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The Impact of Inflation Targeting Policy on Economic Stability and Growth: Empirical Evidence from 28 Countries

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Abstract

The aim of the paper is to analyze the effectiveness of Inflation Targeting monetary policy in selected countries measuring the governments' success in controlling actual inflation rates and thus, impacting the economy. This research is mainly built on the works of Eroğlu et al. (2017), Junankar and Wong (2020) and Shelter et al. (2022). Eroğlu et al. (2017) measured the impact of inflationary targeted rate in Turkey on exchange rate, interest rate, money supply and thus, on the actual inflation of the country to measure the effectiveness of the policy. However, in this research, our hypotheses are twofold: the first hypothesis will test the effectiveness of IT on enhancing the actual inflation rates in the countries whereas the other will check if the effectiveness of the policy to facilitate the increase in the aggregate output.

In order to implement our static estimations, fixed effect (fe) model is utilized. The study covers the total of 28 developing countries and 61 years from 1960 to 2020. The variables employed are actual inflation rates (CPI), targeted inflation rates, real effective exchange rates, real interest rates and real GDP. Regarding the results, the inflation targeting policy is highly significant in controlling the level of inflation though various monetary tools such as changing interest rates, money supply, and thus, positively effected the economy of selected countries by facilitating real GDP growth.

Keywords: *Inflation targeting, developing countries, static estimations, fixed effect model.*

It is interesting to know about the influence of IT policy on macroeconomic situation of various countries. According to Mishkin (2010), economic experts made policies effecting economic situation by controlling money supply as well as interest rates in order to target inflation, because monetary policy control can affect economic indicators dramatically which also can be considered as a key instrument of economic health of the countries. Many active opposite statements have been made by many politicians, economists as well as labor organization professionals about advantages and disadvantages of effecting inflation and the consequent influence on the improvement of economic situation in the first countries employing this policy. At this, according to description of Mishkin (2008) about Inflation Targeting is that *""...an economic policy in which the Central Bank estimates and announces in public a targeted inflation rate, and then attempts to steer the actual inflation towards the targeted range through the use of interest rate changes and other monetary policy instruments.*"

Several nations like Japan, Sweden, New Zealand, Turkey, Switzerland, Canada, United Kingdom as well as Germany has closely paid attention to their inflation rate closely during the past two decades in order to implement better economic improvement (Eroglu et. al, 2017).

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So, is the IT policy really effective? In order to answer this question, our two-stage objective is to examine the influence of the IT policy in selected countries' economy. The first stage is to measure the governments' success in controlling actual inflation rates through various monetary tools and thus, stabilize the economy. If the IT policy's positive effect on regulating inflation rates is confirmed as anticipated, the second stage is to check if the controlled inflation rate along with other monetary tools positively impacted macroeconomic performance of the selected nations. The previous literature, in particular, the works of Eruglu et al. (2017) showed that IT strategy could facilitate growth in economies before Financial Crisis in 2008, which caused financial and macroeconomic instabilities globally. Yet during and after the crisis, it became obvious that IT policy alone was not sufficient to control prices and maintain stability in economy and governments took further measures to regain stability. However, this research concentrates only on the correlation between IT policies and macroeconomic performances of the countries and thus, it is anticipated that the negative impacts of the crisis is not significant in this analysis of longer period.

The prime goal of this study is to examine the real influence of IT (inflation targeting) policy on the actual inflation rates and economic growth (indirect) in selected 28 countries.

Literature review

The previous studies have provided an insight into targe ting inflation in different ways. Nevertheless, it is argued by many people about the method of Mishkin (2000) regarding inflation targeting policy and he states that *"a medium-term numerical target is set for inflation, the primary goal of monetary policy is to assure price stability and no other monetary target is pursued, and the transparency and accountability of the central bank is attained"*. The definition of inflation-targeting in practical economics is organizing low inflation rates in order to control pricing policy as a target.

The inflation targeting is considered by professionals as a successful monetary method in all kind of nations, because this strategy definitely assists the betterment of macroeconomic situation in the country (Portugal, 2007). On these days, several empirical researches on the inflation targeting are not up-to-date with several updates, though, many countries can take advantage from that by sole adjustment. Moreover, several research works on inflation targeting has proven its benefits to macroeconomic situation. As stated by Petursson (2014) as an example, after implementation of this policy continuous stability on currency rate and dramatic decrease on the interest rates have occurred during the past years.

