Inflation Targeting, Employment Creation and Economic Development

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Inflation targeting has become the dominant monetary policy prescription for developing and industrialized countries alike. Initially adopted by New Zealand in 1990, the norms surrounding the inflation targeting regime have been so powerful that virtually all Central Banks have declared that maintaining price stability with inflation in the "low single digits" is their *only* mandate. It is further maintained that price stability will lead to sustained growth and employment creation.

The inflation targeting policy framework involves "the public announcement of inflation targets, coupled with a credible and accountable commitment on the part of government policy authorities to the achievement of these targets",[i] with the target usually in the "low single digits." In addition, inflation targeting is often associated with changes in the central bank law that enhances the independence of the institution. In practice, while few central banks reach the "ideal" of being "full fledged" inflation-targeting institutions, many nonetheless focus on fighting inflation to the virtual exclusion of other goals.

Ironically, employment creation has dropped off the immediate agenda of most central banks just as the problems of global unemployment, underemployment and poverty are taking center stage. The ILO estimates that in 2003, approximately 186 million people were jobless, the highest level ever recorded.[ii] Moreover, the ILO estimates that 22% of the developing world's workers earn less than $1 a day and 1.4 billion (or 57% of the developing world's workers) earn less than $2 a day. To reach the Millennium Development Goal of halving the share of working poor by 2015, the ILO's evaluation shows that on average, real GDP growth has to be maintained at 4.7% per year to reduce the share of "$1 a-day-poverty" by half, and significantly more than that to halve the share of "$2 a-day-poverty."

The key problem is that ongoing financial globalization appears primarily to redistribute limited jobs across countries, rather than to accelerate capital accumulation and job creation across the globe. Currently, global growth is highly uneven and geographically too concentrated to generate sufficient jobs world-wide and, moreover, is associated with too little fixed capital formation. Under these conditions, price stability, on its own, will not suffice to maintain true macroeconomic stability, because, it will not secure *financial stability and employment growth.* As the sub-prime financial crisis originating in the U.S. forcefully exemplifies, it is financial rather than price stability that threatens overall macroeconomic performance.

Against this background, the main motivation of the research summarized here is the conviction that modern central banks ought to move beyond a focus solely on low inflation. Instead, central banks—as most did for decades following the Second World War—should strike a balance among various objectives, with employment creation and more rapid economic growth joining inflation and stabilization as possible goals, depending on the circumstances and challenges facing each country. Equally important, to carry out this broader mandate, central banks must have the opportunity to utilize sufficient tools to achieve more objectives. In the following pages, we will summarize the findings of a series of country studies on alternatives to inflation targeting undertaken by a team of researchers organized by PERI (Political Economy Research Institute at the University of Massachusetts, Amherst) and Bilkent University.[iii] The country studies, produced by a team of country experts, assess the macroeconomic performance of currently existing inflation targeting frameworks, and, more importantly, develop alternative monetary policy frameworks that could better achieve important social and economic goals—all within specific country contexts, including Argentina, Brazil, India, Mexico, The Philippines, Vietnam, South Africa and Turkey. In addition, the project includes several thematic studies relevant to the issue of monetary policy and inflation, including differential gender impacts of contractionary monetary policy, and the impacts of inflation versus economic growth on different income groups within countries. Reporting on the results of this research project, we outline why a shift away from inflation targeting and towards a more balanced approach is both feasible and desirable. Furthermore, to contribute to the task of designing a more socially desirable macroeconomic policy environment, we offer viable alternatives to inflation targeting in order to promote employment, sustained growth, and improved income distribution.

Macroeconomic record of inflation targeting

Much of the existing literature on the record of inflation targeting has focused on whether inflation and its volatility have been reduced, and whether other objectives, in particular the volatility of output, have been compromised. With respect to the issue of inflation levels, a key question is whether inflation has come down in response to adoption of the framework itself or due to a set of "exogenously welcome" factors. On the one side, there is a fair amount of agreement that inflation targeting has been associated with reductions in inflation. Yet, existing evidence also suggests that inflation targeting has not yielded inflation rates below the levels attained by the industrial non-inflation targeting countries that have adopted other monetary regimes.[iv]

In addition, there are widely conflicting estimates about the true costs of inflation targeting on potential and output growth, and little agreement about its impact on employment, poverty and the distribution of income. Bernanke, et al. (1999),[v] despite favoring inflation targeting, report extensive evidence that inflation targeting central banks do *not* reduce inflation at a cost *lower* than other countries' central banks in terms of forgone output. That is, inflation targeting does not significantly increase the credibility of the central bank and therefore, does not reduce the "sacrifice ratio." This position has been contradicted by an IMF study, based on an empirical model and simulations, suggesting that inflation targeting curtails the volatility of inflation, without increasing volatility in real variables such as real GDP.[vi]

However, these results define stability in a very narrow sense, failing to consider the issue of the stability of asset prices, including exchange rates, stock prices and other financial asset prices. More important, as Nelson Barbosa shows in a paper written for this project, these studies use a biased measure of output stability.[vii] In particular, they define "output stability" to mean changes in output *relative* to a measure of potential output. The problem is that this measure of potential output is not fixed: rather, it simply tracks, with a lag, actual output. Therefore, if inflation targeting lowers output growth, then potential output growth will soon go down itself, and the gap between actual and potential will appear to be unaffected by inflation. By this approach, output relative to potential output is virtually guaranteed to be stable no matter how restrictive monetary policy is.

