Why Inflation Targeting?
Evidence from OECD Countries

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Abstract

This paper evaluates the treatment effects of inflation targeting policy using non-experimental panel data of 22 OECD countries between 1985 and 2005, where ten countries are targeters, others are not. Applying the propensity score matching techniques and the difference-in-differences estimator, we examine behaviors of concerned variables both before and after the policy. We identify the targeting countries that experience high inflation relative to the non-targeting countries before the policy adoption. We provide new evidence that in the policy framework the inflation rate is reduced significantly but with lagged effects. That is, the effects emerge after the first year of adoption. Previous studies ignoring the lagged effects may lead to biased inferences. Moreover, this evidence may explain the countries who adopt the policy of a lower target rate or other countries do not. Additionally, we find no significant effects of inflation targeting on inflation variability, output growth, and output variability. Thus, the main benefit of this monetary policy is to lower previously high inflation by the targeting announcement that helps the public anchor inflation expectation without apparent cost on output growth and output variability.

Keywords: inflation targeting, treatment effects, propensity score matching, difference-in-differences

JEL classification: C23; E52

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