

# **Inflation Targeting, Employment Creation and Economic Development:**

## **Assessing the Impacts and Policy Alternatives\***

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# **Inflation Targeting, Employment Creation and Economic Development:**

## **Assessing the Impacts and Policy Alternatives**

*Inflation targeting (IT) has recently become the dominant monetary policy prescription for both the developing and the industrialized countries alike. Emerging market governments, in particular, are increasingly pressured to follow IT as part of their IMF-led stabilization packages and the routine rating procedures of the international finance institutions. However, the common expectation of IT promoters that price stability would ultimately lead to higher employment and sustained growth has failed to materialize. Generally, the world economy is growing too slowly to generate sufficient capital investment and reduce unemployment. Cast in a deflationary environment where there has been a significant addition to the global labor supply, the IT central banks' almost exclusive focus on price stability fails to help address the root causes of the macroeconomic instability, including the globalization of unregulated finance in the past two decades. To contribute to the task of designing a more socially optimal macroeconomic policy environment, we offer viable alternatives to inflation targeting central bank policies in order to promote employment, sustained growth, and improved income distribution.*

### **I. Introduction**

*Inflation targeting (IT) is the new orthodoxy of mainstream macroeconomic thought. The approach has now been adopted by twenty four central banks (CBs), and many more, including those in developing countries, are expressing serious interest in following suit. Initially adopted by New Zealand in 1990, the norms surrounding the IT regime have been so powerful that the Central Banks (CBs) of both the industrialized and the developing economies alike have declared that maintaining price stability at the lowest possible rate of inflation is their *only* mandate. It was generally believed that price stability is a pre-condition for sustained growth and employment, and that “high” inflation is damaging the economy in the long run.*

In broad terms, the IT 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” (Setterfield, 2006: 653). In addition, inflation targeting is usually associated with appropriate 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 targeters, many others still focus on fighting inflation to the virtual exclusion of other goals.

Ironically, employment creation has dropped off the direct agenda of most central banks just as the problems of global unemployment, underemployment and poverty are taking center stage as critical world issues (Heintz, 2006). The ILO estimates that in 2003, approximately 186 million people were jobless, the highest level ever recorded (ILO, 2004a). The employment to population ratio—a measure of unemployment—has fallen in the last decade, from 63.3% to 62.5% (ILO, 2004). And as the quantity of jobs relative to need has fallen, there is also a significant global problem with respect to the quality of jobs. 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, sustained, robust economic growth will be required. The ILO estimates 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 by 2015, and significantly more than that to reduce the share of \$2 a day poverty by half. The IMF economists estimate that economic growth needs to be sustained at 7% per year or more to reach the millennium development goal of reducing poverty by half by 2015 (Batini, *et. al.*, 2006, p. 8).

Moreover, China's and India's opening up to the global markets and the collapse of the Soviet system together have added 1.5 billion new workers to the world's economically active population (Freeman, 2004; Akyuz, 2006). This means almost a doubling of the global labor force and a reduction of the global capital-labor ratio by half. Under these conditions, a large number of developing countries have suffered de-industrialization, serious informalization, and consequent worsening of the position of wage-labor, resulting in a deterioration of income distribution and increased poverty.

The key problem is that the ongoing “financial globalization” appears primarily to redistribute shrinking investment funds and limited jobs across countries, rather than to accelerate capital accumulation across global scale (Akyuz, 2006; Adelman and Yeldan, 2000). Simply put, the world economy is growing too slowly to generate sufficient jobs and it is allocating a smaller proportion of its income to fixed capital formation. Under these conditions, it ought to be clear that price stability, on its own, may not suffice to maintain macroeconomic stability, as it may not suffice to secure *financial stability*. For, in the words of Akyuz (2006, p.46), “...the *source of macroeconomic instability* now is not instability in product markets but asset markets, and the main challenge for policy makers *is not inflation, but unemployment and financial instability*”. (*emphasis added*).

While it might seem obvious that stabilization focused central bank policy represents the only proper role for central banks, in fact, looking at history casts serious doubt on this claim. Far from being the historical norm, this focus by central banks on inflation stabilization to the exclusion of development represents a sharp break from historical practice, not just in the developing world but also in the now developed countries as well (Epstein, 2006a). In many of the successful currently developed countries, as well as in many developing countries in the post-Second World War period, pursuing development objectives was seen as a crucial part of the central banks' tasks. Now, by contrast, development has dropped off the policy agenda of central banks in most developing countries.