Moreover, our project provides further evidence on the negative consequences of monetary policy focused on producing extremely low levels of inflation in the developing countries. Braunstein and Heintz (2008) show that contractionary monetary policy used to fight inflation often has a differentially negative impact on the employment rates of women relative to men.

Furthermore, setting the targeted rate of inflation itself is immensely problematic. Even though there appears to be a consensus among the advocates of an inflation targeting regime that the inflation target has to be "in the low single digits," there is no theoretical or empirical justification of this assertion; and as such, it appears to be a recommendation based on ideological motives rather than careful calculation. For example, given the putative negative costs of inflation on output and employment, there should be some direct survey evidence indicating people's preferences with respect to inflation and unemployment. While some studies have indicated that people have an absolute preference for low inflation, in a paper written for this project, Arjun Jayadev reports on survey results asking people in different countries and income levels what their bigger concern is: *high inflation* or *high unemployment*?[viii] His main result is that poorer people are concerned more about high unemployment than high inflation, while richer respondents have the opposite preferences. Hence, concerns over employment and inflation have an important class dimension.

Most disturbing is the common belief that what is good for developed market economies should simply be replicated by the developing countries as well. Indeed, Pollin and Zhu (2006) argue to the contrary.[ix] Based on non-linear regression estimates of the relationship between inflation and economic growth for 80 countries over the period 1961-2000, Pollin and Zhu report that higher inflation is associated with moderate gains in GDP growth up to a roughly 15 to 18 percent inflation threshold. Thus, there appears to be no justification for contractionary inflation targeting policies to maintain inflation within a 2 to 4 percent band.

Monetary policy alternatives

The PERI/Bilkent research suggests a range of policy alternatives, from modest changes within the inflation targeting framework to a much broader change in the overall mandate of the central bank to focus on *employment* rather than inflation targeting.[x] We begin with proposals complementary to orthodox policy, proceed with a summary of ideas for more far-reaching restructuring of the monetary framework, and conclude with an overview of the main features of both lines of research.

In the case of ***Mexico*** Galindo and Ros argue that the inflation targeting regime has allowed for more flexible monetary policy than had occurred under regimes with strict monetary targets or strict exchange rate targets.[xi] However, monetary policy appears to have been *asymmetric* with respect to exchange rate movements—tightening when exchange rates depreciated, but not loosening when exchange rates appreciated, lending a bias in favor of an over-valued exchange rate. Responding *symmetrically* to exchange rate movements and thus avoiding the bias toward over-valuation without fundamentally changing the inflation targeting framework "would promote a competitive exchange rate by establishing a sliding floor to the exchange rate in order to prevent excessive appreciation," the authors write. Interventions in foreign exchange markets would provide a floor to an otherwise freely floating exchange rate, working against excessive (speculative) capital inflows to signal that the central bank will fight excessive appreciation.[xii] If needed to stabilize exchange rates, Galindo and Ros suggest temporary capital controls, as do some of the other authors from the PERI/Bilkent project.

In his study of ***Brazil*** Nelson Barbosa-Filho (2008) also proposes to extend the inflation targeting framework, but in a more dramatic way. According to Barbosa-Filho, for Brazil, "because of [its] past experience with high inflation, the best policy is to continue to target inflation while the economy moves to a more stable macroeconomic situation." However, "the crucial question is not to eliminate inflation targeting, but to actually make it compatible with fast income growth and stable public and foreign finance." Barbosa-Filho proposes to maintain a stable and competitive real exchange rate (SCRER) to promote these goals. The author furthermore suggests that a targeted reduction in the real interest rate would not only increase productive investment but also reduce the burden of servicing Brazil's large public debt. He proposes that the Brazilian central bank choose exports, inflation and investment as ultimate targets, and focus on the inflation rate, a competitive and stable real exchange rate and the real interest rate as intermediate targets.

Turkey is another highly indebted country in the sample. Using a financial-linked computable general equilibrium model (CGE), Telli, Voyvoda and Yeldan (2008) illustrate the real and financial adjustments of the Turkish economy under the conditionalities they call the *twin targets* of macroeconomic policy[xiii]—(a) a fiscal target on the *primary surplus relative to GNP*, and (b) a monetary target on the *rate of inflation*. As a better alternative, they analyze the impact of a shift in policy from a strict *inflation* to an *exchange rate* targeting regime, combined with a more relaxed fiscal stance (promoting public investments and social capital). Their findings suggest an overall positive response of economic activity to these alternative monetary policy settings.

