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## Does inflation targeting improve fiscal discipline?



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We explore the performances of inflation targeting (IT) adoption in terms of fiscal discipline (FD), while most existing studies focus exclusively on the role of FD as a precondition for IT adoption. Using a sample of developing and developed countries, we show that IT adoption exerts a positive and significant effect on FD, a result robust to a wide variety of alternative specifications. In addition, this effect is statistically significant only in developing countries, a result that may fuel the current debate regarding the relevance of IT adoption in general, and particularly for developing countries.

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### 1. Introduction

Two decades ago, the Reserve Bank of New Zealand adopted a new framework for the conduct of its monetary policy, namely inflation targeting (IT). IT is mainly characterized by 5 criteria, namely (i) public announcement of a medium-term inflation target, (ii) institutional commitment to price stability as the primary goal of monetary policy, (iii) forward-looking strategy for inflation forecasts, (iv) enhanced transparency, and (v) greater accountability of central bank in achieving its inflation target (for an extensive discussion, see, e.g., Svensson, 1997; Mishkin, 2000; or Truman, 2003). Since its first adoption, the popularity of IT has grown considerably, to the point where 30 central banks use it currently as their operational framework for conducting monetary policy, and many others, especially

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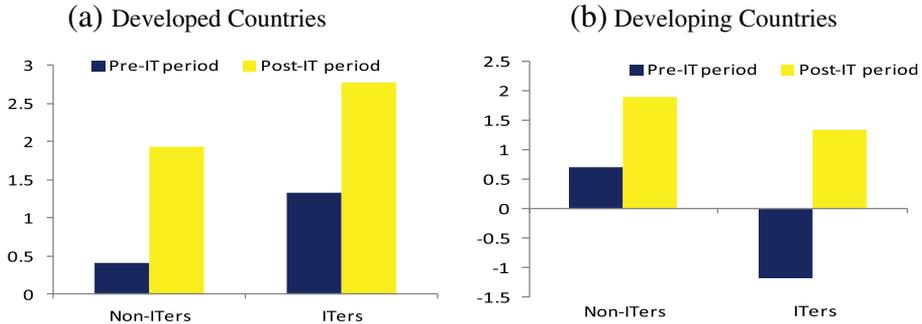


Fig. 1. The evolution of the average primary fiscal balance in IT and non-IT countries.

developing countries, are planning to move towards it.<sup>1</sup> This increased popularity of IT stems mainly from its alleged macroeconomic benefits. For example, IT adoption was found to bring down inflation levels and its volatility (Vega and Winkelried, 2005; Mishkin and Schmidt-Hebbel, 2007; Lin and Ye, 2009), output volatility (Levin et al., 2004; Petursson, 2005; Gonçalves and Salles, 2008), or interest and exchange rates volatility (Batini and Laxton, 2007; Rose, 2007; or Lin, 2010).<sup>2</sup>

The present paper extends this literature by focusing on the linkage between IT and fiscal policy. In addition to the traditional view defending an exclusive role for monetary policy regarding inflation dynamics, an influential strand of literature, inspired by the seminal contribution of Sargent and Wallace (1981), points out that fiscal policy can equally be a source of inflation. Indeed, in a context of “fiscal dominance”,<sup>3</sup> a loose fiscal policy can drive inflation because the central bank must ultimately monetize the public debt, consistently with the unpleasant monetarist arithmetic (Sargent and Wallace, 1981). An alternative rationale, which is the heart of the Fiscal Theory of the Price Level (see, e.g., Leeper, 1991; Sims, 1994; Woodford, 1995; Cochrane, 1999; Gordon and Leeper, 2005; or Sims, 2011) or more broadly of the literature on the price level determinacy (see, e.g., Aiyagari and Gertler, 1985; Sims, 1988; or Woodford, 1994), is that under fiscal dominance, newly issued nominal government bonds will cause the price level to rise to meet the government’s intertemporal budget constraint.<sup>4</sup>

These findings, emphasizing the limits of inflation targeting in the presence of fiscal dominance and/or loose fiscal policies, led to the widespread recognition that a sound fiscal stance is, in addition to the monetary preconditions,<sup>5</sup> a key prerequisite for a credible implementation of inflation targeting (see, e.g., Masson et al., 1997; Mishkin, 2000; Sims, 2005; or Bernanke and Woodford, 2005).

However, contrary to a potential role of fiscal discipline (FD) as a prerequisite for IT implementation, little is said about the eventual effect of IT adoption on FD. Fig. 1 illustrates the change in the average

<sup>1</sup> According to Batini et al. (2006), more than 35 developing countries explore the possibility of adopting an inflation targeting monetary regime.

<sup>2</sup> Note however that some studies challenged these macroeconomic benefits of IT (see, e.g., Ball and Sheridan, 2005; Ball, 2010; or Brito and Bystedt, 2010).

<sup>3</sup> A regime wherein the government sets fiscal balances in a way that does not allow meeting its intertemporal budget constraint.

<sup>4</sup> The impact of these strands of literature is considerable, as recently emphasized by Sims (2011, page 55): “There is no excuse for econometric models intended for monetary policy analysis to continue to omit serious treatment of fiscal behavior. It is clear from the theoretical analysis that fiscal policy can be a primary transmission mechanism or a primary source for changes in the inflation rate”. Leeper (2009, page 21) adds that “...in the realm of inflation control,... it is generally true that it is the joint behavior of monetary and fiscal policy that matters, even in normal times”.

<sup>5</sup> Such preconditions are discussed by, e.g., Amato and Gerlach (2002), Mishkin (2004), or Batini and Laxton (2007), and include a sufficient degree of central bank operational independence, a sound financial system, resilience to changes in exchange and interest rates, absence of dollarization, absence of price regulation, and a developed technical infrastructure for forecasting the inflation process and the transmission mechanism.

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