**Table 1. Inflation Targeting Countries: Initial Conditions and Modalities**

<b>Developing Countries</b> (in order of adoption)	<b>IT Adoption Date</b>	<b>Inflation Rate at Start</b> (%, per annum)	<b>Current Inflation Target</b> (%, per annum)	<b>Officially Declared Policy Instrument</b>
Israel	1997Q2	8.5	1-3	Headline O/N rate
Czech Rep.	1998Q1	13.1	3 (+/- 1)	2 week repo
Poland	1998Q4	9.9	2.5 (+/- 1)	28 day intervention
Brazil	1999Q2	3.3	4.5 (+/- 2)	Selic O/N rate
Chile	1999Q3	2.9	2-4	O/N rate
Colombia	1999Q3	9.3	5 (+/- 0.5)	Repo
South Africa	2000Q1	2.3	3-6	
Thailand	2000Q2	1.7	0-3.5	14 day repo
Korea	2001Q1	3.2	2.5-3.5	O/N call rate
Mexico	2001Q1	8.1	3 (+/- 1)	91-day Cetes
Hungary	2001Q2	10.5	3.5 (+/- 1)	2 week deposit
Peru	2002Q1	-0.8	2.5 (+/- 1)	
The Philipinnes	2002Q1	3.8	5-6	Reverse repo
Slovak Republic	2005Q1	3.2	3.5 (+/- 1)	
Indonesia	2005Q3	7.8	5.5 (+/- 1)	1-month SBI
Romania	2005Q3	8.8	7.5 (+/- 1)	
Turkey <sup>a</sup>	2006Q1	7.8	5 (+/- 2)	CB O/N rate
Turkey <sup>b</sup>	2001Q2	82.0	n.a	CB Net Domestic Assets
<b>Industrial Countries</b>				
New Zealand	1990Q1	7.0	1-3	cash rate
Canada	1991Q1	6.2	1-3	O/N funding rate
United Kingdom	1992Q4	3.6	2	Repo
Sweden	1993Q1	4.8	2 (+/- 1)	Repo
Australia	1993Q2	1.9	2-3	cash rate
Iceland	2001Q1	3.9	2.5	
Norway	2001Q1	3.7	2.5	
<b>Candidate Countries</b>				
Costa Rica, Egypt, Ukraine	Near Term (1-2 years)			
Albania, Armenia, Botswana, Dominican Rep., Gutemala, Mauritius, Uganda, Angola, Azerbaijan, Georgia, Moldova, Serbia, Sri Lanka, Vietnam, Zambia	Medium Term (3-5 years)			
Belarus, China, Kenya, Kyrgyz Rep., Moldova, Serbia, Sri Lanka, Vietnam, Zambia Bolivia, Honduras, Nigeria, Papua New Guniea, Sudan, Tunisia, Uruguay, Venezuela	Long Term (> 5 years)			

Notes: a. Official adoption date for Turkey; b. Turkish CB declared "disguised inflation targeting" in the aftermath of the 2001 February crisis.

Source: Batini et. al. 2006.

The theme of this special issue and this introductory paper is that the modern central banking ought to have more policy space in balancing out various objectives and instruments. In particular, employment creation and more rapid economic growth should join inflation and stabilization more generally as key goals of central bank policy. This paper outlines why a shift away from inflation targeting, the increasingly fashionable, but problematic approach to central bank policies, and a move back toward a more balanced approach is both feasible and desirable. This view, of course, does not argue that inflation stabilization, is unimportant. Indeed, historically, some central banks went much too far in downplaying the stabilization role, sometimes with disastrous consequences. Yet this should not mean that the optimal policy is to go to the other extreme and ignore the possible role of the central banks as developmental agents entirely. As we try to document in this paper and in the remaining pages of the current issue of this journal, balancing between the inflation stabilization and developmental roles is both desirable and feasible for many central banks.

The rest of the paper is organized as follows. In the next section, we briefly survey the macroeconomic record of IT and its current structure. Section III focuses on the role of the exchange rate as one of the key macro prices, and discusses alternative theories of its determination. We also make remarks on the issue of inflation targeting in the context of the so-called “trilemma” of monetary policy. In section IV we discuss various alternatives to inflation focused central banks, concentrating on the results of a multi-country research project undertaken with the support of UN-DESA, among other organizations. This section shows that there are viable, socially productive alternatives to inflation targeting, including those that focus on employment generation, and makes the case that these alternatives should be further developed. Section V concludes.

## **II. Macroeconomic Record of IT**

Much of the existing literature on the record of IT has focused mostly on whether systemic risks and accompanying volatility has been reduced in the IT economies, and whether inflation has come down actually 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 IT has been associated with reductions in inflation. Furthermore, exchange rate *pass-through* effects were reportedly reduced and consumer prices have become less prone to shocks (Edwards 2005; Mishkin and Schmidt-Hebbel, 2001). Yet, existing evidence also suggests that IT has not yielded inflation below the levels attained by the industrial non-targeters that have adopted other monetary regimes (Ball and Sheridan, 2003; Roger and Stone, 2005). Moreover, even if domestic monetary policy *has* reduced inflation, the hoped for gains in employment have, generally, not materialized; and, for many countries following this orthodox approach, economic growth has not significantly increased.