Frenkel and Rapetti (2008) show that targeting a stable and competitive real exchange rate has been very successful in ***Argentina***,[xiv] helping to maintain more rapid output and employment growth. In the case of ***India***, Jha (2008) also argues against an inflation targeting regime, and in favor of one that "errs on the side of undervaluation of the exchange rate" with help from temporary resort to capital controls if necessary, presenting roughly a continuation of policies undertaken in India in the past.[xv] In ***Vietnam***, Packard (2005) concludes that "a strict inflation targeting regime is not appropriate for Vietnam," advising that a more exchange rate-focused framework would be superior, "precisely because it sets as a target a key macroeconomic relative price that is realistic, sustainable, and growth enhancing."[xvi]

Other country case studies propose more comprehensive policy alternatives to simple inflation-focused monetary policy. Joseph Lim (2008) proposes a comprehensive alternative to inflation targeting for the case of the ***Philippines*** with a strong focus on maintaining a competitive real exchange rate, possibly with a peg supported by capital controls.[xvii] This should include strong financial supervision to prevent excessive undertaking of short-term foreign debt, and tax based capital controls on short term capital flows, as was used, for example in Chile. Such an exchange rate policy should be complemented by an explicit statement of output and employment goals. Incomes and anti-monopoly policies can help to limit inflation to moderate levels and targeted credit programs, especially for export oriented and small and medium sized enterprises that can contribute to productivity growth and employment.

These policy proposals in broad outlines are similar to those suggested by Epstein (2008) for the case of ***South Africa***.[xviii] Similarly, Pollin, *et al.* (2006) developed an "employment-targeted economic program" designed to accomplish this goal, with a focus on monetary policy, credit policy, capital management techniques, fiscal policy and industrial policy.[xix] The purpose of the program is to reduce the unemployment rate by half in line with the government's pledge to reduce the official unemployment rate to 13% by 2014.[xx] Epstein (2008) proposes that the Reserve Bank of South Africa lower interest rates to target a higher real GDP growth rate in order to support the proposed government policy of generating more employment, while playing an institutional role in supporting new credit allocation mechanisms to channel more resources for employment generating activities. The Reserve Bank might also need to strengthen capital controls to support the overall program. Here, "*employment* targeting" replaces inflation targeting as the proposed operating principle behind central bank policy, and moderate inflation becomes an additional formal constraint which the central bank must take into account when formulating its policies.

The following schematic summarizes the key policy proposals of the PERI/Bilkent project on alternatives to inflation targeting.

Alternatives *complementing* inflation targeting strategies:

⇒ **Adoption of more symmetric inflation targeting**: The fundamental importance of gaining and maintaining export markets to promote industrialization and development commends *avoiding asymmetric* monetary policy that leans against exchange rate *depreciations* but *not appreciation*, an asymmetry that eventually leads to harmful exchange rate over-valuation over time.

⇒ **Widening of the inflation target band:** The developed country band of "acceptable inflation" between 2% and 4% cannot be transplanted to developing economies. Research suggests that *somewhat* higher inflation can be conducive rather than detrimental to growth and development.

The following lists possible elements of an employment targeting and/or growth enhancing rather than inflation targeting monetary policy package:

Alternatives *replacing* inflation targeting strategies:

⇒ **Stable and competitive real exchange rate targeting**: Maintenance of a stable and competitive real exchange rate, by managing the real exchange rate.

⇒ **Employment and growth targets**: An explicit statement of goals for output and employment growth as the ultimate measures of development.

These will usually require that the central bank expand its policy tool-kit beyond simply manipulating short-term interest rates. This enhanced tool-kit might include:

⇒ **Capital account management**: Capital controls to support exchange rate management, suppressing "hot money" flows and excessive risk taking.

⇒ **Credit policies in support of employment and industrial policies**: Targeted credit programs, especially for export oriented and small and medium sized enterprises that can contribute to productivity growth and employment.

Concluding Comments

In this summary of research conducted at PERI and Bilkent University we have argued that the current orthodoxy of central banking is, especially for developing countries, unlikely to be neither optimal nor desirable. This orthodoxy is based on several false premises: first, that moderate rates of inflation have high costs; second, that in a low inflation environment economies will naturally perform best, and in particular, will generate high levels of economic growth and employment; and third, that there are no viable alternatives to this "inflation-focused" monetary policy. In fact, most *moderate* rates of inflation episodes reveal to have very low or no costs. To the contrary, there *are* viable alternatives to inflation targeting, historically, presently, and looking forward.

