Examining the Success of the Central Banks in Inflation Targeting Countries: The Dynamics of the Inflation Gap and Institutional Characteristics

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Abstract

This paper analyzes the performance of the central banks in inflation targeting (IT) countries by examining their success in achieving their explicit inflation targets. For this purpose, we decompose the inflation gap, the difference between actual inflation and the inflation target, into predictable and unpredictable components. We argue that the central banks are successful if the predictable component diminishes over time. The predictable component of the inflation gap is measured by the conditional mean of a parsimonious time-varying autoregressive model. Our results find considerable heterogeneity in the success of these IT countries in achieving their targets at the start of this policy regime. Our findings suggest that the central banks of the IT adopting countries started targeting inflation implicitly before becoming an explicit inflation targeter. The panel data analysis suggests that the relative success of these countries in reducing the gap is influenced by their institutional characteristics particularly by fiscal discipline and macroeconomic performance.

Keywords: Inflation Targeting, Inflation Gap, Predictability, Time-varying Autoregressive Model, Institutional Characteristics.

JEL Classification Numbers: E52, E58, C32.

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1 Introduction

Explicit inflation targeting (IT) is increasingly being adopted as one of the primary methods of conducting monetary policy. The Reserve Bank of New Zealand initiated inflation targeting in 1990. Since then, the number of countries that have adopted this policy has risen to 27.[1] Under the IT regime, a central bank estimates and announces a target inflation rate and then uses the monetary tools to steer actual inflation towards the target. One very impressive feature of the inflation targeting regime is that no country has left the inflation targeting family unlike other monetary policy strategies such as the exchange rate or monetary targeting (Mihov and Rose (2008)).

The increasing popularity of this monetary policy strategy has evinced keen interest among researchers. The literature on inflation targeting, however, is divided over the efficacy of inflation targeting. There is one strand of the literature where researchers argue that the IT strategy curbs inflation expectations due to the credibility, accountability, and transparency of central banks (Bernanke and Mishkin (1997), Mishkin and Schmidt-Hebbel (2001), Levin, Natalucci and Piger (2004), Mishkin and Schmidt-Hebbel (2007), Baxa, Horvath and Vasicek (2014)). The opposite view takes the stand that the apparent success of the IT regime in most of the countries has been mainly due to favorable shocks affecting the global economy and these economies would have witnessed low and stable inflation even in the absence of an IT regime (Johnson (2002), Ball and Sheridan (2003), Lin and Ye (2007), Genc et al. (2007), Cecchetti and Hakkio (2009)).

Most of the existing studies on the IT regime study its efficacy by examining the behavior of inflation after the adoption of this regime. For example, Neuenkirch and Tillmann (2014) evaluate the central banks' response to the inflation gap for a sample of five inflation targeting countries. Surprisingly, there is no comprehensive work that takes into account the success

[1] Countries operating a fully fledged inflation targeting regime are: Armenia, Australia, Brazil, Canada, Chile, Colombia, the Czech Republic, Ghana, Guatemala, Hungary, Iceland, Indonesia, Israel, Mexico, New Zealand, Norway, Peru, Philippines, Poland, Romania, Serbia, South Africa, South Korea, Sweden, Thailand, Turkey and the United Kingdom (Hammond (2012)).

of these IT countries in achieving their targets. One notable exception is Albagli and Schmidt-Hebbel (2004). They study the determinants of the deviation of inflation from its target in 19 industrialized and emerging market economies over the 1990s and early 2000s. Using a panel and cross-sectional analysis, they find that institutional investor rating and the central bank independence index affect the central bank's ability in achieving its target. Unlike Albagli and Schmidt-Hebbel (2004), we take into account the heterogeneity across different countries explicitly by modeling the dynamic behavior of the difference between actual outcome and the target variable separately for each country. This is important because the ability of central bank to achieve its target may depend upon economic circumstances and there may be significant time variation in its ability to attain the explicit inflation target. In addition to expanding the sample period, our study also includes other IT countries to make the analysis comprehensive for all the explicit inflation targeters.

The success in achieving the target announced publicly by the central bank is crucial if the IT central bank wants to gain credibility. There are different reasons why actual inflation may differ from the target. At the time of the adoption of the IT regime, the central banks want to anchor inflationary expectations over medium to long-horizon. Therefore, the short-term gap between actual inflation and the target may not reflect the inability of the central banks to hit their target. However, the central bank will lose credibility if the gap is non-zero for a considerable period of time. The gap may also arise because of unpredictable shocks, but the impact of these unpredictable shocks should not persist for a long period. We use this feature of inflation targeting and propose to test the success of the IT central banks in meeting their target by decomposing the gap between actual inflation and the target into predictable and unpredictable components. We argue that a successful IT regime should bring down the predictable component of the inflation gap to zero over the medium-horizon if they are successful in bridging the gap that was predictable in advance. Our approach is motivated by Friedman's stabilization policy hypothesis (1953) where he argued that a successful central banker should make inflation perfectly stable. One consequence of a perfectly stable inflation

is that it becomes unpredictable in a sense that a constant inflation forecast model cannot be improved upon. It should be noted that unpredictability is a consequence of superior monetary policy in this context. The linkage between the success of monetary policy and the decline in predictability of inflation has also been shown by Boivin and Giannoni (2006) and Kishor and Kochin (2007). The empirical evidence presented in D'Agostino and Surico (2012) for the twentieth century also supports the above hypothesis where they find that the inflation forecasts based on money growth and output growth were significantly more accurate than the naïve forecasts only during the regimes associated with neither a clear nominal anchor nor a credible commitment to fight inflation.

We examine the success of the IT countries in meeting their target by estimating the predictable component of the inflation gap from a parsimonious time-varying autoregressive (TVP-AR) model. The conditional expectation of this TVP–AR model is the predictable component of the inflation gap. The TVP–AR model takes into account the fact that the capability of the central bank to achieve its target varies over time and is affected by institutional characteristics such as fiscal situation, central bank independence, and financial market depth. Our approach is able to capture the gradual transition of actual inflation to its target over time.[2]

We find considerable heterogeneity in the success of the IT countries in bridging the gap between actual inflation and the target in the years immediately after the adoption of the IT regime. We find that the predictable component of the inflation gap was close to zero for the countries with relatively low level and volatility of inflation even at the beginning of this regime. However, the predictable component converged to zero implying a higher degree of success in achieving the target for almost all the targeters after few years of the IT adoption. Interestingly, we also find that the predictable component of the inflation gap

[2]One could argue that use of a multivariate model will yield a superior estimate of the predictable component. However, the purpose of our study is not to find the most superior forecast of the inflation gap. The use of a simple AR model gives us a benchmark that can be improved upon by the inclusion of more variables in the information set. Therefore, the presence of a predictable component in the inflation gap should also imply the presence of a predictable component if the information set of the model is expanded.

started declining a few years before these countries publicly joined the IT regime. This implies that the central banks of IT countries started targeting inflation implicitly before becoming an explicit inflation targeter.

Our findings that in addition to cross-country heterogeneity, there is also significant time-variation in the success of the IT countries in achieving their targets can reconcile the two conflicting views on the effectiveness of IT. The finding that the IT countries have been successful in achieving their target is consistent with the literature that suggests that the IT regime leads to a gradual build up in the credibility of the central banks (Neumann and von Hagen (2002), Carare and Stone (2006), Creel and Hubert (2010), de Mendonca and de Guimaraes (2012)). The finding that there is considerable cross-country heterogeneity in the performance of the central banks immediately after the adoption is consistent with the literature which suggests the countries that started with high inflation benefitted more from this regime (Levin, Natalucci and Piger (2004), Mishkin and Schmidt-Hebbel (2007) and Batini and Laxton (2007)). We also perform a panel study to examine whether institutional characteristics of a country is related to its success in achieving its target. Our results suggest that high debt-GDP ratio constrains the ability of the central bank to bridge the gap between inflation and the target. We also find that financial development indicators and macroeconomic performance affect the inflation gap in these IT countries.

