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Investigate how Central Banks' Pursuit of Strict Inflation Targeting Impacts Economic Growth and Employment in Different Countries

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Abstract - Inflation targeting has been extensively embraced in both advanced and developing nations. This article examines the evidence on the impact of inflation targeting on macroeconomic performance and evaluates the implications of this data for inflation targeting and monetary policy design. Although there have been similarities in macroeconomic experiences between inflation targeting and non-targeting established nations, it is evident that inflation targeting has enhanced macroeconomic performance in emerging economies. Crucially, the practice of inflation targeting has not been linked to increased actual economic instability in either advanced or emerging economies. Cost shocks, such as the significant increase in commodity prices, need central banks to make challenging immediate decisions. However, a commitment to a specific aim might improve the capacity to handle demand shocks and financial crises. This study analyzes the progression of monetary policy goals and how, after a deviation, it has reverted back to focusing on controlling inflation, similar to the approach during the Gold Standard (GS) era.

Keywords - Inflation, Monetary, Macroeconomic, Capacity, Financial

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INTRODUCTION

Recently, several central banks, responsible for formulating monetary policy, have embraced a strategy known as inflation targeting to manage the overall increase in the price level. Within this framework, a central bank assesses and discloses a predicted inflation rate, often referred to as a "target," and thereafter endeavors to guide the actual inflation rate towards this goal. This is achieved by the use of various measures, such as adjusting interest rates. Under an inflation targeting strategy, the measures that a central bank is expected to take in order to increase or cut interest rates become more evident due to the inverse relationship between interest rates and inflation rates. Proponents of inflation targeting believe that it results in heightened economic stability.

Why inflation targeting?

Typically, a monetary policy framework serves as a reference point for the economy's nominal value. A nominal anchor is a variable that policymakers may use to firmly establish and stabilize the price level. In the past, central banks used a currency peg as a nominal anchor, which included connecting the value of the native currency to that of a low-inflation country's currency. However, adopting this method implied that the country's monetary policy essentially mirrored that of the country it was pegged to. Consequently, it limited the central bank's capacity to react to various economic disturbances, such as fluctuations in the terms of trade or adjustments in the real interest rate. Consequently, several nations started implementing flexible exchange rates, thus necessitating the search for a new reference point.

Subsequently, several central banks adopted the strategy of focusing on the expansion of money supply as a means of managing inflation. This technique is effective when the central bank can effectively manage the money supply and when there is a stable correlation between money growth and inflation over a period of time. In the end, monetary targeting proved to be only partially effective due to the instability of money demand, which was often caused by advancements in the financial markets. Consequently, several nations with adaptable exchange rates started to focus more directly on controlling inflation, using their comprehension of the connections or "transmission mechanism" between the central bank's policy tools (such as interest rates) and inflation.

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How does inflation targeting work?

The concept of inflation targeting is quite simple, at least in principle. The central bank projects the future trajectory of inflation and assesses it against the target inflation rate, which is the rate deemed suitable for the economy by the government. The disparity between the projected outcome and the desired objective dictates the extent to which monetary policy has to be modified. Certain nations have opted for inflation objectives characterized by symmetrical ranges centered on a certain value, whilst others have just established a target rate or an upper threshold for inflation. The majority of nations have established their inflation objectives within the range of low single digits. Inflation targeting offers a significant benefit by integrating aspects of both "rules" and "discretion" in monetary policy. The "constrained discretion" concept has two separate components: a specific numerical objective for inflation over a defined period and a strategy to address immediate economic disturbances.

The method has prioritized accomplishing the aim over the medium term, usually within a two- to three-year timeframe, instead of always striving for it. This enables policy to effectively target additional goals, such as mitigating fluctuations in production, within a limited time frame. Inflation targeting establishes a structured framework that allows the central bank to have discretion in responding to unexpected events. Due to the medium-term orientation of inflation targeting, policymakers are not obligated to take any necessary measures to achieve objectives on a period-by-period basis.

What is required?

