AN ANALYSIS OF INFLATION TARGETING AND ITS MACROECONOMIC CONSEQUENCES

Abstract

Inflation targeting is a widely accepted monetary policy framework and currently, 39 economies are under an inflation targeting regime. However, there is ambiguity in the literature about the macroeconomic performance of inflation targeting. This thesis is an attempt to analyze the effect of inflation targeting on various macroeconomic variables. The first objective of the thesis is to estimate the impact of inflation targeting on the inflation rate and inflation volatility. Generally, central banks adopt the regime after they achieve significant disinflation. The new regime gains credibility since the central banks successfully meet the initial targets due to pre-inflation-targeting-disinflation. We identify the impact of inflation targeting using forward-looking dynamic panel data models in difference-in-difference framework using the data of 114 emerging, advanced and low-income economies. Our results show inflation targeting is successful in locking-in already low inflation instead of reducing the high inflation.

The second objective of the thesis is to compile macro-financial conditions index and analyze the impact of inflation targeting on the index and volatility of index in emerging market economies. Dynamic panel data models are used to analyze the dataset of 56 emerging market economies. The results suggest no adverse impact of inflation targeting on financial stability, whereas it may have significant positive spillover effects on foreign direct investment. The last objective of this thesis is to calculate the sacrifice ratio for disinflationary episodes and analyze the impact of inflation targeting on sacrifice ratios. The chapter analyzes the output cost of disinflation in emerging market economies using a dataset of 58 countries from 1979 to 2020. We find that quick disinflation when the inflation is at higher levels reduces the sacrifice ratio. The results suggest that inflation targeting emerging market economies face lower sacrifice

ratios. We find that anchoring inflationary expectations, increase central bank credibility which result in reduced output cost of disinflation.

We have important suggestions for central banks that plan to adopt inflation targeting in the near future. First, they should achieve some pre-inflation-targeting-disinflation before adopting inflation targeting formally, as it will increase central bank credibility which helps anchor inflationary expectations. Second, we have not found any adverse impact of inflation targeting on financial stability. We suggest inflation targeting lite countries to adopt full-fledged inflation targeting regime. Lastly, we find that inflation targeting countries experience lower sacrifice ratios. Countries should make their central banking system strong and independent before implementing inflation targeting as it would further improve their output-inflation trade-off.