Ehrmann and Cecchetti (2006) as well as Ball at.al (2008) made statements with their research results about the ineffectiveness of inflation targeting. However, according to the overall data from all parts of the globe, macroeconomic stability has been changed positively after the implementation of inflation targeting. According to several empirical researches conducted by IMF (2015), Hu (2013), Hagen (2012) as well as Wu (2014), it has also been approved the advantages of the inflation targeting on the macroeconomic situation.

Reversely, according to the findings of many professionals like Corbo and Herbel (2008) made research in South American nations, Debelle (2009) in inflation targeting implementing country, Australia, Dickman (2011) making its contribution to Debelle (2009)'s research related to Australia, Brash (2012) making a research in New Zeeland, Freedman (2011) studying the case of Canada, Schmidt-Hebbel and Werner (2012) made their study in some Latin American nations like Chile, Brazil as well as Mexico, have also made their statements about several inflation targeting methods in order to reduce the inflation rate. In addition, economic improvement has occurred in the abovementioned nations with less economic growth.

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According to the findings of King (2009) on the influence of inflation targeting in 12 developed nations, it can be pragmatic to reduce inflation without decreasing production. Nonetheless, according to the findings made by Jones and Mishkin (2018) in the case of some European countries like Hungary, Poland as well as Czech Republic, considering the inflation targeting method as the best approach to successful economy is not always true. Karaca (2016) stated with findings that includes the cases of third world-nations that the implementation of inflation targeting policy caused not many improvements as expected and was not able to effect strongly other macroeconomic sectors.

Some experts like Kara and Orak (2018) made their studies on the expectations of average inflation between 2002 and 2004 while Turkey was practicing inflation targeting. The results were great since the expected inflation rate was achieved and they were able to decline the inflation rate dramatically to around 7% from 73% at the beginning of the implementation.

Methodology

Since the paper aims to analyze the macroeconomic impact of the IT monetary policy on the selected countries, our hypothesis will be twofold. The first hypothesis will test the effectiveness of IT on enhancing the actual inflation rates in the countries, whereas the other will check if the effectiveness of the policy to facilitate the increase in the aggregate output.

1st hypothesis – was the IT effective in controlling inflation along with various tools such as interest rate, exchange rate:

H_0: IT policy was significant in controlling the inflation rates.

H_1: IT policy was insignificant in controlling the inflation rates.

2nd hypothesis – did IT facilitate the increase in the countries' output:

H_0: IT policy facilitated the real output though the actual inflation rates.

H_1: IT policy did not facilitate the real output.

To be more accurate, the aim of the paper is to show the impact of the IT monetary policy on the actual inflation rates and the economic development of the selected countries via quantitative estimations.

At this, in order to show the success of the IT policy on above manners, empirical analysis of the secondary data gathered from World Development Indicators (2022) will be conducted.

Model and Dataset

The study employs the total of 5 variables, namely real GDP, consumer price index (CPI – proxy for actual inflation), real exchange rate, (deposit) interest rate, broad money (M2*v) and inflationary targeted rates. The variables contain data on 28 countries that practiced inflation targeting policy and the time frame is 61 years from 1960 to 2020 (the latest available data on World Development Indicators, 2022).

The dataset was preliminary tested in the form of illustration, histogram. As can be seen, from the histograms in the appendix, all of the variables are quite normally distributed, except for the exchange rate with was rather skewed to the right.

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Table 1. Description of variables:

Value	Name of the indicator	Definition
IT	Inflationary target	Inflationary targets (rates) to control the actual inflation, in %
CPI	Inflation rate	Consumer price indices – proxy for the actual inflation rates
ER	Exchange rate	Official exchange rate – currency of the country against 1 US dollar
IR	Rate of interest	Average deposit interest rate, in %
M2	Broad money growth	Increase in the supply of broad money, which is M2*v, in %
GDP	Real GDP (output)	Real Gross domestic product in constant 2015 USD, in log

Econometric model

Model 1: In the first model, the impact of inflation targeting policy in the actual inflation rates are measured on par with the other monetary tools such as interest rate, broad money supply and exchange rate. The model is represented by the following equation:

$$\mathbf{CPI_t = \beta_0 + \beta_1 * IT_t + \beta_2 * IR_t + \beta_3 * EXCH_t + \beta_4 * M2_t + u_t} \quad (1)$$

Where, the CPI stands for the actual inflation rate, IT is the targeted inflation rate, IR is the average interest rate (on deposits), EXCH represents the exchange rate of local currencies of the selected countries and M2 is the broad money supply in these nations. Further, β_0 is the constant coefficient and β_n are the coefficients of the independent variables. This leaves us u_t as the residuals.

