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Timing and duration of inflation targeting regimes



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ABSTRACT

Central banks in G7 countries shifted to unconventional policy measures in the aftermath of the Financial Crisis, when faced with economic slack, financial instability and fiscal trouble. This shift ended a spell of rules-based time consistent monetary policy that started in the mid-1980s. I argue that substantial economic, political and financial risks put pressures on the continued support for a monetary regime. Central banks may be forced to adopt policies with no option to reset those options later on. I demonstrate with duration models – on a sample of industrialized and emerging economies from 1970 to 2012 – that the policy switch to inflation targeting happened after episodes with high inflation and public debt, reflecting broad support for stability-oriented monetary (and fiscal) policy. More generally, changes in monetary regimes occur after a crisis. High inflation makes central banks pursue active monetary policies, while they forsake those same policies in the wake of fiscal or financial crises.

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Sincronización y duración de los regímenes de metas de inflación

RESUMEN

Los Bancos Centrales de los países pertenecientes al G7 dieron un giro hacia políticas menos convencionales a raíz de las consecuencias de la crisis financiera, cuando se enfrentaron a la desaceleración económica, la inestabilidad financiera y las dificultades fiscales. Este cambio ha finalizado un período de políticas monetarias de larga duración basadas en normas que se iniciaron a mediados de los años ochenta. Expongo que los considerables riesgos económicos, políticos y financieros añaden una presión al apoyo continuo de un régimen monetario. Los bancos centrales pueden verse obligados a adoptar políticas sobre la marcha sin ninguna opción de restablecer aquellas opciones más adelante. Demuestro con modelos de duración – en una muestra de economías industrializadas y emergentes de 1970 a 2012 – que el giro de políticas hacia las metas de inflación ocurrió después de episodios con alta inflación y deuda pública, lo que refleja el amplio apoyo a las políticas monetarias (y fiscales) orientadas hacia la estabilidad. A rasgos generales los cambios en los regímenes monetarios se producen después de una crisis. La inflación alta supone que los bancos centrales aspiren a políticas monetarias activas, mientras que renuncian a esas mismas políticas al iniciarse una crisis fiscal o financiera.

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1. Introduction

From the mid-1980s until the recent financial crisis, most developed economies have enjoyed a remarkably long period of economic stability. This Great Moderation owes much to benign

economic circumstances, but many economists would attribute an important role to the anti-inflationary stance of monetary policy (Clarida, Gali, & Gertler, 2000; Lubik & Schorfheide, 2004). A rules-based policy, like inflation targeting that can credibly commit to some nominal anchor and maintain such a policy over time is seen as key to macroeconomic stability. The success of such a policy is proven by curbing economic volatility, and bringing down inflation to low and stable levels (Svensson, 2010).

The economic turmoil starting with the Financial Crisis has questioned this view (CEPR, 2013). Losses on subprime loans in US banks triggered an unwinding of uncovered debt positions. This snowball debt-effect brought down major financial institutions in both the US and Europe. The ensuing financial crisis called for policy intervention out of the deep pockets of the tax payer. Massive public aid in support of the financial sector, together with falling tax revenues and spending on recovery plans to withstand the economic fall-out of the financial collapse, shifted the burden of private debt to a large extent to public debt, and unleashed a sovereign debt crisis. Low and declining inflation has urged central banks in G7 countries to introduce unconventional policy measures. High debt and low inflation have made many a government look to financial repression to place public debt at lower rates in the banking sector.

This unraveling of the policy framework has put monetary policy strategies under considerable stress. Unconventional policies are a radical policy change compared to normal monetary practice. Although central banks argue that exit-strategies out of massive asset purchases do not entail inflationary risks, it does put central bankers at risk of assuming tasks normally attributed to fiscal policy. Doing so creates a substantial political risk and could undermine the political support for inflation targeting. Transparency about its actions and political accountability is crucial for a central bank pursuing inflation targeting. Blurring that task with other policy objectives could lead to a political turn. The temptation to overrule the central bank might be even stronger because of the fiscal consequences of the Financial Crisis. High and rising public debt questions the ability of a central bank to commit to low inflation. Several types of economic models would argue that a central bank faced with rising public debt is not able to maintain a credible inflation anchor.¹ Fiscal austerity to maintain low deficits has in many countries led to political changes already. Central banks might also find the usual monetary transmission impaired when returning to 'business as usual'. Financial repression by governments might distort the incentives of banks favouring investment in government bonds markets. These policies make it harder for a central bank to deliver under the typical inflation targeting framework.

