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journal homepage: www.elsevier.com/locate/jbeeDo preferences shape institutions? The case of inflation aversion and inflation targeting[☆]Nicolás De Roux^a, Marc Hofstetter^{b,*}^a Department of Economics, Columbia University, USA^b Department of Economics and CEDE, Universidad de Los Andes, Colombia

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ABSTRACT

We show that preferences, estimated with subjective measures of individual well-being, help to explain the adoption of certain types of institutions. In particular, we show that countries exhibiting greater inflation aversion are more likely to adopt the inflation targeting monetary regime.

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1. Introduction

A growing strand of economic research has used measures of self-reported well-being as a proxy for individual welfare. Answers to questions like “How happy are you” or “On the whole how satisfied are you with your life” have allowed the study of a series of relevant questions in the discipline.¹ Studies using “happiness” data have examined issues from a wide array of topics such as the valuing of public goods or the assessment of the costs and

benefits of public policies²; the literature has covered both microeconomic aspects—e.g., how subjective well-being is affected by income—and macroeconomic issues—e.g., how inflation and unemployment undermine well-being.³ The relationship between these variables and happiness can be (and has been) interpreted as a direct measure of individual preferences for them.

In our paper, we explore to what extent preferences, measured with subjective well-being data, shape institutions. More specifically, we focus on preferences for macroeconomic outcomes—in particular, inflation—and show that they are related to the type of monetary institution adopted by countries. Our results show that countries that are more inflation averse are more likely to adopt inflation targeting (IT)—a monetary regime that can be interpreted as one that places a larger weight on inflation goals than a non-IT one, e.g., [Walsh \(2010\)](#).

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¹ For a survey of the use of happiness data in economics and the determinants of subjective well-being see for instance [Di Tella and MacCulloch \(2006\)](#), [Frey \(2008\)](#) and [Layard \(2005\)](#).

² See for example [Van Praag and Baarsma \(2005\)](#) and [Gruber and Mullainathan \(2005\)](#).

³ On the effect of income on measures of subjective well-being see for example [Blanchflower and Oswald \(2004\)](#). On the relation between unemployment, inflation and life satisfaction see [Di Tella, MacCulloch, and Oswald \(2001\)](#).

To the best of our knowledge, ours is the first study that documents how preferences, measured directly using subjective well-being data, might shape or at least be related to institutions. There are nevertheless two papers that are close to the spirit of our work. Alesina, Di Tella and MacCulloch (2004) use surveys on life satisfaction to measure preferences over inequality for both Europeans and Americans. While European's subjective well-being is largely and negatively affected by inequality, this effect is less evident in the American case. The authors argue that a possible explanation is that Europeans care about inequality more than Americans do which in turn could explain why European institutions relative to American's are more oriented toward income distribution and the Welfare State. Clark et al. (2005), estimate different marginal utilities of income using measures of self-reported well-being for a sample of European countries. Although they argue that preferences over distribution and economic policies should differ across countries they do not explore empirically whether and how these preferences shape institutions.

In our paper, we test whether inflation aversion along with the other variables proposed in the macro-literature predict the probability of adopting IT. We measure inflation aversion by estimating the impact of inflation on life satisfaction, using empirical specifications similar to those of Di Tella, MacCulloch, and Oswald (2001), Wolfers (2003) and Alesina, Di Tella and MacCulloch (2004).

Why might life satisfaction be affected by inflation? From a theoretical standpoint, modeling inflation as affecting negatively some welfare measure is a well-established tradition in macroeconomics. For instance, the Barro-Gordon family of models relies on utility functions that depend on inflation. From an empirical standpoint, survey-based evidence has shown that people dislike inflation. For instance, Shiller (1997) surveyed 667 individuals from different countries and concluded that the main perceived cost of inflation is that it lowers people's standard of living. Other non-conventional costs are also reported and are related to factors such as political instability, loss of morale and damage of national prestige. Subsequent papers such as Di Tella, MacCulloch, and Oswald (2001) or Wolfers (2003) showed that in industrialized countries inflation reduces self-reported satisfaction levels.