Model 2: On the contrary, the indirect effect of the IT policy on the economic development of the countries through controlled and balanced inflation rates is examined in the second model. At this, the real GDP (dependent variable) of the countries are regressed via macroeconomic indicators, namely, inflation rate, exchange rate and interest rate to show their role in the increase of the aggregate output.

$$\mathbf{GDP_t = \beta_0 + \beta_1 * CPI_t + \beta_2 * IR_t + \beta_3 * EXCH_t + u_t} \quad (2)$$

The above equation is the representation of the model 2.

Empirical results

Prior to moving to the regression analysis, it is important to check the data and models for consistency. For example, the variables should be tested against heteroscedasticity, autocorrelation, normality and multicollinearity. To check which model to use between fixed and random effect models for our panel data, endogeneity check should be carried out.

Endogeniety check

As the first robustness check, the endogeneity test should be carried out.Since the pooled OLS model does not fit our data (checked), it is now important whether random or fixed effect models best suit our data. It is mostly recommended to employ fixed effect model in panel data estimations by Baltagi (2005) and Greene (2008), yet Hausman test should be carried out to identify what model to use. The Hausman test dictates the following assumption:

- H_0: difference in coefficients not systematic, thus, random effect model should be used;

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- H_1: difference in coefficients is systematic, so, fixed effect is more suitable.

Table 3. Results of the Hausman test (model 1&2):

chi2(3) = (b-B)'[(V_b-V_B)^(-1)](b-B) = 6.28 **Prob>chi2 = 0.0988**	chi2(3) = (b-B)'[(V_b-V_B)^(-1)](b-B) = 1.26 **Prob>chi2 = 0.7377**

According to the above results, we cannot reject null hypotheses, so, random effect models should be implemented in both regression estimations (model 1 and model 2).

Heteroscedasticity test

Many tests exist to check the model for heteroscedasticity. As the panel data is being utilized and the endogeneity Hausman test resulted in the employment of random effect model in our regression estimation, the LM test (which is also called as Breusch-Pagan Lagrange multiplier test) should be applied via the STATA command of xttest0. The hypothesis of the test is that:

- H_0: Pooled OLS preferable;
- H_1: Random effect model is more suitable.

Table 5. The LM test results:

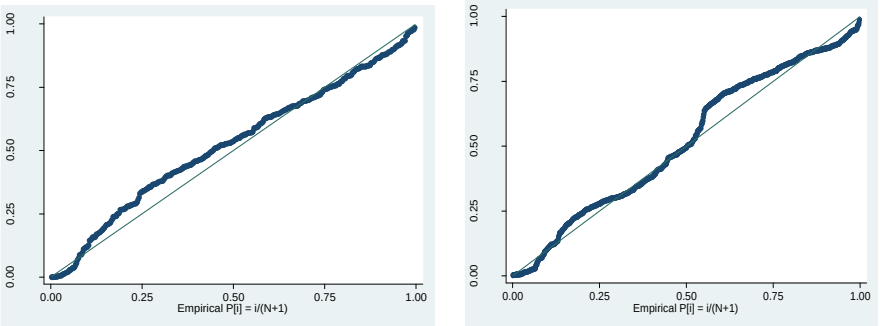
1st model:	**2nd model:**
chibar2(01) = 42.10	chibar2(01) = 9408.22
Prob > chibar2 = 0.0000	Prob > chibar2 = 0.0000

According the above results, the null hypothesis can be rejected and alternative hypothesis can be concluded, as the p-value (prob>chibar2) is equal to 0.0000, which is significant under 1% level. It can be concluded that the random effect model best suits for both regression equations.

Normality Check

According to Septer (2000), one of the assumptions of the linear models is the normality of residuals, which makes the sum of all the error terms equal to 0.

Figure 1. Plot of residuals of the Model 1 and 2 respectively:



The normality of the panel data can be checked by the illustration above. The figures above show that the residuals of the independent variables in two model equations are normally distibuted in the respective dependent variables.

