployment rate for the countries considered, save for Japan in the 1990s. These finding tend to suggest that keeping interest rate in line with the fund rate by targeting inflation rate at a higher level could have alleviated unemployment in OECD countries prior to the recent crisis. However, since monetary policy in the US has been blamed for the debacle in the housing market that triggered the financial crisis, and given that OECD countries had higher interest rates than the US, this should have served as a shield for their housing market, but it did not. Therefore, the consensus that lower interest rate was the major culprit for the financial crisis does not seem to sit on firm grounds. It makes more sense to blame the crisis on lax mortgage rules and financial regulations in general than on monetary policy. The reason is that Canada had almost the same interest rate as the US prior to the recent crisis but did not suffer as much as its counterparts of the G8. Canada's ability to weather the storm, as many economists agree, stems from the sound financial structure and regulations in place.

The rest of the paper is organized as follows. Section 2 discusses the conceptual framework and methodology. Section 3 presents the empirical results and analysis. Section 4 concludes the paper.

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