Section 2 describes data on the inflation targets for all the inflation targeters. Section 3 introduces a time-varying parameter model for the inflation gap, decomposes the inflation gap, and estimates the predictable component for the IT countries. Section 4 analyzes the effect of institutional characteristics on the dynamics of the inflation gap in a panel data framework. Section 5 gives some concluding remarks.

2 Data Description

One of the contributions of our paper is to create a comprehensive database of explicit inflation targets for all the IT countries. Table 1 shows the list of countries that have adopted the IT regime. It includes information on the date of adoption, the initial target and the target at the end of 2013. We consider the midpoint as a target level for countries with a target range. Israel and Poland have the highest gap between the two periods' target level, 14.5 to 2 and 8.25 to 2.5 percent, respectively. Table 1 also shows the type of target path for each IT country. The literature has classified the behavior of inflation targets into two categories: 'convergence' and 'stationary' target paths. Convergence rates relate to the inflation targeters in which initial target levels were high, gradually converging to a lower level. Stationary rates indicate a constantly low level of inflation. In addition, we classify each country into industrial and emerging market economies based on their level of economic development. Among 15 countries that have adopted IT after the year 2000, 14 of them are emerging market economies.

Figure 1 represents the target level at the date of adoption compared to the target level in 2013. Panel (a) shows the target level at the adoption date and panel (b) depicts the level in 2013. For example, at the adoption date, the target level in New Zealand (NZ) that adopted IT in 1989 was 4 percent and it decreased to 2 percent in 2013. The plots show that the target level has decreased in all the targeters over the past few decades.

The data on consumer prices have been obtained from the IMF's International Financial Statistics and FRED from 1980 through 2013 on a quarterly basis. The data on inflation targets have been obtained from the central banks' websites, and other studies (Mishkin and Schmidt-Hebbel (2001), Batini and Laxton (2007), Hammond (2012) and Leyva (2008)).[3] Figure 2 presents the annual inflation rates and targets for our sample. The vertical lines indicate the dates of IT adoption. A visual inspection suggests that there is a significant and protracted gap between actual and the inflation target at the beginning of the IT regime,

[3]More details on inflation target data are available upon request.

this gap seems have narrowed down over time.

Table 2 shows the descriptive statistics of the inflation rates for the IT countries. Inflation targeters such as Colombia, Ghana, Poland, Romania, Serbia, and Turkey have the highest pre-IT inflation levels; the average pre-IT inflation in these countries is above 20 percent. However, the mean of post-IT inflation is significantly low. A substantial gap exists between the means before and after the policy. This gap for Colombia, Ghana, Poland, Romania, Serbia, and Turkey is 15.09, 11.96, 20.36, 17.08, 18.47, and 37.04 percent, respectively.

Conventionally, inflation variability is measured by the standard deviation of inflation. Table 2 also presents the standard deviation for pre- and post-IT. A significant reduction in the standard deviation is noted after the adoption of IT. This reduction can be seen in targeters such as Armenia, Brazil, Ghana, Guatemala, Peru, Romania, Serbia, and Turkey. Overall, Figure 2 and Table 2 show the existence of a lower mean and standard deviation in the post-IT period.

3 A Time-Varying Parameter Model for the Inflation Gap

In this section, we propose to test the success of the IT countries in achieving their inflation targets. There are different ways to assess this success. The simplest method is to look at the inflation gap between actual inflation and the target over time. We observed two main features of the data in Figure 2. First, the difference between the target and actual inflation is time-varying. Secondly, this gap is not just a white noise. This implies that there is a predictable component in the inflation gap and this predictability varies over time. The predicability of the inflation gap can arise due to several reasons. First, interest rate smoothing behavior by the central bank can lead to a gradual adjustment towards the target. Second, there is a lag in monetary policy transmission and this lag tends to be higher for prices than real economic activity. Third, the central bank may have a medium-run horizon

and they want to achieve the target not in the very short term.

We study the success of the IT regime by decomposing the inflation gap into the predictable and unpredictable components. The predictable component disappears over time if the IT regime is successful in achieving its target. Admittedly, if a central bank announces its target, it is not expected to hit the target within a quarter, but we anticipate the inflation gap, that is forecastable, to disappear over medium to long-horizon. Actual inflation may always turn out to be different than the target because of unanticipated shocks, but a successful and credible central bank should not let this deviation persist.

The hypothesized relationship between the predictable component of the inflation gap and effectiveness of the IT regime is motivated by the monetary policy effectiveness literature where researchers like Boivin and Giannoni (2006) and Kishor and Kochin (2007) among others have shown that the aggressive policy stance towards inflation causes a decline in inflation predictability. This idea was originally proposed by Friedman (1953) when he discussed the role of stabilization policy and predictability of inflation. The empirical evidence presented in D'Agostino and Surico (2012) also support the above hypothesis. They find that the inflation forecasts based on money growth and output growth were significantly more accurate than the naïve forecasts only during the regimes associated with neither a clear nominal anchor nor a credible commitment to fight inflation. Therefore, in case of a perfectly successful IT regime, the only difference between actual inflation and the target will be the unforecastable news in the data.

We measure this predictable component in a very parsimonious way. We fit an ARMA(p,q) model to the inflation gap for all the IT countries. We find that AR(1) best approximates the inflation gap data for all the IT countries using the Bayesian information criterion. There are alternative ways to estimate AR(1) model in our example. We can fit the fixed coefficient model $\pi_t^{gap} = \alpha + \beta\pi_{t-1}^{gap} + v_t$, where π_t^{gap} is the inflation gap. In this model, the systematic part or the predictable component is the conditional mean, $\alpha + \beta\pi_{t-1}^{gap}$, and the unsystematic component is the error term, v_t. If monetary policy is perfectly successful

in achieving its target, then $\alpha = \beta = 0$. The intercept represents the bias and the slope coefficient measures the persistence of shock to the inflation gap. The problem with a fixed coefficient model is that it would not be able to capture the time variation in success of the IT central banks as it restricts the coefficients.[4] The fixed coefficient model will restrict the intercept and slope coefficients to be constant across time. This implies that the behavior of the central bank for the full sample has remained fixed and the persistence property of the shocks affecting the inflation gap has also remained the same. To take care of the problems associated with a fixed coefficient model, we modify the above model and allow the coefficients to vary with time. In particular, we allow the coefficients to follow a random walk. Our time-varying parameter (TVP) model becomes

$$\pi_t^{gap} = \alpha_t + \beta_t \pi_{t-1}^{gap} + v_t. \tag{1}$$

The subscript t signifies time-varying coefficients. There are alternative approaches of modeling time variation that includes structural break as well as Markov switching in the reaction function coefficients. The usual test of time variation has a low power against the alternative, that is, it is difficult to distinguish between different forms of time variation. As in Boivin and Giannoni (2006), we note that structural break models are very special cases of time variation and does not allow for the gradual evolution of monetary policy. Moreover, time-varying parameter model may also be used as a good approximation of multiple breaks in the reaction function coefficients.[5] The state-space representation of the above model is

[4] We also performed a simple likelihood ratio test for the null of no time-variation and in most of the countries, we reject the null.