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Multicollinearity test

Then, the variables must be tested again for reliability through multicollinearity test. Since the tolerance is greater than 0.5 and VIF values do not exceed 20, the independent variables lack multicollinearity problem. The below table shows the results of the test.

Table 6. The results of the test for multicollinearity:

Variable	VIF	1/VIF
IT	1.59	0.628361
ln_IR	1.48	0.675647
ln_EXCH	1.19	0.843665
M2	1.07	0.936933
ln_GDP	1.04	0.960727
Mean VIF	1.27	

Besides, the correlation of the variables can be checked by the below correlation matrix.

Table 7. Correlation matrix:

	ln_CPI	IT	ln_M2	ln_IR	ln_EXCH	ln_GDP
ln_CPI	1.0000					
IT	0.5827	1.0000				
ln_M2	0.3079	0.3387	1.0000			
ln_IR	0.5669	0.5113	0.2475	1.0000		
ln_EXCH	0.0428	0.2815	0.0260	-0.0628	1.0000	
ln_GDP	-0.0763	-0.0806	-0.0522	-0.1418	-0.1162	1.0000

Besides, the above matrix lacks the overly correlated variables. The largest correlation is 0.5827 which is between targeted inflation rate and actual inflation rate. This high correlation was expected and yet is lowed that 60%, which is within the level of tolerance. Further steps of the progress report will be conducting two regression analyses as per the equations in the Methodology part.

Random effect results

The outcomes of the regression were found with the help of STATA14 software. As was mentioned earlier, the empirical analyses contain two models that measure the effect of IT monetary policy. In the **Model 1**, the impact of inflation targeting policy in the actual inflation rates are measured on par with the other monetary tools such as interest rate, broad money supply and exchange rate. On the contrary, the indirect effect of the IT policy on the economic development of the countries through controlled and balanced inflation rates is examined in the **Model 2**. At this, the real GDP (dependent variable) of the countries is regressed via macroeconomic indicators, namely, inflation rate, exchange rate and interest rate to show their role in the increase of the aggregate output.

Random effect model regression outcomes are given below. At this, the variables are strongly balanced using the Stata command *cluster (id)*[1].

[1] Countries are fixed with order numbers (*id=Country name)* in order to strongly balance the data.

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Model 1

The regression results comply with the theoretical perspective *(table 8)*. Particularly, IT (inflationary target) holds high significance at 1% level with p-value of 0.000 and the t-value of 4.86. The coefficient of IT is 0.27 which means it is positively correlated with the actual inflation rates and any 1% point tightening in the IT policy can lead to a decrease in the actual consumer price index by around 0.27% points.

Similarly, IR (interest rate) and M2 (broad money supply) are also very significant at 1% level. The reason behind this is the fact that the Central Banks usually implement IT policy with the help of monetary instruments such as interest rate and money supply. To be more accurate, the central banks can increase interest rates to set price stability with lower inflation rates or vice versa. In addition, decreasing the money supply with the issuance of government bonds can also lower inflation rates. Besides, the model itself is significant with the Prob > chi2 = 0.0000 and the between R-squared of 0.796 (detailed information is given in the Appendix). It means that the model is highly significant in line with the result of F-test and this model is sufficient to explain the actual inflation rates by almost 80%.

$$\mathbf{CPI_t = -0.389 + 0.268 * IT_t + 0.362 * IR_t - 0.00838 * EXCH_t + 0.0761 * M2_t + u_t}$$

So, the inflation rates could be represented by the above equation.

Table 8. Model 1 & 2 regression results:

VARIABLES	MODEL 1	VARIABLES	MODEL 2
IT	0.268***	ln_IR	-0.145***
	(0.0551)		(0.0477)
M2	0.0761**	ln_EXCH	0.0221
	(0.0369)		(0.0245)
ln_IR	0.362***	ln_CPI	-0.0789***
	(0.0699)		(0.0288)
ln_EXCH	-0.00838		
	(0.0220)		
Constant	-0.389**	Constant	26.65***
	(0.168)		(0.308)
Observations	367	Observations	720
Number of id	24	Number of id	24