On the “qualitative” policy front, it is generally argued that with the onset of central bank independence, communication and transparency have improved and the CBs have become more “accountable”. Yet, little is known about the true costs of IT on potential output growth, employment, and on incidence of poverty and income distribution. Bernanke, *et. al.* (1999) and Epstein (2006b), for instance, report evidence that inflation targeting central banks do not reduce

inflation at any lower cost than other countries' central banks in terms of forgone output. That is, inflation targeting does not appear to increase the credibility of central bank policy and therefore, does not appear to reduce the sacrifice ratio. Per contra, based on an econometric study of a large sample of inflation targeters and non-targeters, Corbo *et. al.*, (2001) concluded that sacrifice ratios have declined in the emerging market economies after adoption of IT. They also report that output volatility has fallen in both emerging and industrialized economies after adopting inflation targeting. This position is recently complemented by a study of the IMF economists, who, using a complex econometric model and policy simulations, report findings that inflation targeting economies experience reductions in the *volatility* in inflation, without experiencing increased *volatility* in real variables such as real GDP (Batini, *et. al.*, 2006). According to these estimates, inflation targeting central banks do enhance economic “stability” relative to other monetary rules, such as pegged exchange rates and monetary rules.

However, in the assessments of “stability”, these papers do not consider the issue of the stability of asset prices, including exchange rates, stock prices and other financial asset prices. As we discuss further below, asset price stability may need to be included in a full analysis of the impact of inflation targeting on overall economic stability.

Asset price stability aside, while intriguing, these results are only as strong as the simulation model on which they are based and are only as relevant as the relevance of the questions they pose. Moreover, they are only as broad as the alternatives they explore. On all these scores, these results are problematic. First, they do not simulate the impact of inflation targeting relative to other possible policy regimes, such as targeting the real exchange rate as discussed below. Second, the model is based on estimates of potential output that are themselves affected by monetary policy. Hence, if monetary policy slows economic growth, it also lowers the rate of growth of potential output and, therefore reduces the gap between the two, thereby *appearing* to *stabilize the economy*. But in fact, it does so at the expense of slowing growth or even generating stagnation. This highlights the third key point: even if it could be shown that inflation targeting does a good job at stabilization, it is crucial to remember that the stabilization role of monetary policy is only one of the tasks facing central banks; the other task being to contribute directly to economic growth, employment creation and poverty reduction.

A further note at this juncture pertains to the practical *problematique* of setting the *targeted rate of inflation itself*. Even if the advocated requisites of the IT regime are taken for granted, it is not yet clear what the practically targeted rate of inflation should be. Even though there appears to be a consensus among the advocates of the IT regime that the inflation target has to be “as low as possible”, there is no theoretical justification of this assertion; and as such, it sounds more of a recommendation than a careful calculation. Most disturbing is the common belief that what is good for the industrialized/developed market economies should simply be replicated by the developing countries as well. That this may not be the case is forcefully argued in Pollin and Zhu (2006). Based on their 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 – 18 percent inflation threshold. Furthermore they report that there is no justification for inflation-targeting policies as they are currently being practiced throughout the middle- and low-income countries, that is, to maintain inflation with a 2 – 4 percent band.

An overall picture on the selected macroeconomic indicators of the inflation targeters can be obtained from Tables 2 and 3. In Table 2, we provide information on the observed behavior of selected macro aggregates as *annual average of 5 years before* the adoption of the IT *versus* the *annual average after* the adoption date to current period. Table 3 keeps the same calendar frames and reports data on key macro prices, *viz.*, the exchange rate and the interest rates.

As highlighted in the text, evidence on the growth performance of the IT countries is mixed. Taking the numbers of Table 2 at face value, we see that seven of the 21 countries report a decline in the average annual rate of real growth, while three countries (Canada, Hungary and Thailand) have not experienced much of a shift in their rates of growth. Yet, clearly it is quite hard to disentangle the effects of the IT regime from other direct and indirect effects on growth. One such factor is the recent financial glut in the global asset markets and the associated surge of the household deficit spending bubble. The *Institute of International Finance* data reveal, for instance, that the net capital inflows to the developing economies as a whole has increased from US\$47 billion in 1998, to almost US\$400 billion in 2006, surpassing their peak before the Asian crisis of 1997. As the excessive capital accumulation in telecommunications and the *dot.com* high tech industries phased out in late 1990s, the global financial markets seem to have entered another phase of expansion, and external effects such as these make it hard to isolate the growth impacts of the IT regimes.

Despite the inconclusive verdict on the growth front, the figures on unemployment indicate a significant increase in the post-IT era. Only three countries of our list (Chile, Mexico and Switzerland) report a modest decline in their rates of unemployment in comparison to the pre-IT averages. The deterioration of employment performance is especially pronounced (and puzzling) in countries such as The Philippines, Peru, and Turkey where rapid growth rates were attained. The increased severity of unemployment at the global scale seems to have affected the IT-countries equally strongly, and the theoretical expectation that “price stability would bring growth and employment in the long run” seems quite far from being materialized yet.

