

Testing the Transparency Benefits
of Inflation Targeting:
Evidence from Private Sector Forecasts

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Discussion by

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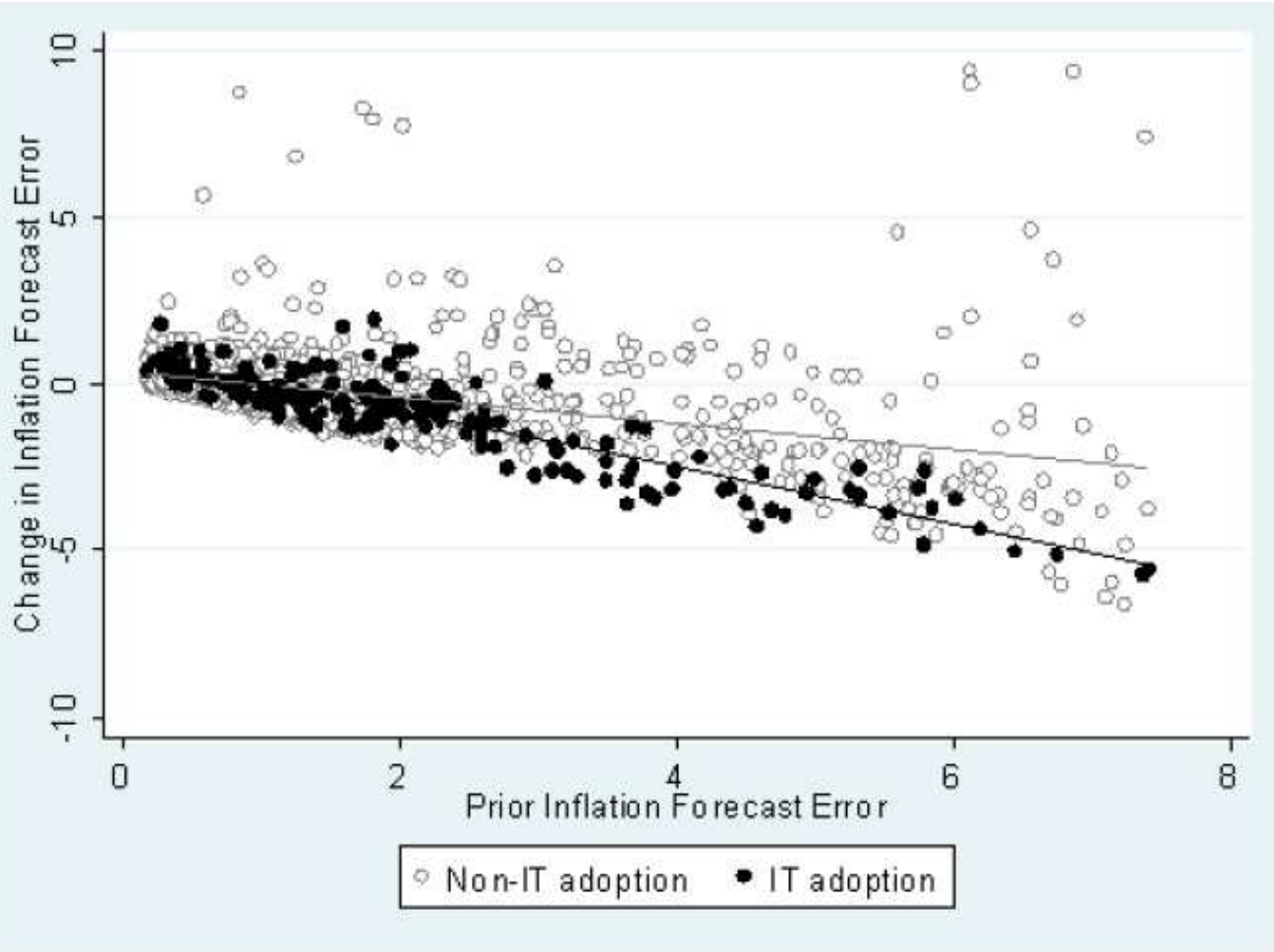
Effect of Inflation Targeting on Private Sector Forecasts

Adoption of inflation targeting (IT)
reduces private sector forecast errors for inflation
significantly only if initial forecast inaccuracy is high.