Robust standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

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Model 2

The second model shows that the 2 out of three variables, namely, interest rate and inflation rate played a significant role in the changes in the real GDP of the selected countries. Accordingly, as was expected, CPI is negatively correlated with the aggregate output and when the inflation rates hike by additional 100 basis points, the real output of the countries used to decrease by 7.9 basis points. Further, IR (interest rate) shows to be very significant at 1% level (t-value of -3.03). However, the interest rates are negatively correlated with GDP: a 1 percentage point increase interest rates result in 14.5% decrease in real GDP. Since the upsurge in the interest rates will increase attractiveness of deposits and people will prefer saving instead of consumption. Besides, the higher rates make borrowing for firm more costly, which will discourage them from taking loans to increase or maintain production. Overall, changing interest rates to a higher one by the central banks will facilitate lower inflation but at the same time, cools down economic growth with lower production and consumption. Besides, the model itself is significant with the Prob > chi2 = 0.0000 and the between R-squared of 0.40 (detailed information is given in the Appendix). It means that the model is highly significant in line with the result of F-test and this model is sufficient to explain the actual inflation rates by almost 40%.

As a result, we can reconstruct the second model equation in a following manner:

$$\mathbf{GDP_t = 26.65 - 0.0789 * CPI_t - 0.145 * IR_t + 0.0221 * EXCH_t + u_t}$$

Overall, it can be stated that the IT policy was of success in the selected countries effectively controlling the inflation rates at balanced level. Besides, since the inflation rates were significant on explaining the real GDP, the indirect effect of IT on the economic growth of the countries holds. Thus, we cannot reject both null hypotheses.

Pre and post application of IT

The empirical outcomes above have shown the significance of IT policy in regulating the economy and facilitating growth in selected countries. These results can be proven by the values of the utilized indicators before and after implementation of this monetary policy. The table below depicts the statistical description of these indicators in the periods varying as per the pre and post IT policy conditions.

In order to compare the effect of IT policy on the macroeconomic performance of the selected countries, the changes in the mean (μ - arithmetic mean) and standard deviation (ε – proxy for volatility) values of the macroeconomic indicators before and during the IT policies were calculated and put into the table.

Figure 5. The basic comparison of variables during pre and post-adoption periods of IT:

#	Macro indicators	Before application		After application	
		μ	ε	μ	ε
1	IT	-	-	2.99%	1.047%
2	CPI	21.57%	7.11%	6.33%	2.34%
3	Change in Real GDP	3.42%	5.12%	9.14%	4.92%
4	Interest rates	27.77%	18.98%	11.15%	6.52%
5	Money supply (% GDP)	201.6%	68.1%	87.3%	27.8%

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6	Change in exchange rate	9.31%	7.29%	-1.05%	2.25%

Regarding the results, IT policies implemented in the selected countries in different time periods on average decreased the inflation rates from 21.57% before IT to 6.33% during IT and considerably lowered the inflationary volatility.

During IT strategy implementation, the broad money amount also decreased, which refers to that the central banks could have cut the money supply to fight high inflation.

This situation can be observed in other macroeconomic indicators that exchange rate fluctuations were stabilized and fast devaluation of the relative currencies was avoided. Most importantly, during IT, greater GDP growth rates started to be recorded.

This contrast of the statistics clearly depicts the effectiveness of IT in the countries under study and provides a statistical reason why nations should adopt IT strategy.

Conclusion

The aim of the paper is to analyze the effectiveness of Inflation Targeting monetary policy in selected countries measuring the governments' success in controlling actual inflation rates and thus, impacting the economy.

Regarding the results, the inflation targeting policy is highly significant in controlling the level of inflation though various monetary tools such as changing interest rates, money supply, and thus, positively effected the economy of selected countries by facilitating real GDP growth. The results of the model 1 regression analysis comply with the theoretical perspective (table 8). Particularly, IT (inflationary target) holds high significance at 1% level with p-value of 0.000 and the t-value of 4.86. The coefficient of IT is 0.27 which means it is positively correlated with the actual inflation rates and any 1% point tightening in the IT policy can lead to a decrease in the actual consumer price index by around 0.27% points. Besides, the model itself is significant with the Prob > chi2 = 0.0000 and the between R-squared of 0.796 (detailed information is given in the Appendix). It means that the model is highly significant in line with the result of F-test and this model is sufficient to explain the actual inflation rates by almost 80%. The similar condition for the model 2.

To conclude, it can be recapitulated that the IT policy was of success in the selected countries effectively controlling the inflation rates at balanced level. So, it would be quite useful for other countries to implement IT policy.

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