**Table 2. Selected Macroeconomic Aggregates in the IT Countries****Before:** annual average of 5 years prior to adoption of IT; **After:** annual average of adoption of IT to current

	Year IT Started	Growth Rate		Unemployment Rate		Trade Balance (External Balance on goods and services) / GDP (%)		CB Foreign Reserves (Mill US\$)	
		Before	After	Before	After	Before	After	Before	After
New Zealand	1990	2.7	3.0	4.2	6.9	0.4	1.3	2,897.9	4,623.2
Canada	1991	2.9	2.8	8.4	8.7	0.5	2.7	11,964.0	24,256.0
UK	1992	2.2	2.7	7.4	5.2	-2.5	-1.6	39,666.5	37,408.5
Sweden	1993	0.8	2.7	2.8	6.1	1.3	6.2	15,399.0	18,521.8
Australia	1994	2.2	3.9	8.6	7.3	-0.6	-1.3	13,777.9	20,337.1
Israel	1997	5.8	3.1	8.5	9.4	-14.6	-7.2	7,567.3	24,421.1
Czech Rep <sup>a</sup>	1998	4.5	3.2	4.0	8.9	-3.4	-1.8	9,172.5	21,686.5
Poland	1998	7.9	3.7	14.3	16.7	0.0	-4.1	12,591.8	31,581.8
Brazil <sup>b</sup>	1999	3.2	2.3	7.0	9.8	-1.7	1.0	47,701.3	42,304.5
Colombia	1999	3.3	2.3	11.1	15.8	-6.0	-0.5	7,567.3	24,421.1
Mexico	1999	1.7	4.8	2.7	1.9	-0.5	-1.9	20,630.9	51,396.6
South Africa <sup>c</sup>	2000	2.6	3.8	n.a	27.7	0.0	0.0	15,860.0	9,580.0
Switzerland	2000	1.4	1.7	4.1	3.1	0.1	0.1	38,277.1	40,646.5
Thailand	2000	1.5	1.7	1.9	2.4	0.0	0.1	32,556.1	40,474.8
Korea	2001	4.6	4.5	4.4	3.7	0.0	0.0	55,299.5	157,739.2
Hungary	2001	4.2	4.2	8.0	6.1	-1.3	-2.9	9,918.1	13,652.1
Peru <sup>d</sup>	2002	2.0	5.2	7.8	10.2	-3.2	-0.4	9,264.8	11,222.9
Philippines	2002	3.1	5.1	10.2	11.5	-3.6	-0.7	11,281.6	14,006.6
Indonesia	2005	4.6	5.6	6.5	10.3	7.3	-4.6	31,326.7	32,989.2
Turkey <sup>e</sup>	2006	4.5	7.8	9.9	10.4	-9.8	-11.0	33,237.4	56,990.4
Turkey <sup>e</sup>	2001Q2	4.0	4.5	6.6	10.0	-7.5	-9.8	20,083.4	33,237.4

Source: IMF Statistics and Asian Development Bank

**a-**The period before the inflation targeting refers the period of 94-97 for "Growth" and "CPI inflation" for the Czech Rep.**b-**The period before the inflation targeting refers the period of 96-98 for reserves in Brazil**c-** The period before the inflation targeting refers the period of 94-97 and after inflation targeting refers the period of 99-04 for unemployment rate in South Africa. Note that due to change in methodology and data coverage, unemployment figures are not directly comparable before and after *apartheid* ..**d-**The period after the inflation targeting refers the period of 03-04 for unemployment rate in Peru.**e-**Official adoption date for Turkey is 2006. However, Turkish CB declared "disguised inflation targeting" in the aftermath of the 2001 February crisis.

The adjustment patterns on the balance of foreign trade have been equally diverse. 10 of the 21 countries in Table 2 achieved higher (improved) trade surpluses (balances). While there have been large deficit countries such as Turkey, Mexico, The Philippines, and Australia, there were also sizable surplus generators such as Brazil, Korea, Thailand, Canada, and Sweden. Not surprisingly much of the behavior of the trade balance could be explained by the behaviour of the real exchange rates. This information is tabulated in Table 3.



