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Coping with the recent financial crisis: Did inflation targeting make any difference?

Armand Fouejieu A. *

Laboratoire d'Economie d'Orléans (LEO), CNRS, University of Orléans, Rue de Blois, BP 26739-45067 Orléans Cedex 2, France

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ABSTRACT

The effects of the 2008/2009 financial crisis went largely among financial markets and hit the real economy, generating one of the greatest global economic shocks. The purpose of this study is to investigate whether inflation targeting has made a difference during this crisis. First, we put forward some arguments suggesting that inflation targeters can be expected to perform better when facing a global shock. Applying difference in difference in the spirit of Ball and Sheridan (2005), we assess the difference between targeters and non-targeters and find that there is no significant difference as regards inflation rate and GDP growth. However, the rise in real interest rate and inflation volatility during the crisis has been significantly less pronounced for targeters.

1. Introduction

The global economy has recently faced one of the greatest economic shocks due to a financial crisis originating from the US financial market, and especially the US subprime market. The causes of the 2008/2009 financial crisis are subject to debate. On the one side, the conduct of monetary policy during the economic boom preceding the crisis has been pointed out to be responsible of the financial bubble which crashed.[1] On the other side, the ineffectiveness of financial regulation and the lack in

* Tel.: +33 2 38 41 70 37, +33 2 38 49 48 19; fax: +33 2 38 41 73 80.
E-mail address: armand.fouejieu-azangue@univ-orleans.fr

[1] This is because the five years preceding the crisis were characterized by a large increase in liquidity coupled to relative good control of inflation, encouraging credit demand since risk premium and interest rate went down at the same time.

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financial innovations control is considered as the main cause of the financial turmoil.[2] Facing such a crisis and analyzing its consequences, a concern should be to investigate whether specific characteristics peculiar to a particular economic policy framework could have helped some countries to better cope with the shock. For instance, the comparative performances of alternative exchange rate regimes during economic shocks have been investigated in the literature. This type of analysis is much scarcer as regards monetary policy. We aim in contributing to fill this gap.

This paper analyzes the role of monetary policy framework on countries resilience during the 2008/2009 financial crisis. Precisely, we investigate the comparative performances of inflation targeting regime in this context of crisis. Inflation targeting is a relatively recent monetary policy strategy which is not exactly defined in the same way by researchers. The most complete definition, according to us is that of Mishkin (2000): "*Inflation targeting is a monetary policy strategy that encompasses five main elements: (i) the public announcement of a medium-term numerical target for inflation; (ii) an institutional commitment for price stability as a primary goal of monetary policy, to which other goals are subordinated; (iii) an informative inclusive strategy in which many variables, and not only monetary aggregates or the exchange rate are used for deciding the setting of policy instruments; (iv) increased transparency of monetary policy through communication with the public and the market […]; and (v) increased accountability of the central bank for attaining objectives.*" Our analysis is a contribution to the relatively poor literature on the performance of inflation targeting when facing economic shocks.[3] Neumann and Von Hagen (2002) use the difference in difference approach to compare targeters with non-targeters during the 1978 and 1998 oil prices shocks and find that the rise in inflation, long term and short term interest rate were lower for targeters. Using panel VAR estimations, Mishkin and Schmidt-Hebbel (2007) also compare targeters and non-targeters facing oil price shocks. Their main hypothesis is the following: if inflation targeting increases central bank's credibility in anchoring price expectations, targeters could be expected to perform better in terms of inflation, and the consequences of shocks through exchange rate will be less pronounced. Their conclusions are in favor of targeters. de Carvalho Filho (2010, 2011) analyzes the difference between inflation targeters and non-targeters during the recent financial crisis. With panel estimates and difference in difference approach, considering 51 countries including 23 inflation targeters, de Carvalho Filho (2011) finds that countries which adopted the inflation targeting monetary strategy faced lower decrease in GDP growth.

We provide a rigorous approach to investigate the difference between targeters and non-targeters during the 2008/2009 financial crisis. First, we start by discussing the main reasons why inflation targeters can be expected to do better during the crisis. Second, we use a more rigorous econometric approach in the spirit of Ball and Sheridan (2005) to empirically test our hypotheses. Contrary to de Carvalho Filho (2011), we are not focussing only on the relative performances in terms of GDP growth. Targeters and non-targeters are compared in two ways during the crisis: (1) on central banks' performances, based on inflation and interest rate and (2) in more general terms on GDP growth performances. The findings suggest that there seems to have been no significant difference between the two groups in terms of GDP growth. However, inflation targeters central banks performed better since the rise in inflation volatility and real interest rate have been significantly lower.

The rest of this paper is organized as follows: Section 2 exposes supportive arguments that inflation targeting can make a difference during the crisis. Section 3 presents the empirical tests and results. In Section 4, the robustness checks are conducted and Section 5 concludes.

2. Why targeters could be expected to perform better during the crisis?

The comparison between targeters and non-targeters will rely mainly on a set of three variables: inflation rate and its volatility, interest rates (real, nominal and central bank's reference rate), and GDP growth. Our argumentation intends to hypothesize that inflation targeters could have registered better performances on these indicators during the crisis.

[2] This view is supported by Dooley (2010) and Rose and Spiegel (2010), among others.

[3] The 2008/2009 financial crisis certainly gives the first real opportunity to assess the performances of inflation targeting in context of such a global economic shock, since the implementation of this monetary policy strategy is relatively new.