[5] Stock and Watson (2002) and Boivin and Giannoni (2006) discuss merits of the TVP model over other forms of structural break.

given by

$$\pi_t^{gap} = F_t\theta_t + v_t, \qquad v_t \sim \mathcal{N}(0, V_t),$$
$$\theta_t = G_t\theta_{t-1} + w_t, \quad w_t \sim \mathcal{N}(0, W_t), \tag{2}$$

where $\theta_t = (\alpha_t, \beta_t)'$ and the system matrices are

$$F_t = \begin{pmatrix} 1 & \pi_{t-1}^{gap} \end{pmatrix}, \quad V_t = \sigma_v^2, \tag{3}$$

$$G_t = I_2, \quad W_t = \begin{pmatrix} \sigma_\alpha^2 & 0 \\ 0 & \sigma_\beta^2 \end{pmatrix}. \tag{4}$$

We assume the initial state, θ_0, is normally distributed with the mean m_0 and variance G_0 and the sequences v_t and w_t are independent of θ_0. We use Kalman filtering algorithms to obtain the means and variances of the conditional distributions of the unobservable states given the data. Petris, Petrone and Campagnoli (2009) argue that a naïve use of the Kalman filter causes numerical instability issues. One way to overcome this problem is to define more robust algorithms. We utilize a singular value decomposition-based algorithm proposed by Wang, Libert and Manneback (1992). Given observed data, $\{\pi_1^{gap}, \ldots, \pi_T^{gap}\}$, we find the optimal 'signal extraction' and the optimal 'h-step ahead prediction' of states and data.[6]

Figure 3 plots the time-varying and fixed conditional expectations of the inflation deviation from its target. The time-varying conditional expectations, the predictable components, are plotted by the black lines. We annualized the quarterly time-varying conditional means to reduce the noise in the time series. The residuals, the unpredictable components, are shown by the red lines. The vertical lines represent the dates of the IT adoption. For comparison, we also estimate the conditional mean a few years prior to the adoption. Since the inflation targets prior to adoption are not available, we use the initial

[6]For details, see Zivot and Yollin (2012).

inflation target for each country. In many cases, these targets were known in advance since the central banks announce them prior to the official adoption of the IT regime.

We observe some clear and interesting patterns in our estimated results. First, we find that there is considerable heterogeneity in the success of the IT countries in bridging the gap between actual inflation and the target in the years immediately after the adoption of the IT regime. We find that the conditional mean of the inflation gap was close to zero for countries with relatively low level and volatility of inflation even at the beginning of this regime. For example, we can clearly observe that the conditional mean in Australia, Canada, Chile, New Zealand, and Sweden hovered around zero for most of the time period after the adoption of the IT regime. On the other hand, there are countries such as Colombia, Ghana, and the United Kingdom among others where the conditional mean was not close to zero during the initial years of this regime. We also find that the predictable component converged to zero implying higher degree of success in achieving the target for almost all the IT countries after a few years of the IT adoption.

Interestingly, our findings show that the predictable component of the inflation gap starts declining few years before these countries publicly joined the IT regime. It implies that the central banks of IT countries started targeting inflation implicitly before becoming an explicit inflation targeter. Usually, the countries make an announcement about their intention to move to full-fledged inflation targeting at a future date. There is usually a time lag involved between the announcement and the formal move to the new regime. Our results that the predictable component starts declining before the formal date of adoption may reflect this time lag. Secondly, we find that for most of the countries, the residuals or the unpredictable component in the TVP–AR model is significant. This implies that the naïve way of just looking at the inflation gap and not making the distinction between the predictable and unpredictable components would not provide us the proper understanding into the effectiveness of the IT regime in meeting its target.

Our findings that in addition to cross-country heterogeneity, there is also significant

time-variation in the success of IT countries in achieving their targets can reconcile the two conflicting views on the effectiveness of IT. The finding that IT countries have been successful in achieving their target is consistent with the literature suggesting that the IT regime leads to a gradual build up in the credibility of the central banks (Neumann and von Hagen (2002), Carare and Stone (2006), Creel and Hubert (2010), de Mendonca and de Guimaraes (2012)). The finding that there is considerable cross-country heterogeneity in the performance of the central banks immediately after the adoption is consistent with the literature which suggests the countries that started with high inflation tended to have benefited more from the IT regime in terms of lower level and volatility of inflation over a medium to long-horizon. Our estimates also suggest that the conditional mean of the inflation gap for these emerging economies has gradually declined over time and was not very close to zero at the beginning of the IT regime.

Our approach estimates the conditional mean using information from only the past values of the inflation gap. It is conceivable that the expansion of information set in the calculation of conditional mean may provide us a different estimate. However, it should be noted that our estimated conditional mean consistently show a clear pattern for all the countries and even if information set is expanded, we should be able to find similar pattern in the data. Moreover, a complex model is more prone to misspecification especially since we are estimating the conditional mean of all the targeters.

To look deeper into the behavior of the predictable component, we examine the evolution of the intercept and slope coefficients, separately. Figure 4 shows the time-variation in these coefficients. The solid black lines plot the time-varying intercept coefficients and the blue dashed lines graph the time-varying slope coefficients. The vertical lines indicate the date of the IT adoption. The findings from time-varying intercept and slope coefficients suggest that the estimated intercepts are driving the results in countries where the predictable component of inflation was significant at the beginning of the IT regime. This was not the case for the countries with low level and volatility of inflation. These are also the countries with

very low conditional means. It should be noted that the persistence parameter beta for the inflation gap is different than the inflation persistence parameter that has attracted widespread attention from researchers. One of the implications of that strand of research is that higher credibility of a central bank is associated with lower persistence implying that a shock to inflation disappears quickly as inflationary expectations are anchored. (See Cogley, Primiceri and Sargent (2010) among others.)

4 Institutional Characteristics and Inflation Targeting Effectiveness

It has been argued in the literature that the success of IT depends on the institutional strength of the country that adopts this regime. Mishkin and Schmidt-Hebbel (2001) suggest that the success of full-fledged inflation targeting is based on five pillars: the absence of other nominal anchors, an institutional commitment to price stability, the lack of fiscal dominance, policy instrument independence, and accountability. In this section, we examine this hypothesis by investigating whether the success of IT countries in achieving their targets is determined by the strength of their institutions. To do so, we examine the role of fiscal situation, central bank independence, financial market development, and macroeconomic outcomes. Fiscal stance is measured by the debt-GDP ratio. We measure the financial market development using domestic private credit to the real sector by deposit money banks. We obtain the data on these variables from the International Financial Statistics published by the International Monetary Fund. Financial depth and financial sophistication are measured by the stock market capitalization-GDP and Central Bank Assets-GDP ratios, respectively. The data are obtained from the World Bank. The central bank independence measure is calculated by the turnover rate of the central bank governor's tenure (Cukierman, Webb and Neyapti (1994)). The rapid turnover signifies less autonomy and instability in the policy regime. This index is the inverse measure of central bank independence. The details of

the construction of this index is provided in Appendix A. We also use GDP per capita as the measure of macroeconomic outcomes in our analysis. Since we are interested in the relationship between the inflation gap and institutional characteristics, we only consider the post-IT sample period for each country.

To examine the impact of institutions on the deviation of actual inflation from the target, we consider a dynamic fixed-effects specification:

$$Y_{it} = X_{it}\beta_1 + W_{it}\beta_2 + \eta_i + \lambda_t + \epsilon_{it}, \tag{5}$$

where $Y_{it} = \pi_{it}^{gap} = \pi_{it} - \pi_{it}^{*}$. X_{it} includes strictly exogenous regressors, W_{it} are predetermined regressors including lags of Y. η_i is the country-specific characteristics and λ_t is the time-specific effect. Our panel estimation includes both the individual and time-specific effects. We also use Panel Corrected Standard Errors (PCSE) introduced by Beck and Katz (1995). To control for the lag dependence, we include the lag of dependent variable as explanatory variables. In our analysis, we regress the inflation gap on a set of regressors including its own lag, GDP growth, money growth, central bank independence index, and central bank assets-GDP, stock market capitalization-GDP, and private credit-GDP ratios. In addition of the inflation gap, we also consider the cumulative inflation gap as a dependent variable because central banks may not try to achieve their target every period because of the noise in the aggregate inflation data, but instead they may want to focus on cumulative deviation as consistent deviation from the target that may affect its credibility.

Table 3 summarizes the estimation results for the panel analysis. The results suggest significant dependence of the inflation and cumulative inflation gaps on their past. This is consistent with our findings in Section 3. Higher debt-GDP ratio is a measure of increased debt burden and has bearing on the conduct of the monetary policy. We find that higher debt burden is associated with the higher degree of the inflation gap and this relationship

is statistically significant at all levels of significance. This relationship remains robust to the use of cumulative deviation as a dependent variable. This finding is consistent with the fiscal dominance theory which suggests that fiscal indiscipline constrains monetary policy and may affect the central bank's ability to function prudently. We observe that the central bank independence index measured by the central bank governor's turnover ratio has a positive impact on the inflation and cumulative inflation gaps. It implies that greater central bank autonomy lowers the inflation gap and cumulative inflation gap. The independence of central banks is one of the preconditions for adopting inflation targeting. There is a consensus in the central banking literature that greater central bank independence is associated with lower and more stable inflation (Mishkin and Schmidt-Hebbel (2001) and Batini and Laxton (2007)).