<b>Table 3. Macroeconomic Prices in the IT Countries</b>									
<i>Before</i> : annual average of 5 years prior to adoption of IT; <i>After</i> : annual average of adoption of IT to current									
	Year IT Started	Inflation Rate (Variations in CPI)		Exchange Rate Real Depreciation <sup>1,2</sup>		CB Real Interest Rate <sup>2,3</sup>		Public Assets Real Interest Rate <sup>3,4</sup>	
		Before	After	Before	After	Before	After	Before	After
New Zealand	1990	11.6	2.2	-7.6	-0.6	7.0	5.5	2.1	5.1
Chile <sup>a</sup>	1991	19.7	7.2	-6.0	-4.0	..	0.0	-16.0	-4.6
Canada	1991	4.5	2.1	-7.5	-1.7	6.0	2.6	5.8	2.5
United Kingdom	1992	6.4	2.6	-2.4	-2.2	5.4	3.0	5.0	2.8
Sweden	1993	6.9	1.5	-8.5	1.2	2.8	1.7	5.0	2.9
Australia <sup>b</sup>	1994	4.2	2.5	-6.9	-1.1	7.1	3.2	6.3	4.0
Israel	1997	11.3	3.1	-4.2	0.9	2.0	5.0	1.5	5.0
Czech Republic <sup>c</sup>	1998	9.1	3.1	-6.6	-6.2	1.9	0.7	0.0	0.9
Poland <sup>d</sup>	1998	24.1	4.7	-4.5	-4.6	1.6	6.2	1.8	11.6
Brazil	1999	819.2	7.9	-428.0	5.5	-782.6	15.7	-786.9	12.4
Colombia	1999	20.4	7.5	-9.5	0.5	18.4	6.6	1.5	2.0
Mexico	1999	24.5	7.2	2.8	-4.6	7.5	5.0	3.2	3.8
Thailand	2000	5.1	2.2	4.5	-1.0	4.9	1.6	4.7	3.1
South Africa <sup>e</sup>	2000	7.3	5.1	4.3	-2.5	8.6	4.4	7.3	4.2
Switzerland	2000	0.8	1.0	1.6	-3.7	0.2	0.1	0.9	0.3
Korea	2001	4.0	3.3	6.0	-5.0	-0.2	-1.0	6.5	2.1
Hungary	2001	15.2	5.9	2.5	-12.4	2.0	3.4	2.3	3.4
Peru	2002	5.0	1.9	-1.6	1.4	9.3	2.0	3.8	-0.5
Philippines	2002	6.3	5.0	8.7	-3.0	5.1	0.9	5.2	1.2
Indonesia	2005	8.0	10.5	-6.2	-1.9	4.2	2.3	4.1	-2.4
Turkey <sup>f</sup>	2006	28.3	10.5	-6.3	-1.2	11.7	7.5	14.8	10.5
Turkey <sup>f</sup>	2001Q2	74.1	28.3	-9.9	-6.3	-13.3	12.7	23.9	15.5

Source: *IMF Statistics*

1- A rise in value indicates depreciation. Annual average market rate is used for: United Kingdom, Canada, Turkey, Australia, New Zealand, Brazil, Peru, Israel, Indonesia, Korea, and Philippines; Annual average Official Rate is used for: Colombia, Thailand, Hungary, Poland and Switzerland; Principle rate is used for: South Africa, Mexico and Czech Republic

2- Nominal values are deflated by the corresponding inflation averages (CPI column).

3- Sweden, New Zealand, Canada: Bank Rate; Mexico: Banker's Acceptance.

4-Colombia: Interbankaria TBS; Peru and Chile: Saving Rate; New Zealand Newly issued 3 months Treasury bill rates; Indonesia: 3 Months Deposit Rate; Korea:National Housing Bond Rate; Thailand: Government Bond Yield Rate

a- the period after the inflation targeting period refers the period of 93-05; the period before the inflation targeting refers the period of 87-90

b- Treasury Bill: the period after the inflation targeting refers the period of 94-00; CB Rate: the period after the inflation targeting refers the period of 94-95

c-the period before the inflation targeting refers the period of 94-97;

d-Treasury Bill rates; the period after the inflation targeting refers the period of 98-00;

e- Treasury Bill: the period before the inflation targeting refers the period of 94-00

f- Official adoption date for Turkey is 2006. However, Turkish CB declared "disguised inflation targeting" in the aftermath of the 2001 February crisis.

Table 3, as previously in Table 2 above, calculates the annual averages of the five-year period *before* the IT *versus* annual averages *after* IT to-date. Focusing on the inflation-adjusted *real* exchange rate movements, we find a general tendency towards *appreciated* currencies in the aftermath of adoption of the IT regimes. Mexico, Indonesia, Korea and Turkey are the most significant currency appreciating countries, while Brazil, and to some extent Columbia, have

pursued active export promotion strategies and maintained real depreciation. The Czech Republic, Switzerland and Hungary are observed to have experienced *nominal* currency appreciation, and Poland seems to have maintained an appreciating path for its real exchange rate.

Clearly much of this generalized trend towards appreciation can be explained by reference to the increased expansion of foreign capital inflows due to the global financial glut mentioned above. With the IT central bankers announcing a “no-action” stance against exchange rate movements led by the “markets”, a period of expansion in the global asset markets have generated strong tendencies for currency appreciation. What is puzzling, however, is the rapid and very significant expansion in the foreign exchange reserves reported by the IT central banks. As reported in the last two columns of Table 2 above, foreign exchange reserves held at the CBs rose significantly in the aftermath of the IT regimes. The rise of reserves was especially pronounced in Korea, The Philippines and Israel where almost a five-fold increase had been witnessed. Of all the countries surveyed in Table 3, UK and Brazil are the only two countries that had experienced a fall in their aggregate reserves.<sup>1</sup>

This phenomenon is puzzling because the well-celebrated “flexibility” of the exchange rate regimes were advocated precisely with the argument that, under the IT framework, the CBs would gain freedom in their monetary policies and would no longer need to hold reserves to defend a targeted rate of exchange. In the absence of any officially stated exchange rate target, the need for holding such sums of foreign reserves at the CBs should have been minimal. The proponents of the IT regimes argue that the CBs need to hold reserves to “maintain price stability against possible shocks”. Yet, the acclaimed “defense of price stability” at the expense of such large and costly funds that are virtually kept idle at the IT central banks’ reserves is questionable at best in an era of prolonged unemployment and slow investment growth, and needs to be justified economically as well as socially.

