

# Understanding the disinflations in Australia, Canada and New Zealand using evidence from smooth transition analysis

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## Abstract

This paper investigates the disinflation experiences of three countries, Australia, Canada and New Zealand. Unlike previous approaches which have sought to use institutional data to pre-determine the causes, speed and duration of the transitions to low inflation regimes this paper allows price data itself to determine the speed and timing of the reforms using smooth transition analysis. The results show that the process of transition is related to two factors: central bank independence and the general slowdown in economic activity which occurred during the early 1990s in all OECD countries. Other reforms to the labor market and fiscal policy were less influential. © 1999 Elsevier Science Ltd. All rights reserved.

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## 1. Introduction

The 1990s have seen a major shift of emphasis in the objectives and operation of macroeconomic policy in industrialized countries. For many countries, the move towards quantified inflation targets set by governments and tracked by newly independent central banks has marked a distinct regime change from an era of more discretionary policy aimed broadly at full employment. The adoption of inflation

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targets and the role of central bank independence in achieving them has received a considerable amount of attention in the literature, yet often the monetary policy reforms have been accompanied by other changes in fiscal policy, labor markets and general economic conditions.<sup>2</sup> While the vast majority of the empirical papers consider the direct link between inflation targets, central bank independence and inflation performance fewer consider the impact of other simultaneous reforms.<sup>3</sup> In this paper we introduce a method of endogenously determining the timing and duration of the transition process in price series *before* matching the results to the institutional changes to central banks, labor markets, fiscal policy and general economic conditions. In so doing we can remain objective about the precipitating causes of the transition, since we do not have to specify in advance exactly which reforms influenced the trend path of prices or how they may have done so.<sup>4</sup> In previous work other authors have used prior institutional knowledge to suggest the likely speed and duration of reforms, which is then tested against the data itself by allowing the disinflation process to alter during the period of the reforms. There are evident pitfalls that exist when specifying the transition a priori from institutional data, however, since the methodology requires that the process is correctly identified and that the timing of its impact is known.

The smooth transitions analysis, due to Leybourne et al. (1997), endogenously determines the transition length and speed, which can then be matched up to timing of reforms. Thus, the heart of our approach is to endogenously pre-determine the timing and duration of the transition in prices and then to compare this with the timing of reforms.<sup>5</sup> The smooth transition analysis provides information on the actual speed and duration of the transition between regimes, which is only obtainable directly from the price data itself. Only *after* the transition path has been determined is the institutional data consulted. This enables us to make an objective assessment of the timing and impact of various reforms on the transition process. If the reforms have been successful in reducing inflation the results should be evident in the coincident timing of the reforms and the transition in the trend of price indices for these countries.

The paper proceeds as follows, Section 2 explains the institutional reforms of central banks in Canada, Australia and New Zealand that offer three examples of significant macroeconomic policy reforms with respect to the control of inflation.

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<sup>2</sup> Examples of papers in the literature that have dealt with central bank independence and inflation performance include Cukierman (1992), McCallum (1995a,b), Lohmann (1992), Waller and Walsh (1996) and Walsh (1995a,b).

<sup>3</sup> A notable exception is Bleaney (1996) who makes this the main focus of his paper. He seeks to explain inflation performance in 17 OECD countries over two sample periods using indices of central bank independence *and* centralization of wage bargaining.

<sup>4</sup> The countries concerned have targeted inflation but the effects of the change in regime, amounting to a disinflation, should be apparent in the trend path of the relevant price series. Even if there is base drift the effects of the reforms, when successful, will be apparent in a change in trend to prices.

<sup>5</sup> We do not attempt to use regression analysis, based on an arbitrary assessment of the timing and impact of reforms using dummy variables, to explain the disinflation process. Rather we turn the process on its head and establish the transition period and compare this to the timing of institutional reforms.

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