Inflation targeting has two prerequisites. One essential element is the presence of a central bank that has a certain level of autonomy in implementing monetary policy. While no central bank can attain complete independence from political interference, it should have the freedom to choose the tools necessary to achieve the desired inflation rate as determined by the government. Monetary policy cannot be determined by fiscal policy concerns. The second criterion is the readiness and capacity of the monetary authorities to refrain from focusing on other measures, such as salaries, employment levels, or the currency rate.

Once a nation has fulfilled these two fundamental criteria, it might potentially implement a monetary policy that focuses on inflation targeting. Practically, the authorities may also undertake certain first measures:

- Set clear numerical goals for inflation over a certain number of future periods.
- Publicly communicate with absolute clarity and without any doubt that achieving the inflation target is of utmost importance and is given priority over all other goals of monetary policy.
- Establish a model or approach for predicting inflation that incorporates many indicators holding data pertaining to future inflation.
- Develop a proactive operating mechanism that adjusts monetary policy instruments based on the projected future inflation in order to achieve the desired objective.

Target practitioners?

Inflation targeting has been implemented by central banks in advanced, emerging market, and developing countries, spanning every continent. Countries that are considered full-fledged inflation targeters are those that explicitly commit to achieving a specific inflation rate or range within a defined timeframe. They regularly communicate their targets to the public and have established institutional mechanisms to ensure that the central bank is held responsible for meeting the target.

New Zealand was the pioneer in using inflation targeting as a monetary policy framework. Finland, Spain, and the Slovak Republic are the only central banks that have ceased inflation targeting after adopting the euro as their local currency. During their transition from centrally planned to market economies, Armenia, the Czech Republic, Hungary, and Poland used inflation targeting. Following the 1997 crisis, several emerging market nations opted for inflation targeting as a monetary policy framework, since they were compelled to leave fixed exchange rate pegs.

In addition, some central banks in developed countries, such as the European Central Bank and the US Federal Reserve, have implemented most of the key components of inflation targeting, although they do not formally identify as inflation targeters. These central banks are dedicated to attaining low inflation, although not all of them publicly state specific numerical goals. For instance, the United States explicitly adopted a 2 percent inflation target in 2012. Additionally, some central banks have other objectives, such as promoting maximum employment and maintaining moderate long-term interest rates, in addition to ensuring stable prices.

On target?

Distinguishing the precise effect of inflation targeting from the broader impact of concurrent economic changes is challenging. However, empirical data about the efficacy of inflation targeting generally supports the framework's ability to achieve low inflation, stabilize inflation expectations, and reduce

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fluctuations in inflation. Furthermore, these improvements in inflation performance were accomplished without any negative consequences on production and fluctuations in interest rates.

In addition, those that set inflation targets seem to have shown more resilience in volatile conditions. Recent research has shown that in developing countries, the practice of inflation targeting has proven to be more successful than other monetary policy frameworks in stabilizing public inflation expectations. In several nations, particularly in Latin America, the implementation of inflation targeting was followed with enhanced fiscal measures. Frequently, it has also been accompanied by the augmentation of technological capability in the central bank and upgrading of macroeconomic data. Emerging market nations have taken measures to enhance and cultivate the financial sector since inflation targeting heavily relies on the interest rate channel for transmitting monetary policy. Consequently, the monetary policy results after the implementation of inflation targeting may indicate enhanced overall economic decision-making, including not just monetary aspects.