→ IT promotes convergence of private sector inflation forecasts.

Data:

Individual Consensus Forecasts for inflation next calendar year
for 11 IT adoption episodes using window of ± 12 months.



Econometric Methodology

★ Propensity score matching to select control group of forecasters from non-IT countries for each IT adoption episode.

▲ More than half of control group observations from United States, Venezuela and India.

★ 2SLS estimation to control for endogeneity due to initial forecast error leading to mean-reversion.

Instruments for initial inflation forecast accuracy:

Initial output growth forecast accuracy and initial inflation forecast.

▲ Accuracy of short term forecasts for inflation and output growth correlated due to unanticipated shocks.

Robustness

▲ 2SLS results for 'best country' control group not significant when Venezuela is dropped.

Suggestions for further robustness checks:

- Drop Spain and Switzerland from non-IT control group.
- Run placebo regressions (with shifted window) for same control group.
- Use wider window (instead of ± 12 months).
- Estimate propensity score for IT adoption using country (rather than just forecast) characteristics.
- Use mean square (instead of average absolute) forecast error as measure of forecast inaccuracy.
- Directly estimate effect on forecast dispersion.

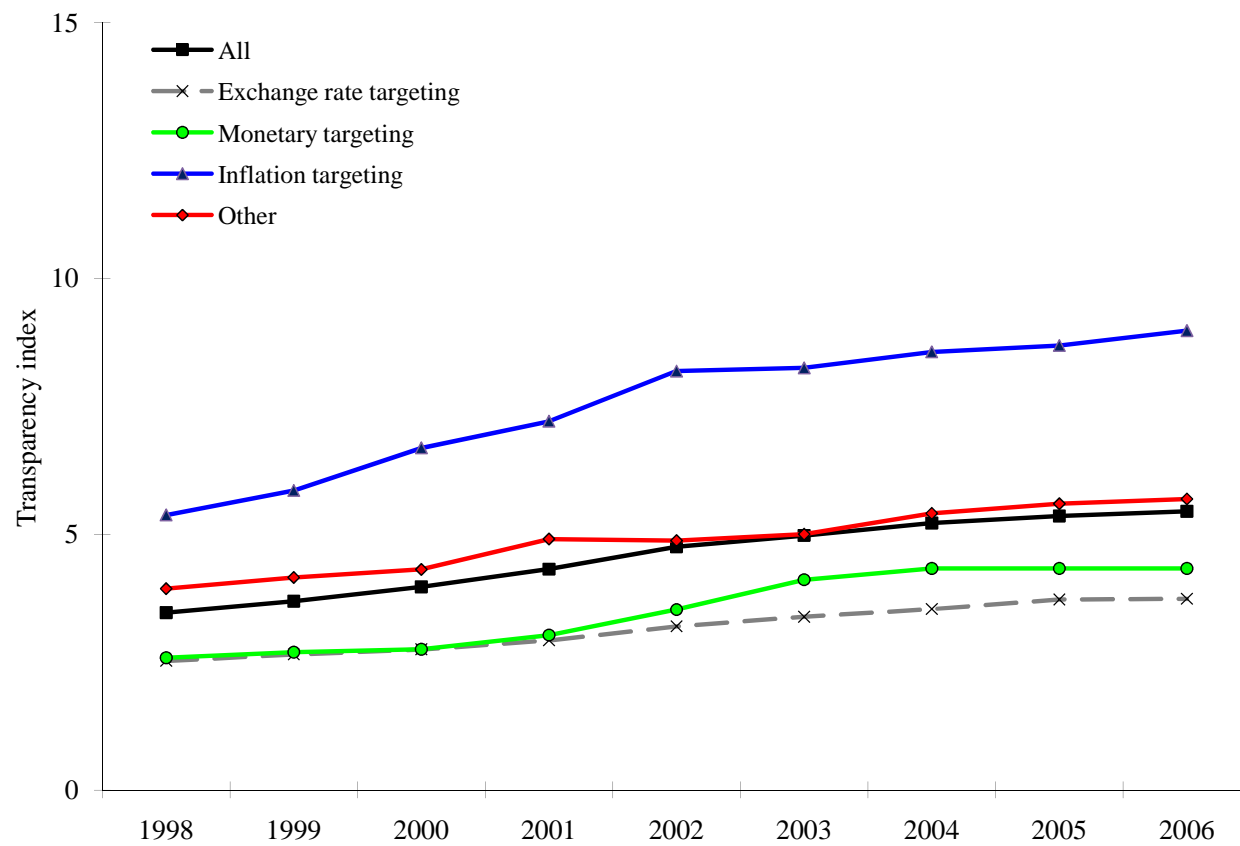
Interpretation of Results

“Direct test of transparency benefits of inflation targeting.”