We now turn to the issue of exchange rate policy more formally.

### **III. The Role of the Exchange Rate under IT**

As stated above, part of the broader requirements surrounding the IT system is often argued to be the implementation of a “floating/flexible” exchange rate system in the context of free mobility of capital. Accordingly, the CBs should abandon their interventionist policies in the foreign exchange markets for all practical purposes other than pursuit for price stability.

Thus, “exchange rate flexibility and floating exchange rate system” became the new *motto*, and to many advocates, central bank “policy” has typically been reduced to mean merely “setting the policy interest rate”. The exchange rate and macro prices are, in theory at least, thereby left to the unfettered workings of the global finance markets. The role of the exchange rate as an adjustment variable has clearly increased over the last decade since the adoption of the floating exchange rate systems. In the meantime, however, the role of the interest rates and reserve

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<sup>1</sup> Brazil’s case is actually explained in part by the recent decision (late 2005) of the Lula government to close its debt arrears with the IMF with early payments out of its reserves.

movements has declined substantially as counter-cyclical instruments available to be used against shocks<sup>2</sup> (see Table 2 above).

Against this background a number of practical and conceptual questions are inevitable: what is the role of the exchange rate in the overall macroeconomic policy when an explicit inflation targeting regime is adopted? Under what conditions should the central bank, or any other authority, react to shocks in the foreign exchange market? And perhaps more importantly, if an intervention in the foreign exchange market is regarded necessary against, say, the disruptive effects of an external shock, what are the proper instruments?

To the proponents of IT, the answer to these questions is simple and straightforward: the CB should not have any objective in mind with regards to the *level* of the exchange rate, yet it might interfere against the *volatility* of the exchange rate in so far as it affects the stability of prices. However, nuances remain. To what may be grouped under “strict conformists”, the CB should be concerned with the exchange rate only if it affects its ability to forecast and target price inflation. Any other response to the foreign exchange market represents a departure from the IT system. Advocated in the seminal works by Bernanke *et. al.* (1999) and Fischer (2001), the approach argues that attending to inflation targeting and reacting to the exchange rate are mutually exclusive. Beyond this assertion, the conformist view also holds that intervention in the foreign exchange market could confuse the public regarding the ultimate objective of the central bank with respect to its priorities, distorting expectations. In a world of credibility game, such signals would be detrimental to the CB’s authority.

Yet, while maintaining the IT objective, one can also distill a more active role for the exchange rate in the literature. As outlined in DeBelle (2001) and Ho and McCauley (2003), this “flexible IT” view proposes that the exchange rate can also be a legitimate policy objective alongside the inflation target. More formally, an operational framework for the “flexible IT” view was envisaged within an expanded *Taylor rule*. Taylor (2000) argued, for instance, that an exchange rate policy rule can legitimately be embedded in a monetary rule that is consistent with the broad objectives of targeted inflation rate and the output gap.

In contrast to all this, the structuralist tradition asserts that irrespective of the conditionalities of foreign capital and boundaries of IT, it is very important for the developing economies to maintain a *stable and competitive real exchange rate* (SCRER) (see, *e.g.*, Frenkel, 2006; Frenkel and Taylor 2006; Frenkel and Ros, 2006). They argue that the real exchange rate can affect employment, and the economy more generally, through a number of channels: (1) By affecting the level of aggregate demand (*the macroeconomic channel*); (2) By affecting the cost of labor relative to other goods and thereby affecting the amount of labor hired per unit of output (*the labor intensity channel*); and by affecting employment through its impact on investment and economic growth (*the development channel*) (Frenkel and Ros, pp. 634-637). While the size and even direction of these channel effects might differ from country to country, in many countries, including countries in Latin America, maintaining a competitive and stable real exchange rate is likely to have a positive employment impact though some combination of these effects.

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<sup>2</sup> Though, note the one sided ever increase in the aggregate reserves of the CBs. The social desirability and economic optimality of this phenomenon in the aftermath of the adoption of floating exchange rate systems is another issue that warrants further research.