ECONOMIC DEVELOPMENT, EMPLOYMENT CREATION, AND INFLATION TARGETING

Inflation targeting has emerged as the prevailing monetary policy recommendation for both emerging and developed nations. First implemented by New Zealand in 1990, the principles governing the inflation targeting regime have had such a strong impact that almost all Central Banks have said that their only objective is to maintain price stability with inflation in the "low single digits." Furthermore, it is argued that maintaining price stability would result in long-term economic development and the generation of job opportunities. The inflation targeting policy framework includes the public declaration of specific inflation objectives, together with a trustworthy and responsible commitment by government policy authorities to attain these targets. Typically, the target is set at a level within the low single digits. Furthermore, inflation targeting is often linked to modifications in the central bank legislation that bolster the autonomy of the institution. In reality, while only a few central banks achieve the "ideal" of being fully committed inflation-targeting institutions, many nonetheless prioritize combating inflation at the expense of other objectives. Paradoxically, the focus on generating jobs has diminished for most central banks at the same time as the issues of worldwide unemployment, insufficient employment, and poverty are becoming more prominent. According to the ILO, almost 186 million individuals were unemployed in 2003, marking the greatest recorded level of joblessness. Furthermore, according to the International Labour Organization (ILO), around 22% of workers in developing countries receive a daily income of less than $1, while 1.4 billion individuals (equivalent to 57% of the workforce in developing countries) earn less than $2 per day. In order to achieve the Millennium Development Goal of reducing the proportion of working poor by half by 2015, the International Labour Organization's evaluation indicates that an average annual real GDP growth rate of 4.7% is necessary to decrease the percentage of individuals living in "poverty of $1 a day" by half. To achieve the same reduction in the percentage of individuals living in "poverty of $2 a day," a significantly higher GDP growth rate is required.

The main issue is that continuous financial globalization seems to mainly shift scarce employment opportunities across nations, rather than expedite the accumulation of money and the creation of jobs worldwide. Presently, the expansion of the global economy is characterized by significant disparities and a concentration in certain regions, which hinders the creation of an adequate number of employment on a worldwide scale. Furthermore, this growth is also accompanied by insufficient investment in fixed assets. In these circumstances, price stability alone will not be sufficient to provide genuine macroeconomic stability, since it will not guarantee financial stability and employment expansion. The sub-prime financial crisis that started in the United States serves as a strong example of how financial stability, rather than price stability, poses a danger to the entire macroeconomic performance. Given this context, the primary impetus for the study outlined here is the belief that contemporary central banks should go beyond prioritizing just low inflation. Instead, central banks should aim to achieve a balance between different objectives, such as employment creation, rapid economic growth, inflation control, and stabilization. The specific goals pursued by each country's central bank should depend on the prevailing circumstances and challenges. Furthermore, to fulfill this wider responsibility, central banks must be given the chance to use an ample array of instruments to accomplish many goals. The following pages will provide a concise overview of the results obtained from a collection of nation studies investigating different approaches to inflation targeting. These studies were conducted by a team of researchers affiliated with PERI (Political Economy Research Institute) at the University of Massachusetts, Amherst, and Bilkent University. The country studies, conducted by a team of country specialists, evaluate the macroeconomic performance of existing inflation targeting frameworks and propose alternative monetary policy frameworks that could more effectively accomplish significant social and economic objectives. These assessments are carried out within the unique contexts of specific countries, including Argentina, Brazil, India, Mexico, The Philippines, Vietnam, South Africa, and Turkey. Furthermore, the project encompasses other topic studies pertaining to the subject of monetary policy and inflation. These studies examine the differential gender effects of contractionary monetary policy, as well as the effects of inflation compared to economic

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development on different income categories within nations. In this research project, we provide the reasons why it is both possible and advantageous to move away from inflation targeting and adopt a more balanced strategy. In addition, we propose feasible alternatives to inflation targeting in order to foster employment, sustainable economic growth, and enhanced income distribution, so contributing to the development of a more socially favorable macroeconomic policy framework.

Macroeconomic record of inflation targeting

A significant portion of the current body of scholarship about inflation targeting has mostly examined the extent to which inflation and its volatility have been reduced, as well as the potential trade-offs with other goals, notably the volatility of output. Regarding the matter of inflation levels, a crucial inquiry is whether the decrease in inflation is a result of the implementation of the framework itself or owing to a series of external variables that are favorable. There is a considerable consensus that inflation targeting has led to decreases in inflation. However, available research also indicates that inflation targeting has not resulted in inflation rates lower than those achieved by industrial non-inflation targeting nations that have implemented alternative monetary systems.