In this paper, after estimating inflation aversion, we assess whether or not it affects the probability of adopting IT. We find strong evidence supporting our conjecture: inflation aversion is a good predictor of the likelihood of adopting IT. A few papers evaluating the impact of IT have taken some preliminary steps trying to uncover what variables make the IT adoption more likely (e.g., Goncalves and Carvalho, 2008; Mishkin and Schmidt-Hebbel, 2001). We show that the statistical and economic relevance of inflation aversion as a determinant of the likelihood of adopting IT holds even after controlling for the variables studied in this literature. As a matter of fact, inflation aversion is the only variable in our estimations that remains significant across most specifications and empirical strategies. Nevertheless, given that we have a small sample, our results are only suggestive and do not necessarily imply a causal relation between inflation aversion and IT.

Of course, a natural question that arises is through which mechanisms the population's preferences for inflation might shape monetary institutions as our results suggest. While this is not a question addressed in the paper, some clues can be found elsewhere. Vargas and Betancour (2010) discuss anecdotal evidence for Colombia that suggests that the monetary policymaker preferences respond to those of the population if the independence of the Central Bank is threatened. More generally, it is plausible that the population's preferences translate into a particular set of institutions through democratic or political processes.

The remainder of the paper is organized as follows. Section 2 describes our empirical strategy; Section 3 describes the data;

and Section 4 reports and interprets the results. In Section 5, we describe several robustness tests and extensions. Section 6 concludes.

2. The empirical model

Our main conjecture is that the adoption of inflation targeting depends, among other things, on the level of inflation aversion in a country. Countries with high levels of inflation aversion should adopt institutions designed to fight inflation. Thus, our first task is to estimate the degree of inflation aversion. For this, we follow a strategy inspired by Di Tella, MacCulloch, and Oswald (2001). In their seminal paper, they show that inflation and unemployment negatively affect self-reported life satisfaction measures. The coefficient linking life satisfaction to inflation can be interpreted as a measure of the degree of inflation aversion. We then use the inflation aversion estimates to assess their role as potential determinants of the probability of a country adopting IT. Thus, our empirical strategy has three stages:

- Estimate a country-year measure of life satisfaction (LS);
- Estimate the inflation aversion of each country—that is, the effect of inflation on our LS measure; and
- Estimate the role of inflation aversion and other variables in explaining the probability of a country adopting inflation targeting.

2.1. Life satisfaction measure

The first stage focuses on obtaining our country-year life satisfaction measure using surveys (described in detail in the next section) including the following question: "In general terms, would you say that you are satisfied with your life? Would you say that you are: very satisfied, fairly satisfied, not very satisfied, or not at all satisfied?"

Our strategy to obtain our LS measure follows closely one proposed by Wolfers (2003). In particular, we first code the answers as follows: 1 = "not at all satisfied"; 2 = "not very satisfied"; 3 = "fairly satisfied"; and 4 = "very satisfied" and then run an ordered probit regression of this variable on a full set of dummies for each country-year and a set of micro-controls. LS is the corresponding country-year fixed effect in the ordered probit. In other words, we obtain country-year satisfaction levels that emerge after controlling for the characteristics of the persons interviewed, such as income proxies, marital status, age, employment, education, and so forth.⁴

2.2. Inflation aversion

For the baseline case, we estimate the following pooled regression (similar to that in Di Tella, MacCulloch, and Oswald, 2001; Wolfers, 2003):

$$LS_{it} = \beta_i - \gamma_i \pi_{it} - \delta U_{it} + \epsilon_{it} \quad (1)$$

LS_{it} is our measure of life satisfaction for country i and year t , β_i is a country fixed effect, π_{it} is the inflation rate, U_{it} is the

⁴ Other measures of LS at the country-year level have been proposed (see Wolfers, 2003, for an example). Two of them are prevalent in the literature. (i) The simple average of LS for each country year; (ii) the country-year fixed effect of an ordered probit but without micro controls (e.g. Stevenson and Wolfers, 2008). We also computed these two measures of LS and they turn out to be highly correlated with our measure of LS. The correlations are respectively 0.987 and 0.988. The main results of the paper remain unchanged if any of these two measures is used instead of ours. Results are available upon request to the authors.

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