The gist of the structuralist case for SCRER rests on a recent (and unfortunately not well understood and appreciated) paper by Taylor (2004). Resting his arguments on the system of social accounting identities, Taylor argues that the exchange rate can not be regarded as a simple “price” determined by temporary macro equilibrium conditions. The mainstream case for exchange rate determination rests on the well-celebrated Mundell (1963) and Fleming (1962) model where the model rests on an assumed duality between reserves (fixed exchange rate system) *versus* flexible exchange rate adjustments. The orthodox mainstream model, according to Taylor, presupposes that a balance of payments *exists* with a potential disequilibrium that has to be cleared. This, however, is a false presumption. The exchange rate is not an “independent” price and has no fundamentals such as a given real rate of return (or a trade deficit) that can make it *self-stabilizing*. In Taylor’s (2004, p.212) words, “... the balance of payments is at most an accumulation rule for net foreign assets and has no independent status as an equilibrium condition. The Mundell-Fleming duality is irrelevant, and in temporary equilibrium, the exchange rate does not depend on how a country operates its monetary (especially international reserve) policy”.

Within the mainstream orthodoxy, the major policy implication of the Mundell-Fleming duality is the so-called “trilemma”, which commands that central banks can only have two out of three of the following: open capital markets, a fixed exchange rate system, and an autonomous monetary policy geared toward domestic goals. While this so-called “trilemma” is not strictly true as a theoretical matter, in practice it does raise serious issues of monetary management. From our perspective, the real crux of the problem turns out to be the very narrow interpretation of the constraints of the trilemma: CBs are often thought to be restricted to choose two “*points*” out of three. Yet, the constraints of the trilemma could as well be regarded as the boundaries of a *continuous* set of policies, as would emerge out of a bounded, yet continuous depiction of a “*policy triangle*”. Thus, even within the boundaries of the trilemma a menu of choices does exist, ranging from administered exchange rate regimes to capital management/control techniques.

The conundrum is that those interpreting the trilemma in a very orthodox fashion regard one of its corners, namely the free mobility of capital, as a pre-determined choice and take for granted that virtually complete financial liberalization in the external sector is the first-best, optimal policy environment. Yet recent evidence amply shows that open capital markets can create very costly problems for developing countries and that many successful developing countries have used a variety of capital management techniques to manage these flows in order, among other things, to help them escape the rigid constraints of the so-called “tri-lemma” (Ocampo, 2002; Epstein, Grabel and Jomo, K.S., 2005).

#### **IV. Socially Responsible Alternatives to Inflation Targeting CB Policies**

In this section we report on a series of country studies undertaken by a team of researchers working on a Political Economy Research Institute (PERI) (University of Massachusetts, Amherst)/Bilkent project on alternatives to inflation targeting, where their findings can be found in the remaining pages of the current issue of this journal. A range of alternatives were

developed by the researchers, from modest changes in the targeting framework to allow for more focus on exchange rates and a change in the index of inflation used, to a much broader change in the overall mandate of the central bank to a focus on employment targeting, rather than inflation targeting.

It has to be noted at the outset that “inflation control” is revealed among the ultimate objectives in all country studies summarized below. Thus, there is a clear consensus among the authors that controlling inflation is important and desirable. However, all agree that the current prescription insisting on “very low” rates of inflation at the 2-4 % band is not warranted, and that responsibilities of the central banks, particularly in developing countries, must be broader than that. Accordingly, the policy matrix of the CBs should include other crucial “real” variables that have a direct impact on employment, poverty, and economic growth, such as the real exchange rate and/or investment allocation. They also agree that in many cases, central banks must broaden their available policy tools to allow them to reach multiple goals, including, if necessary, the implementation of capital management techniques.

#### **IV-1. Modest but Socially Responsible Adjustments to the Inflation Targeting Regime**

Some of the country studies in the PERI/Bilkent project proposed only modest changes to the inflation targeting regime. In the case of Mexico, for example, the authors 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 (Galindo and Ros, 2008). They suggest modifying the IT framework to make it somewhat more employment friendly. In the case of Mexico, Galindo and Ros find that monetary policy was *asymmetric* with respect to exchange rate movements –tightening when exchange rates depreciated, but not loosening when exchange rates appreciated. This lent a bias in favor of an over-valued exchange rate in Mexico. So they propose a “neutral” monetary policy so that the central bank of Mexico responds symmetrically to exchange rate movements and thereby avoid the bias toward over-valuation without fundamentally changing the inflation targeting framework. In their own words, “the central bank would promote a competitive exchange rate by establishing a sliding floor to the exchange rate in order to prevent excessive appreciation (an “asymmetric band”...). This would imply intervening in the foreign exchange market at times when the exchange rate hits the floor (i.e., an appreciated exchange rate) but allows the exchange rate to float freely otherwise.” They point out that such a floor would work against excessive capital inflows by speculators because they would know the central bank will intervene to stop excessive appreciation. If need be, Galindo and Ros also propose 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 proposed extending the inflation targeting framework, but as we will see shortly, in a more dramatic way. According to Barbosa-Filho: “...because of Brazil's 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 actually make it compatible with fast income growth and a stable public and foreign finance”. (*ibid*). In order to achieve that, Barbosa-Filho joins a number of the country case study authors in proposing a monetary policy

to maintain a stable and competitive real exchange rate (SCRER) which, they argue, will have a number of significant benefits for many of these economies and their peoples.

