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What Impact Does Inflation Targeting Have on **Unemployment?**

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IPC One Pager 51 argued that inflation targeting has only slim prospects of success. This One Pager presents the findings of a recent empirical study of the impact of inflation targeting in a cross section of developing and emerging countries. The reasons usually given to justify adoption of this policy regime are transparency and credibility in monetary policy, the reduction of uncertainty, and implementation of the institutional and economic reforms required by the new regime. For developing and emerging countries, however, the economic benefits of inflation targeting are not yet well documented.

An inflation targeting regime uses the nominal interest rate as a policy instrument and aggregate demand is the transmission channel for monetary policy. On the real side of the economy, the consequences of this policy are twofold. On the one hand, adoption of a monetary policy regime might have undesirable effects on the labour market. Inflation might be brought close to the target rate, but at the cost of higher unemployment and lower economic growth. On the other hand, the price stability achieved might lessen uncertainty and create a favourable economic environment for consumption and investment. What does the empirical evidence reveal?

Here, we investigate the impact of inflation targeting on unemployment, economic growth, and the output gap (as measured by real GDP). We compare inflation targeters with non-targeters and use annual data for the period 1985–2005. The empirical research applied a difference-in-difference approach, accounting for both the regression to the mean problem and the potential effects of a poor economic performance in the first period (pre-targeting) on a country's decision to become an inflation targeter.

The main results are summarised in the table and they indicate that, on average, targeting countries were able to reduce the unemployment rate by about 5 per cent in the post-targeting period relative to non-targeters. But there was no significant difference in the volatility of unemployment between the two groups of countries or across the two periods, pre- and post-targeting. As regards economic growth, the results were less favourable for inflation targeting. The change in regime did not spur higher average economic growth or lessen the volatility of growth. For the output gap, however, the results provide some additional support for inflation targeting: targeters reduced the average output gap by about 1 per cent relative to non-targeters. Nonetheless, there was no significant difference in output gap volatility among targeters and non-targeters across the two periods.

Impact of Inflation Targeting on Selected Variables

Dependent variable	Change in unemployment	Change in output gap	Change in economic growth
Constant	3.29** *(1.17)*	-0.06 *(0.13)*	3.00*** *(0.40)*
IT dummy	-4.98* *(2.78)*	-1.05*** *(0.33)*	0.70 *(1.07)*
Initial mean	-0.34** *(0.12)*	-2.13*** *(0.08)*	-0.75*** *(0.09)*
IT*initial mean	0.82** *(0.33)*	?	-0.08 *(0.27)*
Heterosc. test	2.53 *[0.1115]*	1.89 *[0.1692]*	0.48 *[0.4862]*
R-squared	0.3521	0.9211	0.5910

Note: *, **, *** indicate statistical significance at the 10%, 5% and 1% level, respectively. Standard deviations are in parenthesis. Numbers in square brackets are p-values.

Data Sources: For unemployment—Labour Statistics Database (Laborsta) of the International Labour Organisation. For economic growth, gross domestic product (GDP), and consumer price index (CPI) —World Bank. The output gap was computed as the percentage deviation of real GDP from potential output, as predicted by a linear trend. Up to 64 countries were included in the study.

A possible explanation for the mixed results is that several countries have moved to anti-inflation monetary policies based on interest-rate rules, without announcing target values for inflation. Hence they are not formally classified as inflation targeters even though they are acting as such. Apart from the absence of a declared target for the inflation rate, the primary goal of their monetary policy is to stabilise inflation. This approach makes it difficult to identify changes in economic performance arising from the explicit adoption of an inflation targeting regime.

Despite this attribution problem, the empirical findings indicate that adoption of an inflation targeting regime did not exacerbate unemployment in developing and emerging countries. On the contrary, adoption of the regime reduced the average unemployment rate and narrowed the output gap. Hence there is no apparent reason to condemn these countries for adopting an inflation targeting regime for their monetary policies.

References:

Jose Angelo Divino (2009) "Does Inflation Targeting Affect Unemployment in Developing and Emerging Countries?" Working Paper (forthcoming), International Policy Centre for Inclusive Growth.

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