Historically, countries both in the currently developed and developing worlds had central banks with multiple goals and tools, and pursued broad developmental as well as stabilization goals. Currently, very successful economies such as Argentina, China and India have central banks that are using a broad array of tools to manage their economies for developmental purposes. Looking forward, the PERI/Bilkent project on alternatives to inflation targeting and PERI's UNDP work on South Africa, Kenya and Ghana suggest the availability of an array of "real targeting" approaches.

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[i] See Setterfield, Mark (2006) "Is Inflation Targeting Compatible with Post Keynesian Economics?" *Journal of Post Keynesian Economics*, 28 (4): 653-671, page 653.

[ii] ILO (2004) *Global Employment Trends 2004*. Geneva: International Labor Office.

[iii] The full set of the country studies of this project can be obtained from PERI (http://www.peri.umass.edu/) or from the International Development Economics Associates (*http://www.networkideas.org*). These papers will be published in two versions, one in a special issue of *The International Review of Applied Economics*, March, 2008, and the other in a volume published by Elgar Press in the fall of 2008, entitled *Alternatives to Inflation Targeting: Central Bank Policy For Employment Creation, Poverty Reduction And Sustainable Growth*.

[iv] See Ball, L. and Sheridan, N. (2003) "Does Inflation Targeting Matter?" *IMF Working Paper* No. 03/129, and Roger, Scott and Mark Stone (2005) "On Target? The International Experience with Achieving Inflation Targets," Washington, D.C.: *IMF, Working Paper*, WP/05/163.

[v] Bernanke, Ben S., Thomas Laubach, Adam S. Posen and Frederic S. Mishkin (1999) *Inflation Targeting: Lessons from the International Experience*. Princeton, NJ: Princeton University Press.

[vi] Batini, Nicoletta, Peter Breuer, Kalpana Kochhar and Skott Roger (2006) "Inflation Targeting and the IMF" IMF Staff Paper, Washington DC, March.

[vii] Barbosa-Filho, Nelson H. (2008) "Inflation Targeting and Monetary Policy In Brazil." *International Review of Applied Economics*, forthcoming.

[viii] Jayadev, Arjun (2008) The Class Content of Preferences Towards Anti-Inflation and Anti-Unemployment Policies, *International Review of Applied Economics*, forthcoming.

[ix] Pollin, Robert and Andong Zhu, (2006) "Inflation and Economic Growth: A Cross-Country Nonlinear Analysis." *Journal of Post Keynesian Economics*. Summer. Vol. 28, No. 4., pp. 593-614.

[x] It should be emphasized that "inflation control" is an important objective for all the countries studied. Thus, there is a clear consensus among the authors that controlling inflation is important and desirable – even the more comprehensive proposals to target employment are therefore to be understood to address the current imbalance in policy emphasis on inflation, without turning its back on the latter.

[xi] Galindo, L.M. and Ros J. (2008) "Alternatives to Inflation Targeting in Mexico" *International Review of Applied Economics*, forthcoming.

[xii] For a more formal and theoretical discussion of the macroeconomics of SCRER, see Frenkel and Ros (2006) and Frenkel & Taylor (2006).

[xiii] Telli, Cagatay, Ebru Voyvoda, and Erinc Yeldan (2008) "Macroeconomics of *Twin-Targeting* in Turkey: Analytics of a Financial CGE Model" *International Review of Applied Economics*, forthcoming.

[xiv] Frenkel, Roberto and Martin Rapetti (2008) "Five Years of Competitive and Stable Real Exchange Rate in Argentina, 2002-2007" International Review of Applied Economics, forthcoming.

[xv] Jha, Raghbendra (2008) "Inflation Targeting in India: Issues and Prospects" *International Review of Applied Economics*, forthcoming.

[xvi] Packard, Tu Anh (2005) "Monetary Policy in Vietnam: Alternatives to Inflation Targeting" Presented at the *Alternatives to Inflation Targeting Monetary Policy for Stable and Egalitarian Growth in Developing Countries* conference, Centro de Estudios de Estado Y Sociedad (CEDES), Buenos Aires, May 13-14, 2005.

[xvii] Lim, Joseph (2008) "A Review of Philippine Monetary Policy Towards An Alternative Monetary Policy" *International Review of Applied Economics*, forthcoming.

[xviii] Epstein, Gerald, (2008) "Employment Targeting Central Bank Policy in South Africa." *International Review of Applied Economics*, forthcoming.

[xix] Pollin, Robert N., Gerald Epstein, James Heintz and Leonce Ndikumana (2006) *An Employment-Targeted Economic Program for South Africa;* A Study Sponsored by the United Nations Development Program (UNDP), UNDP and the Political Economy Research Institute (PERI). Northampton: E. Elgar Publishers.

[xx] As of March 2007, South Africa had an unemployment rate of anywhere from 20% to 35%, depending on exactly how it is counted.