The variable real money growth is used as an indicator of inflationary pressure in the economy. We find that an increase in real money growth is associated with lower inflation gap. This is a counterintuitive result. One proposed explanation of this counterintuitive sign is that in many emerging economies real money growth reflects the level of financial development. This is especially true in countries where dollarization is a strong feature of the economy. In this scenario, finding a negative coefficient on real money growth is not surprising. We also find that higher GDP growth is associated with higher inflation gap. Higher inflation due to higher GDP growth will lead to an increase of the inflation gap in countries with stationary target rates.

We also examine the relationship between financial market depth indicators and inflation gap. For this purpose, we look at two measures of financial soundness: central bank assets-GDP and private credit-GDP ratios. We don't find statistically significant relationship between central bank assets-GDP ratio and the inflation gap. However, we find that the private credit-GDP ratio positively affects inflation and cumulative inflation gaps. This impact is statistically significant. If private credit is just an indicator of financial market depth, then we would have expected the inflation gap to go down in response to higher private

credit-GDP ratio. However, it has been argued that in many emerging market economies a rapid increase in private credit may indicate overheating the economy and in that case it's not surprising that we find positive relationship with inflation and cumulative inflation gaps.

Overall, our results from the panel analysis are largely consistent with the literature where researchers have argued that for the success of inflation targeting regime, stable and strong institutional set up is required. We find that the success of IT countries in terms of achieving their targets is strongly associated with the extent of fiscal discipline and macroeconomic performance.

5 Concluding Remarks

This paper examines the effectiveness of inflation targeting in terms of central banks' success in achieving their explicit inflation targets. Keeping in mind that there are unanticipated shocks that can affect actual inflation, we propose to test the effectiveness of the central bank by decomposing the inflation gap, the difference between actual inflation and its target, into predictable and unpredictable components. We argue that the predictable component of the inflation gap, which we measure by the conditional mean of a time-varying parameter autoregressive model should converge to zero if the IT regime is successful in achieving the target. Our results find considerable heterogeneity in the success of these IT countries in achieving their targets at the start of this policy regime. We find that countries such as Canada and New Zealand have been consistently successful, whereas there was a gradual decline in the predictable component of the inflation gap in some emerging market economies such as Colombia, Guatemala, and Turkey. Interestingly, we also find that the predictable component of the inflation gap started declining few years before these countries publicly joined the IT regime. This implies that the central banks of the IT adopting countries started targeting inflation implicitly before becoming an explicit inflation targeter. Our panel data analysis suggests that the relative success of these countries in achieving their

targets is influenced by their institutional characteristics particularly by fiscal discipline and macroeconomic performance.

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Appendix A

This appendix shows how we constructed the central bank independence measure. Cukierman, Webb and Neyapti (1994) develop four measures of central bank independence and find their correlation with the inflation outcomes. The legal index, the rate of turnover of central bank governors, an index based on a questionnaire answered by specialists and an aggregation of the legal index with the turnover rate. They conclude that the legal independence is negatively related to inflation in industrial countries, but not in developing countries. We consider the turnover of central bank governors as an index for central bank independence. The turnover rate is more accurate than the legal index or questionnaire based criterion in the emerging market economies, because the latter two indices are build upon central bank laws and they do not reflect the independence of the central bank.

We construct the index based on the findings of Cukierman, Webb and Neyapti (1994) by assuming that above a threshold, a rapid turnover of central bank governors determines a higher dependence. If the political authorities frequently choose a new governor, they have the opportunity to pick those who favor the nominators' will. Frequent turnover reflects firing those who challenge the government. This is true especially in developing countries. Therefore, the measure for this index is in accordance with the electoral cycle for the central banks. If the turnover of central bank governor is four years the index will be .25, and so on.

Using the turnover index, we find the central bank independence for all the inflation targeters. Table A1 presents the average annual turnover rates in our sample countries for two time periods, 1980–1999 and 2000–2013. The average annual turnover rates are calculated from the ratio of governor changes to the number of years in that period. The average turnover rate during 1980–1999 ranges from a minimum of 0.0 to a maximum of 0.2. An average turnover of 0.0 indicates no change in the last 20 years. Canada, Colombia, the Czech Republic, Hungary, and the United Kingdom are a few examples of totally independent structures. Countries such as Chile, Poland, and Turkey have the highest rates of dependency. The central banks' independence has increased from the period 1980–1999 to 2000–2013. In the first period, there are five countries with totally independent central banks; whereas, after 2000 it has risen to 13 countries. The average annual turnover rate reduced significantly in 15 countries, i.e. the degree of central bank independence has been increasing over time.

Table A1: Average Annual Turnover Rates of the central bank governors for the inflation targeters, 1980–2013

Countries	1980–1999	2000–2013	Countries	1980–1999	2000–2013
Armenia	0.10	0.07	New Zealand	0.15	0.07
Australia	0.05	0.00	Norway	0.15	0.00
Brazil	0.05	0.07	Peru	NA	0.14
Canada	0.00	0.00	Philippines	0.15	0.07
Chile	0.20	0.07	Poland	0.20	0.14
Colombia	0.00	0.07	Romania	0.15	0.00
Czech	0.00	0.00	Serbia	NA	0.21
Ghana	0.15	0.21	South Africa	0.05	0.00
Guatemala	NA	NA	South Korea	0.10	0.00
Hungary	0.00	0.00	Sweden	0.10	0.14
Iceland	0.10	0.00	Thailand	0.15	0.00
Indonesia	0.05	0.00	Turkey	0.20	0.00
Israel	0.15	0.14	UK	0.00	0.00
Mexico	0.10	0.14			

Table 1: Inflation Targeting countries in the world, 1989–2013

Countries	Adopt. Date	Target Adopt.	Target 2013	Group	Target Path
Armenia (AM)	2006Q1	4.0	4.0	EME	Convergence
Australia (AU)	1993Q2	2.5	2.5	IND	Stationary
Brazil (BR)	1999Q2	8.0	4.5	EME	Convergence
Canada (CA)	1991Q1	4.0	2.0	IND	Stationary
Chile (CL)	1999Q3	3.0	3.0	EME	Stationary
Colombia (CO)	1999Q3	5.0	3.0	EME	Convergence
Czech (CZ)	1997Q4	6.0	2.0	EME	Stationary
Ghana (GH)	2002Q1	12.0	8.0	EME	Convergence
Guatemala (GT)	2005Q1	5.0	4.5	EME	Convergence
Hungary (HU)	2001Q2	7.0	3.0	EME	Convergence
Iceland (IS)	2001Q1	3.5	2.5	IND	Stationary
Indonesia (ID)	2005Q3	5.0	4.5	EME	Convergence
Israel (IL)	1992Q1	14.5	2.0	EME	Stationary
Mexico (MX)	2001Q1	5.0	3.0	EME	Stationary
New Zealand (NZ)	1989Q4	4.0	2.0	IND	Stationary
Norway (NO)	2001Q1	2.5	2.5	IND	Stationary
Peru (PE)	2002Q1	2.5	2.0	EME	Stationary
Philippines (PH)	2002Q1	4.7	4.0	EME	Stationary
Poland (PL)	1998Q1	8.2	2.5	EME	Stationary
Romania (RO)	2005Q3	7.5	2.5	EME	Convergence
Serbia (RS)	2006Q3	8.0	4.0	EME	Convergence
South Africa (ZA)	2000Q1	3.0	4.5	EME	Stationary
South Korea (KP)	1998Q2	9.0	3.0	EME	Stationary
Sweden (SE)	1993Q1	2.0	2.0	IND	Stationary
Thailand (TH)	2000Q2	1.7	3.0	EME	Stationary
Turkey (TR)	2006Q1	5.0	5.0	EME	Convergence
United Kingdom (UK)	1992Q3	3.0	2.0	IND	Stationary

[a] EME and IND indicate Emerging Market and Industrial Economies, respectively.
[b] Adoption dates and inflation targets are taken from the central banks' web pages. Country group and target path are based on Schmidt-Hebbel (2009).

