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Inflation targeting makes the difference: Novel evidence on inflation stabilization

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Though Svensson (1997, 2003) provides theoretical evidence that the introduction of inflation targeting is consistent with an inflation stabilizing monetary policy, empirical evidence that the introduction of inflation targeting actually changes central bank's behavior is still missing. This paper aims to close this gap and estimates forward-looking monetary policy rules for 20 inflation targeting countries. To this end, we use a data set which is available to the central bank in real-time, published on a frequently basis, comparable among all countries, and which includes the periods before and after the introduction of inflation targeting. We find that the introduction of inflation targeting significantly shifts the central bank's reaction function toward inflation stabilizing. We also provide evidence of time-varying effects and find that central banks stabilize inflation once inflation targeting is introduced. We take our results as strong evidence that the introduction of inflation targeting makes the difference for monetary policy strategies.

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1. Introduction

In the past decades inflation rates across the globe have been reduced significantly. In the 1980s Latin-American countries experienced the highest inflation rates of all countries averaging more than 200 percent per year. In contrast, in 2007 they had an average inflation rate of about 6 percent. A

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similar process of declining inflation rates took place in many central and eastern European countries during the 1990s. As a group, these countries reduced their inflation rates substantially from, on average, 45 percent per year in the 1990s down to, on average, 5 percent per year in 2007. This process of stabilizing inflation was achieved under fairly different monetary and exchange rate regimes, ranging from the adoption of inflation targeting combined with floating exchange rates to the abandonment of independent monetary policy by introducing currency boards or even by a dollarization of the economy.

While all stabilization strategies aim to increase central bank's credibility in order to stabilize inflation expectations and, thus, inflation itself, inflation targeting is the most prominent strategy and, hence, has gained substantial support among the economics profession. So has the use of Taylor rules for characterizing central banks' behavior. Even though theoretically inflation targeting is proven to be consistent with monetary policy rules (Svensson, 1997, 2003), empirical evidence that inflation targeting has actually changed the monetary policy behavior has not yet provided. There are studies which support the view that inflation rates have decreased in inflation targeting countries (Corbo et al., 2002; Landerrechte et al., 2001), however, it is less clear whether this is due to the introduction of inflation targeting, since this effect also occurs in non-inflation targeting countries (Mishkin and Schmidt-Hebbel, 2006). By comparing 7 inflation targeting countries with 13 non-inflation targeting countries Ball and Sheridan (2006) could not detect any differences in economic performance once they controlled for differences in the economies' historical development. Looking at the trade-off in output and inflation volatility in inflation targeting and non-inflation targeting economies Cecchetti and Ehrmann (2002) found evidence that although the aversion to inflation variability increased in all economies, the increase was (modestly) higher in the inflation targeting countries. Other studies fail to show that central banks indeed act more stabilizing once inflation targeting is introduced (Mehrotra and Sánchez-Fung, 2009; Brito and Bystedt, 2010). This paper contributes to the literature since it does not employ the cross-section dimension and compare inflation targeting countries to non-inflation targeting countries but rather employs a time-series approach for a group of 20 inflation targeting economies.

We provide strong and unique evidence that the introduction of inflation targeting has changed the behavior of monetary policy authorities in the sense that once a country formally introduces inflation targeting, the inflation coefficient in its monetary policy reaction function increases significantly to values above unity for the majority of inflation targeting countries. This feature reflects the Taylor principle and it is strongly associated with economic stability (Galí, 2008).

To this end, we use a data set which allows us to exactly estimate the effect of inflation targeting for a large number of countries. This identification strategy is superior to comparing inflation targeting to non-inflation targeting countries since the latter method neglects country specific characteristics (Mishkin and Schmidt-Hebbel, 2006). Our data set and research strategy is similar to Crowe (2010) and allows us to directly measure the impact of an inflation targeting regime. Crowe (2010) shows that the adoption of inflation targeting promotes the convergence in forecast errors for eleven countries suggesting that the adoption enhances transparency. Our data set is available to the central banks in real-time, frequently published and reflects the forward-looking nature of central bank's policy. Furthermore, it allows us to compare the results among a large number of countries since the characteristics of the data are similar among the countries.

The paper continues as follows. The subsequent Section 2 briefly reviews the commonly applied empirical concept of Taylor-type rules. Section 3 introduces the data set. Sections 4 presents the empirical results. Finally, Section 5 concludes.

2. The empirical morphology of Taylor-type rules

All major central banks in industrial and emerging economies currently conduct monetary policy by using market-oriented instruments in order to influence the short-term interest rate. Since the seminal paper of Taylor (1993), it has virtually become a convention to describe the interest rate setting behavior of central banks in terms of monetary policy reaction functions. In its plain form, the so-called Taylor rule states that the short-term interest rate, i.e., the instrument of a central bank, reacts to deviations of inflation and output from their respective target levels. Although the Taylor rule started

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