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Inflation targeting in emerging economies: What do the data say?

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Abstract

In a recent thought-provoking paper, Ball and Sheridan [Ball, L., Sheridan, N., 2005. Does inflation targeting matter? In: Bernanke, B.S., Woodford, M. (Eds.), The Inflation-Targeting Debate, University of Chicago Press] show that the available evidence for a group of developed economies does not lend credence to the belief that adopting an inflation targeting regime (IT) was instrumental in bringing inflation and inflation volatility down. Here, we extend Ball and Sheridan's analysis for a subset of 36 emerging market economies and find that, for them, the story is quite different. Compared to non-targeters, developing countries adopting the IT regime not only experienced greater drops in inflation, but also in growth volatility, thus corroborating the view that the regime's "constrained flexibility" to deal with adverse shocks delivered concrete welfare gains.

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1. Introduction

In the last 15 years, some developed and developing countries opted to follow in New Zealand's footsteps and implemented the now famous Inflation Targeting framework for managing monetary policy. Since then, numerous researchers (Bernanke and Mishkin, 1997; Svensson, 1997; Bernanke et al., 1999), as well as practitioners in central banks worldwide, have claimed that the potential benefits to be reaped from the adoption of an IT regime are considerable. Some of the alleged gains are lower and less variable inflation and interest rates, more stable growth and enhanced ability to respond to shocks without losing credibility.

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This optimistic assessment is, however, at odds with available empirical evidence. As Ball and Sheridan (2005) show in a recent thought-provoking paper, adopting IT appears to have been irrelevant for a group of 20 OECD developed economies, entailing neither gains nor losses in terms of economic performance. Among other things, their results indicate that the greater reduction in average inflation and inflation variability observed in "targeters" vis-à-vis " nontargeters" vanishes once one controls for mean reversion. The bigger drop in inflation for those economies that moved to inflation targeting systems, they argue, follows simply from the fact that these same countries displayed higher initial inflation and there is a tendency for this variable to revert to its mean.

But, because their paper focused solely on developed economies, these results, somewhat baffling at first sight, may be plagued with a kind of "selection bias" problem. In fact, it is not really surprising that the adoption of IT by a developed economy did not deliver important economic gains since these countries were not suffering from severe inflation problems or other destabilizing macroeconomic disturbances to begin with. Therefore, it is entirely possible that while IT has not brought the heralded good results for developed economies, it may have enhanced macroeconomic performance among developing countries, which are undoubtedly hit by larger shocks and face greater difficulties in designing sound domestic macroeconomic policies.[2]

In this article, we carefully explore this appealing conjecture and apply Ball and Sheridan's idea of comparing countries' economic performances (using a "difs-in-difs" estimation) to a group of 36 emerging economies, 13 of which have opted for the inflation targeting framework. Summing up the results, we find that, within these groups, those that adopted IT experienced greater reductions in inflation and GDP growth variability, even after controlling for mean reversion. In short, IT did matter for them.

2. Data and methodology

As mentioned above, our data set includes 36 emerging economies (13 of which implemented the IT regime)[3] and spans from 1980 to 2005. Using the kind of difs-in-difs strategy employed by Ball and Sheridan (2005), we investigate whether changes in average inflation, inflation variability and growth volatility were greater in targeters when compared to non-targeters.

Before proceeding, it is important to emphasize that it does not suffice to check whether the observed changes in these economic variables between two distinct periods were bigger for those who chose to inflation target. The reason for this caveat is that if initial inflation was higher within this group, a more significant reduction in the level of this variable may simply reflect mean reversion and not a direct contribution of the IT regime. To control for this potential problem, we add the initial value of the dependent variable as a right-hand side regressor. We therefore run our "difs-in-difs" regressions based on the following general specification:

$$\Delta x^i = c + \beta \cdot x^i + \alpha \cdot D + \varepsilon \tag{1}$$

Where:

$\Delta x^i = x^i_{\mathrm{F}} - x^i_{\mathrm{I}}$, x^i_{F} is the "final" period (to be defined below) value of an economic variable i;
x^i_{I} is the "initial" period (to be defined below) value of an economic variable i;

[2] Ball and Sheridan raise this possibility when concluding their paper.

[3] The inflation targeters in the sample are: Brazil, Chile, Colombia, Czech Republic, Hungary, Israel, Mexico, Peru, Philippines, Poland, South Africa, South Korea and Thailand. The group of non-targeters is comprised by Argentina, Bulgaria, China, Costa Rica, Côte d'Ivoire, Dominican Republic, Ecuador, Egypt, El Salvador, India, Indonesia, Lebanon, Malaysia, Morocco, Nigeria, Pakistan, Panama, Tunisia, Turkey, Uruguay, Venezuela, Singapore and Taiwan.