Table 2: Descriptive statistics of inflation

Countries	Period	Mean	St. Dev.	Countries	Period	Mean	St. Dev.
	Pre-IT	10.70	23.20		Pre-IT	10.41	4.57
Armenia	Post-IT	5.54	2.66	New Zealand	Post-IT	2.31	1.40
	Whole	*8.69*	*18.14*		*Whole*	*4.50*	*4.49*
	Pre-IT	6.49	3.07		Pre-IT	4.69	3.04
Australia	Post-IT	2.62	1.30	Norway	Post-IT	1.81	1.11
	Whole	*4.10*	*2.85*		*Whole*	*3.58*	*2.86*
	Pre-IT	12.25	14.11		Pre-IT	13.05	13.87
Brazil	Post-IT	6.32	2.49	Peru	Post-IT	2.66	1.49
	Whole	*7.72*	*7.39*		*Whole*	*7.52*	*10.78*
	Pre-IT	5.77	2.73		Pre-IT	9.82	8.86
Canada	Post-IT	1.96	1.15	Philippines	Post-IT	4.23	1.85
	Whole	*3.12*	*2.51*		*Whole*	*7.87*	*7.68*
	Pre-IT	14.43	6.95		Pre-IT	24.23	8.40
Chile	Post-IT	3.03	2.14	Poland	Post-IT	3.87	2.82
	Whole	*9.55*	*7.84*		*Whole*	*9.62*	*10.56*
	Pre-IT	20.26	4.28		Pre-IT	22.52	11.98
Colombia	Post-IT	5.17	2.10	Romania	Post-IT	5.44	1.90
	Whole	*13.82*	*8.33*		*Whole*	*13.21*	*11.85*
	Pre-IT	10.72	4.12		Pre-IT	26.53	21.23
Czech	Post-IT	3.12	2.62	Serbia	Post-IT	8.06	3.15
	Whole	*5.14*	*4.58*		*Whole*	*18.83*	*18.64*
	Pre-IT	24.82	12.38		Pre-IT	11.19	3.65
Ghana	Post-IT	12.86	4.42	South Africa	Post-IT	5.71	2.63
	Whole	*20.03*	*11.58*		*Whole*	*8.94*	*4.20*
	Pre-IT	11.05	9.32		Pre-IT	5.73	3.54
Guatemala	Post-IT	5.70	2.90	South Korea	Post-IT	2.89	1.23
	Whole	*9.64*	*8.48*		*Whole*	*4.38*	*3.05*
	Pre-IT	14.17	7.40		Pre-IT	6.85	2.56
Hungary	Post-IT	4.87	1.75	Sweden	Post-IT	1.37	1.34
	Whole	*10.66*	*7.48*		*Whole*	*3.39*	*3.26*
	Pre-IT	9.15	8.86		Pre-IT	4.26	2.55
Iceland	Post-IT	5.65	3.32	Thailand	Post-IT	2.63	1.87
	Whole	*7.63*	*7.2*		*Whole*	*3.61*	*2.43*
	Pre-IT	10.00	9.10		Pre-IT	45.02	24.88
Indonesia	Post-IT	7.02	3.64	Turkey	Post-IT	7.98	1.71
	Whole	*9.20*	*8.18*		*Whole*	*31.62*	*26.73*
	Pre-IT	16.86	1.84		Pre-IT	5.85	2.32
Israel	Post-IT	4.49	3.99	UK	Post-IT	2.17	0.91
	Whole	*7.11*	*6.27*		*Whole*	*3.48*	*2.36*
	Pre-IT	16.20	8.68				
Mexico	Post-IT	4.31	0.83				
	Whole	*9.64*	*8.33*				

'Pre-IT' refers to the period before the inflation targeting is adopted by each county. 'Whole' refers to the entire sample.

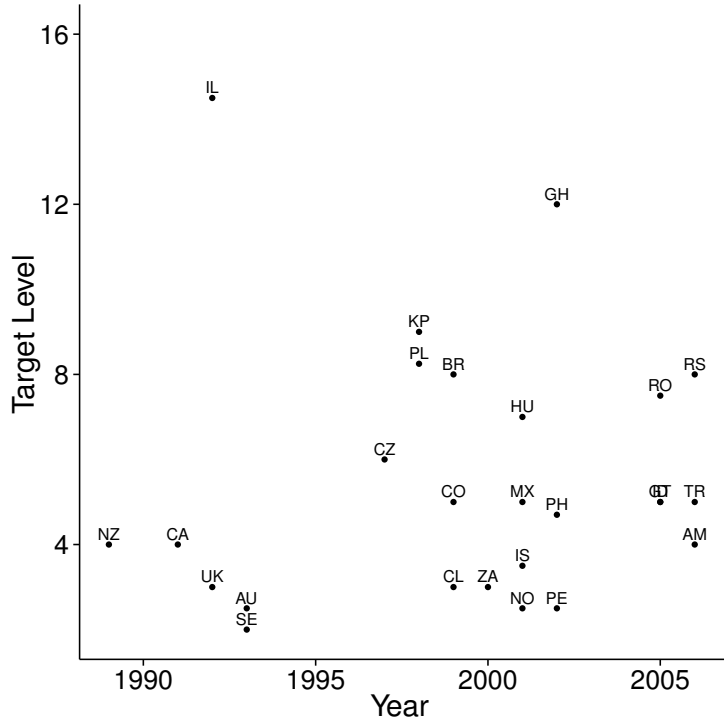
Table 3: Inflation gap and institutional characteristics

	Dependent variable	
	π^{gap}	π^{gap}_{csum}
π^{gap}_{t-1}	0.419^{***}	
	(0.075)	
π^{gap}_{t-2}	-0.180^{***}	
	(0.062)	
$\pi^{gap}_{csum,t-1}$		1.224^{***}
		(0.074)
$\pi^{gap}_{csum,t-2}$		-0.340^{***}
		(0.066)
Money Growth	-0.064^{**}	-0.070^{***}
	(0.025)	(0.026)
Private Credit-GDP	0.010^{**}	0.011^{***}
	(0.004)	(0.003)
GDP Growth	22.939^{***}	12.457
	(7.995)	(8.361)
ICBI	1.634	1.400
	(2.452)	(1.977)
CB Assets-GDP	0.005	0.009
	(0.023)	(0.024)
Debt-GDP	0.026^{***}	0.029^{***}
	(0.008)	(0.008)

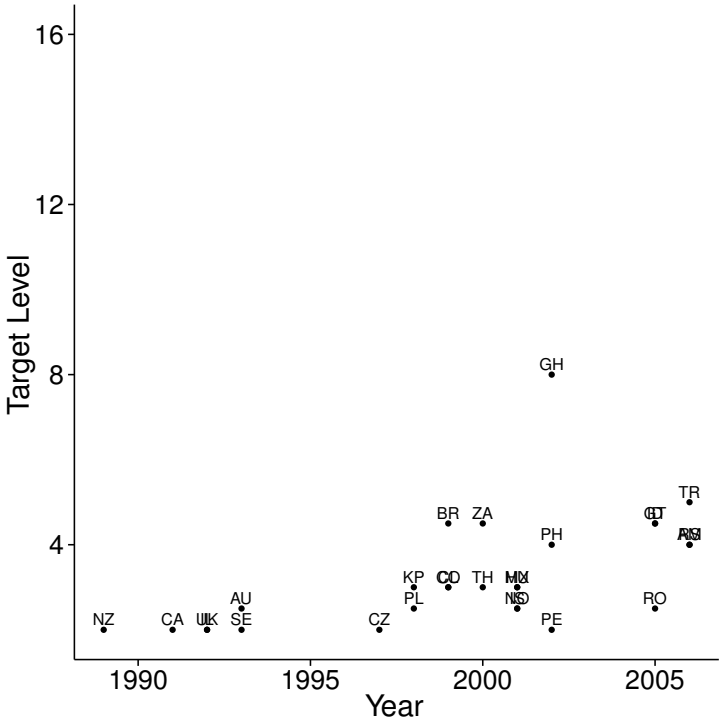
[a] π^{gap} is the inflation gap, and π^{gap}_{csum} is the cumulative inflation gap. ICBI is the inverse measure of central bank independence.

