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Does inflation targeting matter for output growth? Evidence from industrial and emerging economies

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Abstract

This paper examines the effects of inflation targeting (IT) on output growth over the "globalization years" of 1986–2004. Employing static panel data methods that control for traditional growth determinants, trade openness and financial globalization, the paper finds that the adoption of a fully fledged IT regime results in higher output income per capita for industrial and emerging economies. However, under dynamic model specifications, the estimated long-run output impact of inflation targeting for emerging market economies is found to be lower than in the case of static models. We argue that this might be due to the long lags until the full effects of greater credibility are felt in the real economy and the fact that emerging market economies adopted the regime much later than industrial economies.

JEL classification: F31; F32; F33; F34

Keywords: Economic growth; Globalization; Inflation targeting; Panel data methods

1. Introduction

Inflation targeting (IT) started to be implemented in the late-1980s by some industrial economies and by a number of emerging and developing countries throughout the 1990s. Research on the topic has gradually gained importance and the partial consensus among researchers seems to

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suggest that IT has been effective in achieving price stability but with differing paces in emerging market economies and in industrial economies (see Ball & Sheridan, 2005 for earlier evidence).

There are different reasons that may lead a country to pursue the objective of price stability. Several studies have highlighted the effects of inflation on growth and other development related factors. For instance, in a recent paper Son and Kakwani (2008) observe that a lower level of inflation is associated with pro-poor growth – defined as the type of growth that benefits the poor proportionally more than the non-poor – and that a higher level of inflation is related to anti-poor growth. Their results are in line with those by De Gregorio (1992), and Barro (2001), who conclude that inflation is harmful for growth.

Although there is no theoretical and empirical consensus about the overall impact of IT on output growth, it is well accepted that all IT central banks "not only aim at stabilizing inflation around the target but also put some weight on stabilizing the real economy" (Svensson, 2007, p. 1).[1] Recent theoretical models point at mixed effects. One could mention the ambiguous effects of inflation targeting on growth provided by Gupta (2006), or the suboptimal nature of IT (dominated by nominal income growth) put forward by Kim and Henderson (2005).

At the empirical front, Batini and Laxton (2006), Mishkin and Schmidt-Hebbel (2007) and Svensson (2007) find no evidence that IT has negatively affected productivity growth, employment, or other measures of economic performance. These studies also present evidence that inflation targeting helps countries achieve lower inflation in the long run, reduce their response to oil price and exchange rate shocks, strengthen monetary policy independence, and improve monetary policy efficiency.

A relatively novel strand in the literature suggests that empirical analyses of economic growth should pay particular attention to the potential contribution of financial globalization and trade to output growth.[2] Alfaro, Chanda, Kalemli-Ozcan, and Sayek (2004), for example, find that countries with well-developed financial markets gain significantly from FDI while Alfaro and Hammel (2007) identify that stock market liberalizations are associated with a significant increase in the share of machinery and equipment and, therefore, tend to have a positive effect on economic growth.

Kyaw and Macdonald (2009) separate countries by income levels and find that FDI and portfolio investment flows promote economic growth. They also observe that upper middle-income countries appear to gain more from such flows than low-income countries. Jalilian and Kirkpatrick (2005), on the other hand, go beyond the financial development-economic growth link to suggest alternative channels through which financial development can enhance economic growth and thus lead to poverty reduction. They empirically show that, up to a threshold level of economic development, the expansion of the financial sector can effectively contribute to poverty reduction through economic growth-enhancing effects.[3]

[1] Bernanke (2003) also considers that the idea of IT focusing exclusively on control of inflation and ignoring output and employment objectives is a misconception. He suggests that "short-run stabilization of output and employment is more effective when inflation expectations are well anchored" through the constrained discretion that provides an IT regime.

[2] See Mishkin (2009) for a survey and a positive view. A similar characterization of globalization has been put forward recently by Kose et al. (2008) on the rising trade and financial linkages. Sachsida, Carneiro, and Loureiro (2003) document a negative relation between inflation and trade openness for 152 countries over 1950–1992.

[3] According to Mishkin (2009), opening the financial market to foreigners promotes financial development through two different channels. First, increasing the access to capital and reducing the cost of borrowing to those agents willing to make productive investment. Second, allowing foreign financial institutions to operate in less developed economies brings expertise and best practices designed to screen loans and monitor borrowers' activities to reduce the amount of risk taken.