▲ Convergence of forecast errors could be due to lower inflation rather than greater transparency.

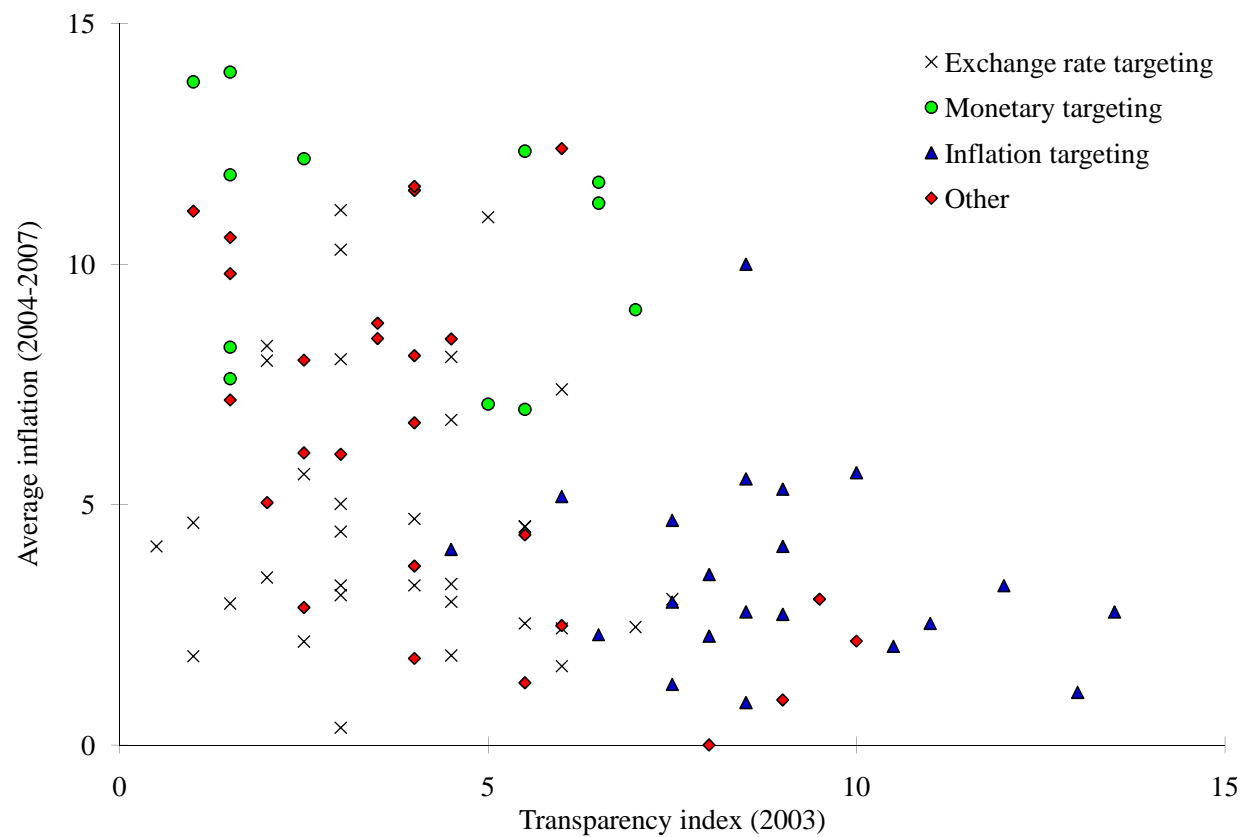
Lower inflation is associated with less inflation variability, making it more predictable.

Transparency of Inflation Targeting



Source: Geraats (2009)

IT, Transparency and Inflation



Source: Geraats (2009)