[b] The robust standard errors are reported in parentheses, according to the Beck and Katz (1995) method, a.k.a. Panel Corrected Standard Errors (PCSE).

[c] *p<0.1; **p<0.05; ***p<0.01.



(a) Adoption Date



(b) 2013

Figure 1: Target level at the adoption date and 2013

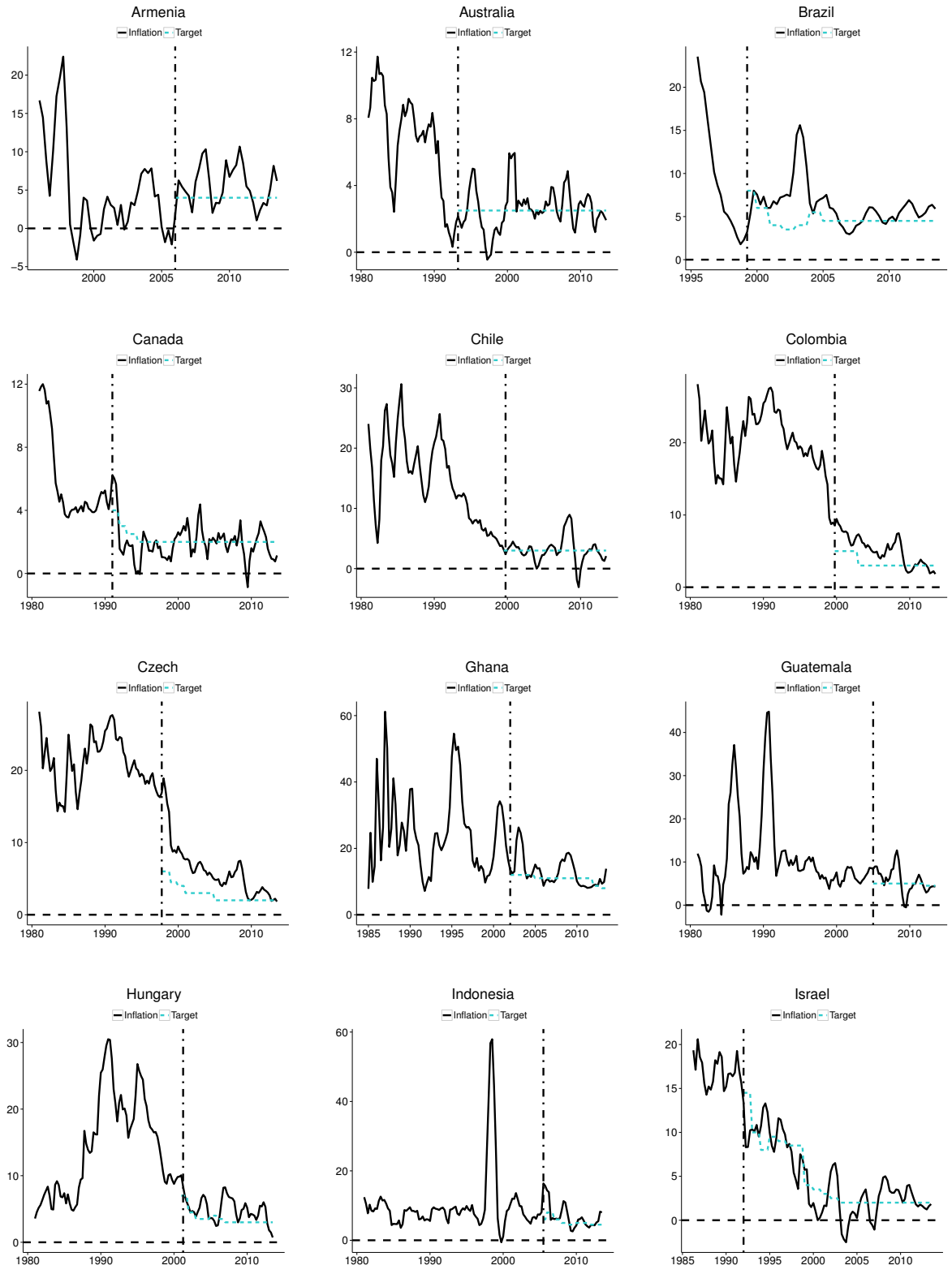


Figure 2: Annual inflation rates and targets in inflation targeting countries, 1980–2013

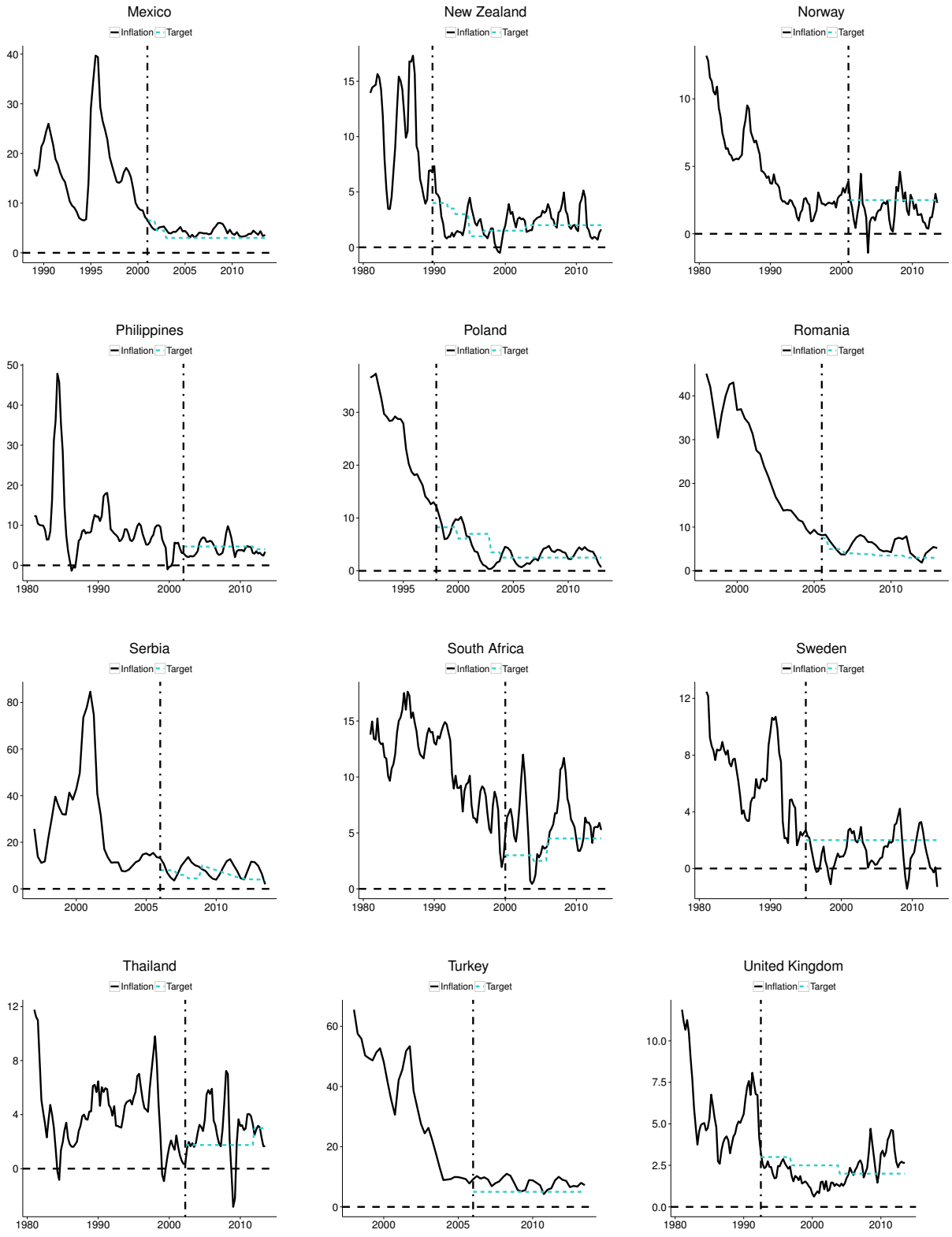


Figure 2: Annual inflation rates and targets in inflation targeting countries, 1980–2013 (Continued)