Given Brazil's large public debt, Barbosa-Filho also proposes that the targeted reduction in the real interest rate would reduce the Brazilian debt service burdens and help increase productive investment. In terms of the familiar targets and instruments framework, 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. Furthermore, in order to achieve these goals, the central bank can use direct manipulation of the policy interest rate, bank reserve requirements and bank capital requirements.

Brazil is not the only highly indebted country in our project sample. Turkey is another case with that problem. Here, too, the authors raise concerns to the conformist straightjacket of inflation targeting, and develop an alternative macroeconomic framework. Using a financial-linked computable general equilibrium model (CGE) for the case of Turkey, Telli, Voyvoda and Yeldan (2008) illustrate the real and financial sectorial adjustments of the Turkish economy under the conditionalities of the *twin targets*: on *primary surplus to GNP ratio* and on the *inflation rate*. They utilize their model to study the impact of a shift in policy from a strict inflation targeting regime, to one that calls for revisions of the primary fiscal surplus targets in favor of a more relaxed fiscal stance on public investments on social capital, together with a direct focus on the competitiveness of the real exchange rate. They further study the macroeconomics of a labor tax reform implemented through reduction of the payroll tax burden on the producers, and an *active* monetary policy stance via reduction of the central bank's interest rates. They report significant employment gains due to a policy of lower employment taxes. They also find that the economy's response to the reduction of the CB's interest rate is positive in general; yet, very much dependent on the path of the real exchange rate, thus they also call for maintaining a *stable real exchange rate* path à la Frenkel, Ros and Taylor.

Frenkel and Rapetti (2008), in the case of Argentina, show that targeting a stable and competitive real exchange rate has been very successful in helping to maintain more rapid economic growth and employment generation. 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 possible help from temporary resort to capital controls. Jha argues, that, to some extent, such a policy would be a simple continuation of policies undertaken in India in the past. In Vietnam, Packard (2005) concludes: "...a strict inflation targeting (IT) regime is not appropriate for Vietnam. IT's rigid rules constrain policymakers to operate in a framework that requires inflation to take priority over more pressing development objectives. (Thus), a stable and competitive real exchange rate is (a) superior alternative, precisely because it sets as a target a key macroeconomic relative price that is realistic, sustainable, and growth enhancing." (Packard, 2005).

## IV-2. More Comprehensive Alternatives to Inflation Targeting

Other country case studies propose more comprehensive policy alternatives to simple inflation-focused monetary policy, including inflation targeting. Joseph Lim (2008) proposes a comprehensive alternative to inflation targeting for the case of the Philippines. He argues that the Philippine government has been seeking to achieve a record of dramatically higher economic growth, but that its monetary policy has been inadequate to achieving that goal. He therefore proposes an “alternative” that “clearly dictates much more than just a move from monetary targeting to inflation targeting” with the following proposals: 1) Maintenance of a competitive real exchange rate, either by pegging the exchange rate or intensively managing it as in South Korea. 2) Implementation of capital management techniques, as in China and Malaysia, to help manage the exchange rates. 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. 3) An explicit statement of output and employment goals, as the central bank transits from a purely inflation-targeting regime. 4) Incomes and anti-monopoly policies to limit inflation to moderate levels and 5) 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 proposed by Epstein (2006b) for the case of South Africa, which, in turn, have been developed in a much broader framework and in more detail by Pollin, *et. al.* (2006). Pollin, *et. al.* 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. The purpose of the program is to reduce unemployment rate by half in line with the government’s pledge to reduce the official unemployment rate to 13% by 2014.<sup>3</sup> 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.

## V. Concluding Comments

In this overview paper we have argued that the current day orthodoxy of central banking -- namely, that the top priority goal for central banks is to keep inflation in the low single digits -- is, in general, neither optimal nor desirable. This orthodoxy is based on several false premises: first, that moderate rates of inflation have high costs; second, that in this low inflation environment, economies will naturally perform best, and in particular, will generate high levels of economic growth and employment generation; and third, that there are no viable alternatives to this “inflation-focused” monetary policy. In fact, *moderate* rates of inflation episodes reveal to have very low or no costs; and whether countries where central banks have adopted formal or informal inflation targeting have not performed better in terms of economic growth or

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<sup>3</sup> As of March 2005, South Africa had an unemployment rate of anywhere from 26% to 40%, depending on exactly how it is counted.

employment generation is a matter of dispute. Per contra, 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. And looking forward, the PERI/Bilkent project on alternatives to inflation targeting and PERI's UNDP work on South Africa have developed an array of “real targeting” approaches to central banking which we believe are viable alternatives to inflation targeting and, in particular, do a better job than orthodox inflation targeting in balancing the developmental and stabilization functions of central banks.

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