Inflation targeting has moreover been criticised for contributing to the Great Recession. With an excessive focus on inflation abatement, inflation has fallen to levels that make it impossible to further react with the interest rate instrument to changing circumstances. A conventional response to economic slack is impossible when monetary policy reaches the zero lower bound. Furthermore, the single-minded focus of central banks on anchoring expectations of low inflation, and not on controlling the transmission to the banking sector led to the build-up of financial imbalances in the banking sector (Whelan, 2013).

Looking at these economic, political and financial circumstances, inflation targeting seems ripe for a change. Most empirical work on time variation in monetary policy behavior supposes that

changes occur either exogenously – due to some shock – or are endogenously driven by past changes in inflation or output. These approaches have been successful in characterizing different policy regimes over time (Chung, Davig, & Leeper, 2007; Davig & Leeper, 2007; Favero & Marcellino, 2005). However, other factors driving policy change are not explicitly modeled. While there is much empirical and theoretical work on the choice of exchange rate regimes (Klein & Shambaugh, 2010), only Carare and Stone (2006) and Rose (2007) look at how monetary regimes underwent regime changes due to economic, political or financial conditions.

The aim of this paper is to examine the timing of policy changes, and the duration of different policy regimes. I focus on the adoption of different monetary regimes – and inflation targeting in particular – in a large sample of industrialised and emerging economies over the period 1970–2012. The main finding is that inflation targeting is a regime whose adoption was favoured by previous crises. In particular, high inflation and high public debt prepared the ground for reforms to monetary policy and the eventual adoption of inflation targeting. The end of monetary regimes is also interesting to examine. Yet, even with the Financial Crisis, no central bank has formally abandoned inflation targeting. When I test the timing and duration of more generally defined monetary policy regimes, then policy switches are more likely after a fiscal or a financial crisis. High inflation make central banks pursue active monetary policies, while they forsake those same policies in the wake of fiscal or financial crises.

The plan of this paper is as follows. In the next section, I relate regime changes in monetary policy to economic and political conditions. In Section 3, I test the timing and duration of inflation targeting regimes, and broaden the analysis to other monetary regimes in Section 4. I draw policy implications for stability-oriented policies in the final section.

2. Regime changes in policy

Discussion of regime change in monetary policy is most easily cast with a simple policy rule, or Taylor rule, which has the central bank adjust the short-term nominal interest rate in response to fluctuations in inflation and some measure of output

$$i_t = \alpha + \beta\pi_t + \phi y_t + \varepsilon_t, \quad (1)$$

with i_t the short-term nominal interest rate controlled by the central bank, π_t the inflation rate, and ε i.i.d. $N(0, \mu)$ is an exogenous policy disturbance. A policy rule of this kind has been used in an extensive empirical literature to describe various types of monetary policy. Changes in regimes can be examined in this framework by letting the reaction coefficients in (1) depend on changes in some underlying state. The most straightforward way to do so is to rewrite (1) as

$$i_t = \alpha(S_t) + \beta(S_t)\pi_t + \phi(S_t)y_t + \varepsilon_t, \quad (2)$$

where the state S_t is a discrete valued random variable that evolves stochastically and independently of the endogenous economic variables. This state S_t makes policy shift according to different regimes. A large body of evidence characterizes changes in the state-dependent coefficients of the switching rule in (2) (Davig & Leeper, 2007). There is much evidence of changes from active monetary policy regimes, in which central banks combat inflation, to more lenient regimes, in which monetary policy gives in to inflationary pressures. Such a distinction lays at the root of characterizing the inflation targeting policy as the active policy that prevails since the mid-1980s in most industrialised economies.

While in the simple Taylor rule, shocks only happen for some exogenous reason, in (2) policy can be subject to changes in regime. This shock to the policy regime is still determined outside the

¹ Under the unpleasant monetary arithmetic, a central bank is forced to accept the fiscal stance (Sargent & Wallace, 1981). The Fiscal Theory of the Price Level would see as the only solution to a situation in which a government cannot reduce debt, a jump in price levels to make intertemporal budget constraints hold (Leeper, 1991). Game-theoretic models of policy interaction stress the combined impact of policies and which policy bears the brunt of adjustment (Dixit & Lambertini, 2003).

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