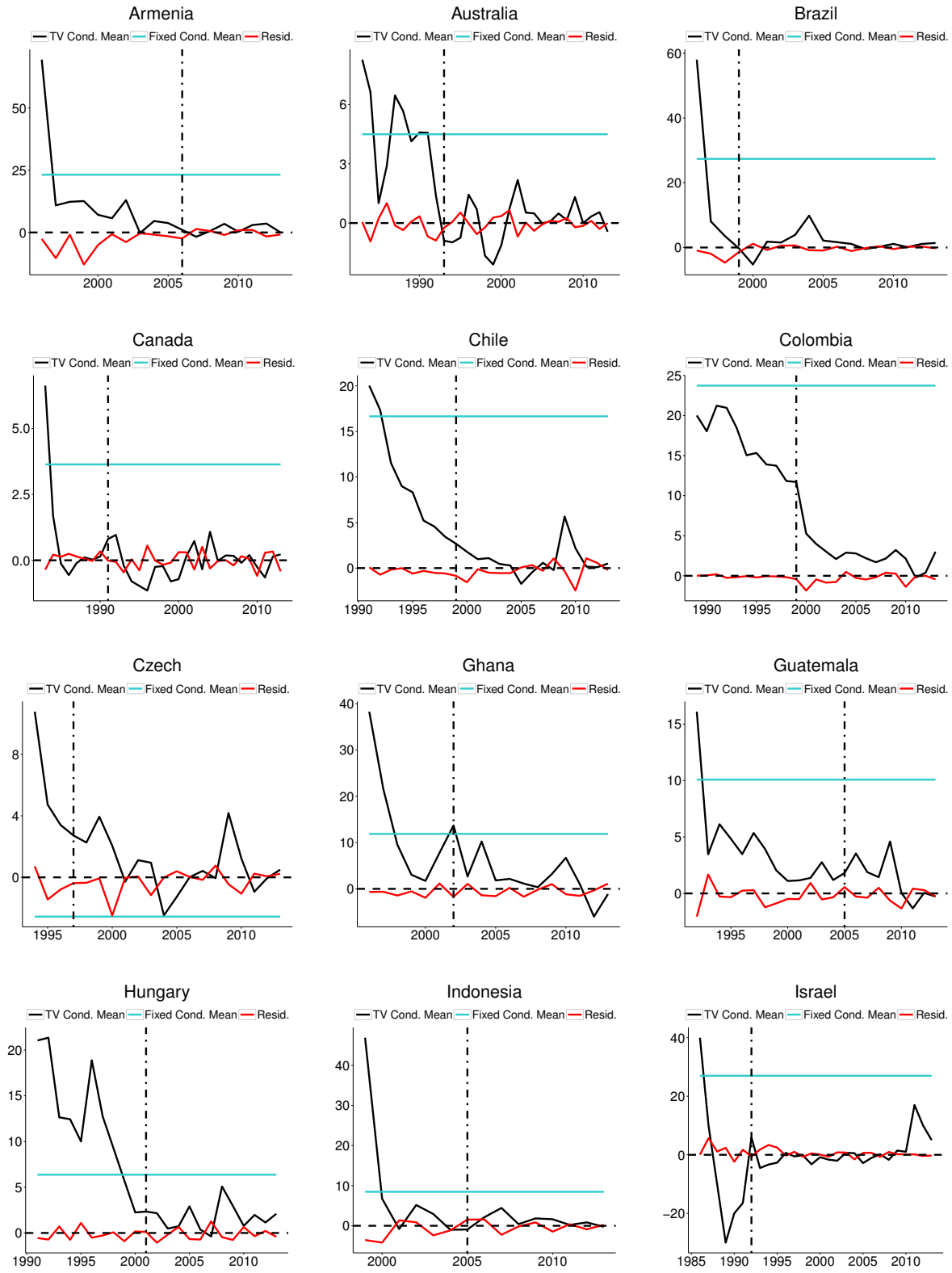


Figure 3: Annualized conditional means of the inflation gap and residuals from the time-varying parameter autoregressive model

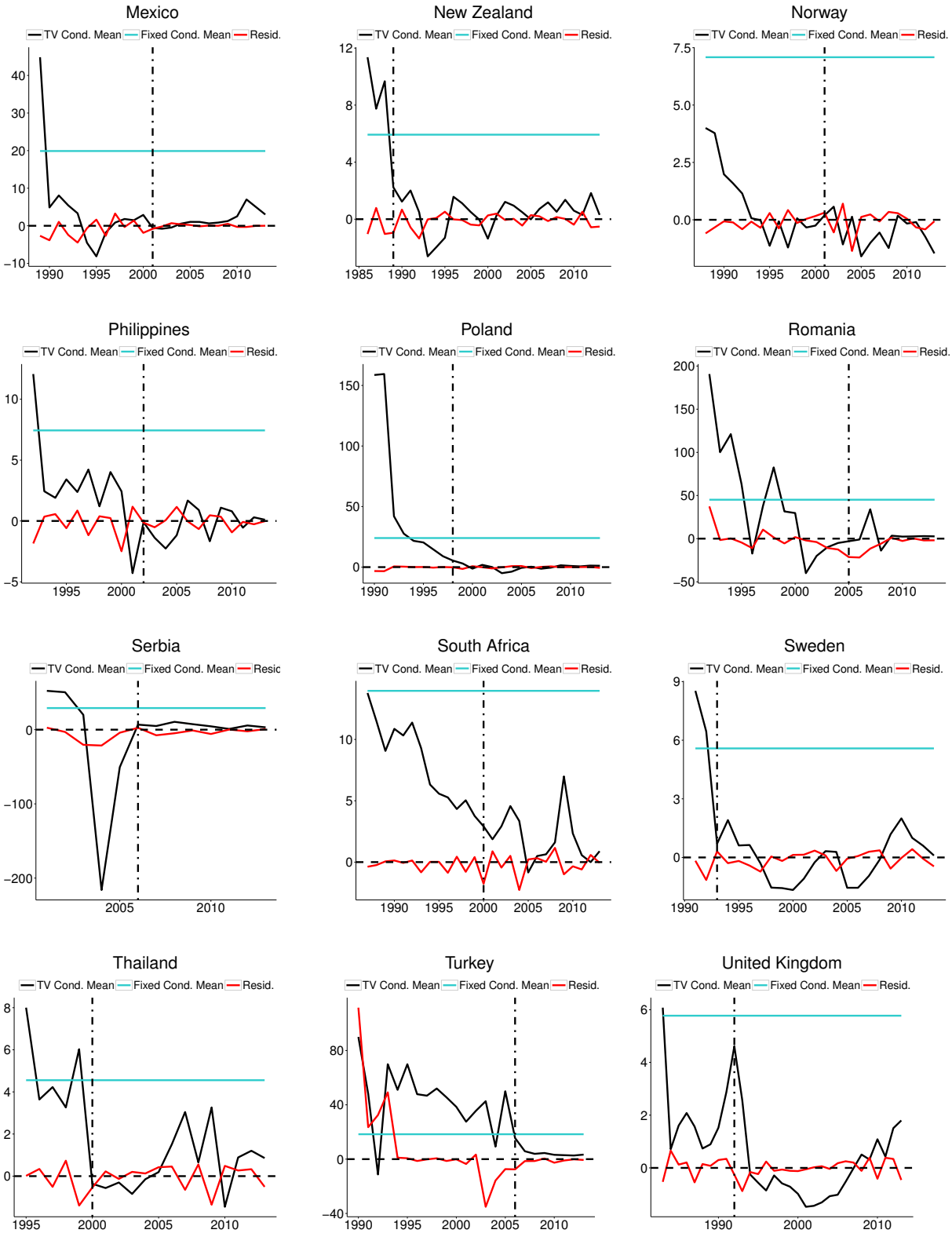


Figure 3: Annualized conditional means of the inflation gap and residuals from the time-varying parameter autoregressive model (Continued)

