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ScienceDirect
Journal of Policy Modeling 34 (2012) 621–645
Journal of Policy Modeling
www.elsevier.com/locate/jpm

Inflation Targeting: A three-decade perspective☆

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Received 1 February 2011; received in revised form 1 June 2011; accepted 1 August 2011
Available online 11 August 2011

Abstract

Using cross-country data for developed and developing countries over the period 1980–2007, we study the effects of the Inflation Targeting regime on levels and volatilities of inflation, GDP growth and fiscal imbalances. Our results indicate that the targeting developing countries are associated with lower and more stable inflation, as well as higher and more stable GDP growth. The targeting developed nations experience higher GDP growth and conduct more disciplined fiscal policy after adopting the regime. The improvements in fiscal imbalances may be at least partly attributed to the attempts to achieve an inflation target. We conclude that non-targeting countries, would highly benefit from targeting inflation.

JEL classification: E31; E52; E58; E62

Keywords: Inflation Targeting; Monetary policy; Fiscal policy

1. Introduction

As the adoption of the Inflation Targeting (IT) regime is becoming more common around the world, the merits of the regime are being debated more. While the advocates of the regime, such as Svensson (1997), Mishkin (1999) and King (2002) argue that the regime helps the targeting countries to attain lower and less volatile inflation rates, some economists have opposing views.

☆ We would like to thank Carmen Reinhart for her invaluable comments. The views expressed in this paper are solely those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of Kansas City or the Federal Reserve System.
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doi:10.1016/j.jpolmod.2011.08.004

In a notable study, Ball and Sheridan (2005) claim that the reductions in inflation rates during the past two decades are not unique to the countries targeting inflation, but they are results of the reversion of inflation rates to their historical lower means. Moreover, the doubts on the role of the IT regime in dampening inflation increase when developed countries are considered.

The aim of this paper is to shed light on the debated effects of the IT regime by conducting detailed comparisons between the evolutions of the major macroeconomic variables of the inflation-targeting (IT) and the non-targeting (NT) countries during the past three decades. Our work takes steps further beyond the existing literature in some important aspects: we discuss not only the behavior of inflation following the adoption of the IT regime, but also the behavior of output growth and fiscal imbalances. To the best of our knowledge, this paper is the first one to consider the links between the IT regime and fiscal policy.

Our main results suggest that the IT regime has important benefits for both developed and developing countries. We show that inflation rates are considerably lower in the targeting developing countries. While all targeters seem to have higher GDP growth rates, there is a clear convergence in GDP growth rates amongst the developing IT countries after the adoption of the regime. Lastly, our results suggest that fiscal policy is conducted in a more disciplined fashion when developed countries target inflation.

Existing studies have been mostly interested in examining the effects of the IT regime on inflation rates and on volatilities of inflation and GDP growth. We believe that it is equally important to study the evolutions of actual GDP growth rates following the adoption of the IT regime. More specifically, we are interested in testing the claim that committing to an inflation target can be harmful for economic growth. The argument is that, in a targeting country the monetary authority's concern is shifted towards inflation stability and away from promoting economic activity. We challenge this belief by comparing GDP growth rates in the IT countries with those in the NT countries. Our results show that both developed and developing targeters are associated with higher GDP growth rates. Therefore, we conclude that reducing inflation actually supports economic growth.[2]

The possible links between the IT regime and fiscal policy are also interesting and important. It has been the belief that higher budget deficits are associated with higher inflation rates (Amato & Gerlach, 2002; Sargent & Wallace, 1981).[3] Wimanda, Turner, and Hall (2011) claim that Indonesia's inflation rate might be affected by the budget deficit. According to Vu (2004), government budget deficits and monetization of public sector budget deficits are among the key reasons for high inflation rates experienced in Turkey during the 1970s, 1980s and 1990s. The common argument regarding the inflation-budget deficit nexus is that the government inflates in order to increase inflation tax revenues and lower the real value of its deficits. However, the adoption of the IT regime may also reduce these incentives (Mishkin & Schmidt-Hebbel, 2001). Having the IT regime in place, the government may become more fiscally-disciplined in order to achieve the target. We show that this is likely to be the case in developed world.

This paper is organized as follows. Section 2 presents a brief literature review. Section 3 provides an overview of the data. Section 4 reports the statistical facts about the macroeconomic variables in both the IT and the NT countries. Section 5 presents the econometric methodology and results. Section 6 discusses the policy implications of our findings. Finally, Section 7 concludes.

[2] These results support the findings in earlier studies. For example, Fischer (1993) shows that inflation can be harmful for economic growth. Singh and Kalirajan (2003) show similar results for India, and conclude that reducing inflation to the levels in India's trade partners enhances India's growth.

[3] This idea has been empirically challenged too. See Catao and Terrones (2005).