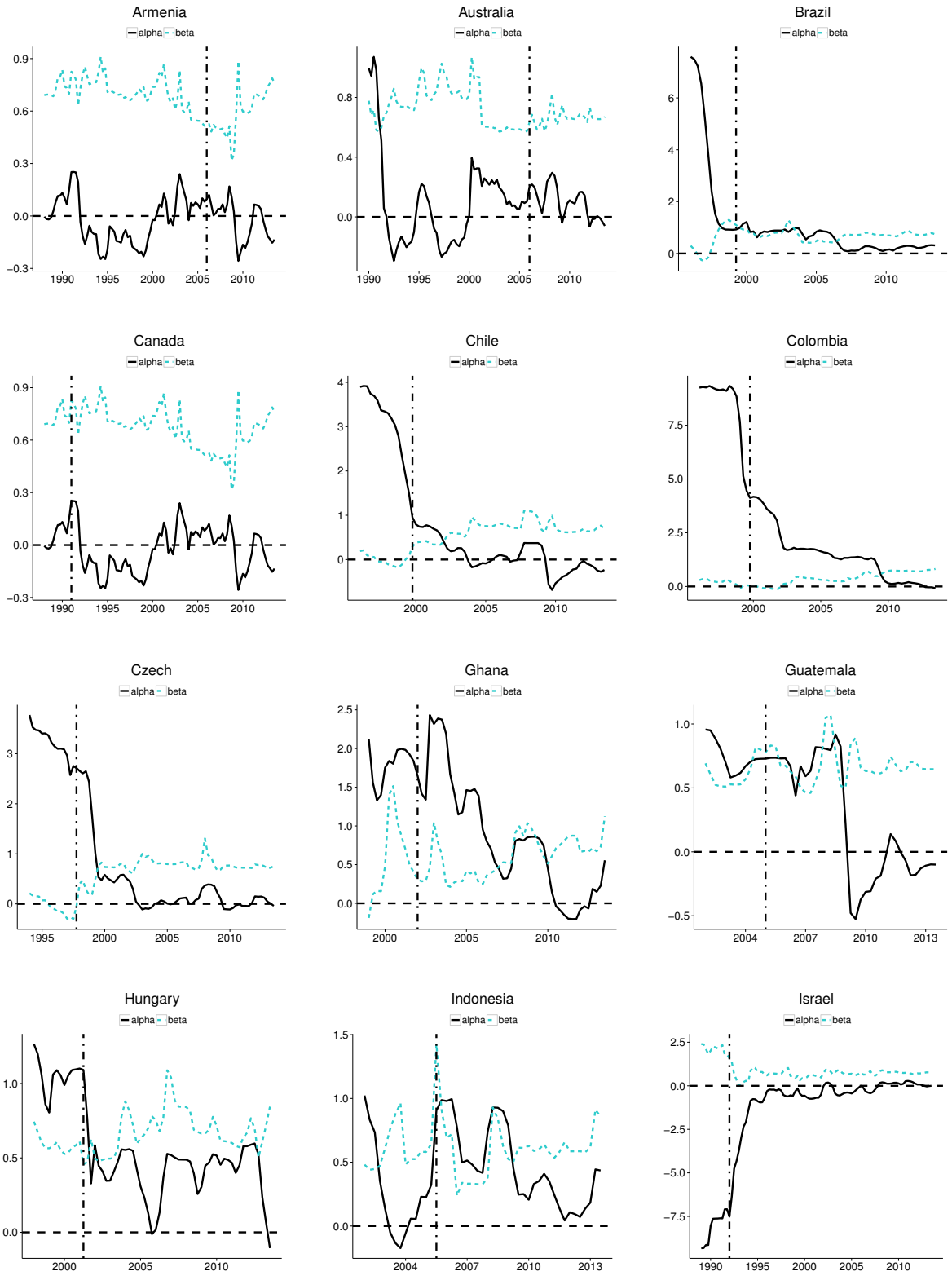


Figure 4: Filtered time-varying coefficients

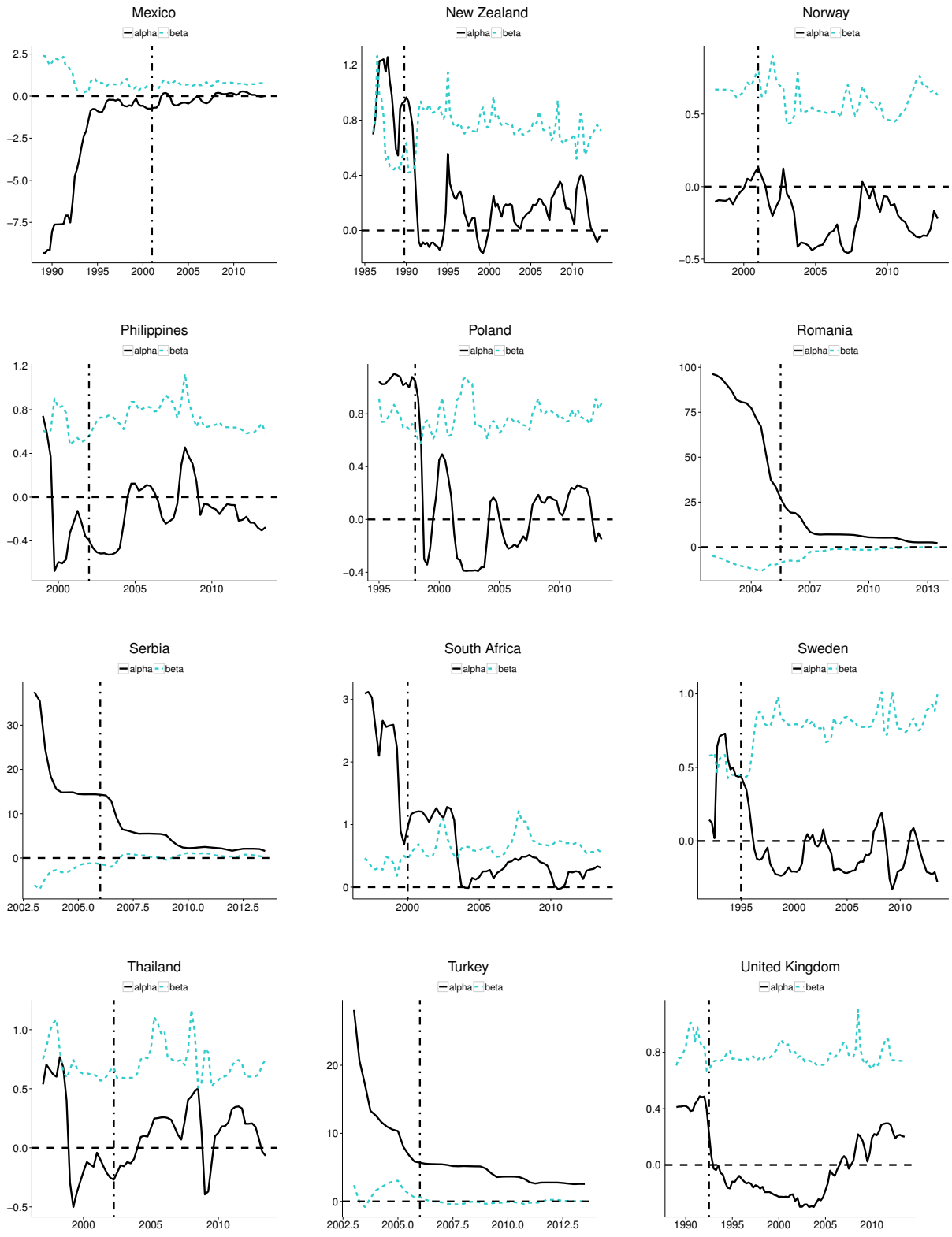


Figure 4: Filtered time-varying coefficients (Continued)