Furthermore, there is significant disparity in the estimations of the actual expenses associated with inflation targeting in relation to potential and production growth. Additionally, there is less consensus regarding its effects on employment, poverty, and income distribution. Bernanke, et al. (1999) provide substantial evidence that inflation targeting central banks, despite their preference for this approach, do not effectively cut inflation at a lower cost compared to central banks in other nations in terms of lost productivity. Inflation targeting does not substantially enhance the central bank's credibility and, as a result, does not diminish the "sacrifice ratio." An IMF research, using an empirical model and simulations, has refuted this stance by demonstrating that inflation targeting reduces the fluctuation of inflation while not raising the fluctuation of real variables like real GDP.

Nevertheless, these findings delineate stability in a limited manner, neglecting to address the matter of asset price stability, including exchange rates, stock prices, and other financial asset values. Furthermore, Nelson Barbosa's study for this project demonstrates that these studies use a prejudiced measure of production stability. The term "output stability" is defined as the variations in output in relation to a metric of potential production. The issue lies in the fact that this metric for prospective output is not constant; instead, it only follows, with a delay, the actual production. Consequently, if inflation targeting reduces the increase of production, the growth of potential output will also decrease, and the disparity between actual and potential output will seem to be unaffected by inflation. This strategy ensures that the output relative to potential output remains steady, regardless of the level of restrictiveness of monetary policy. Furthermore, our study offers further proof on the adverse outcomes of monetary policy that prioritizes achieving excessively low levels of inflation in emerging nations. Braunstein and Heintz (2008) demonstrate that implementing contractionary monetary policy as a measure to combat inflation often results in a disproportionately adverse effect on the employment rates of women compared to males.

Moreover, establishing the desired level of inflation is very complicated. While proponents of an inflation targeting regime generally agree that the inflation target should be "in the low single digits," there is no theoretical or empirical evidence to support this claim. Therefore, it seems that this recommendation is driven by ideological motives rather than careful analysis. For instance, if we consider the presumed adverse effects of inflation on economic production and employment, it is necessary to have specific survey data that directly reflects people's preferences for inflation and unemployment. In a paper published for this project, Arjun Jayadev presents survey results that explore people's primary worry between high inflation and high unemployment across various nations and income levels. Although previous research have shown a strong inclination towards low inflation, Jayadev's findings provide light on individuals' preferences in this regard. The primary finding of his study is that individuals with lower socioeconomic status exhibit more anxiety over high unemployment rates rather than high inflation rates, while those with higher socioeconomic status have the opposite preferences. Therefore, the worries over employment and inflation include a significant class-related aspect.

THE IMPACT OF MONETARY POLICY ON GROWTH AND INFLATION

Evolution of Monetary Policy

The peripheral nations, whose currencies served as reserve money, and the core countries, whose currencies served as reserve money, implemented different monetary policies during the gold standard (GS) era. Although the methods varied, monetary policy was used in both sets of nations to control the balance of payments (BOP) and maintain a stable exchange rate. Interest rates were increased in the core nations that exported capital, especially England, while the BOP was in deficit. As a result, there was less capital outflow and more inflow, improving the capital account. A decrease in economic activity as a result of the increased interest rate also helped to minimize the current account deficit. Changes in the capital and current accounts contributed to the preservation of BOP equilibrium. The increased interest rates in the peripheral nations decreased economic activity and, therefore, imports, which in turn decreased the BOP imbalance.

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Changes in interest rates mostly affected the capital account in core nations and the current account in peripheral countries. In other words, governments did not worry about internal balance since monetary policy was utilized to preserve outward balance.

Monetary policy from the end of World War II to the 1973 spike in oil prices

- **Rediscovery of the role of monetary policy**

After World War II, central banks focused heavily on maintaining low interest rates to facilitate the financing of the substantial national debt that had been left over from the conflict. In addition, governments were more focused on keeping the economy at a certain level in order to prevent the high rates of unemployment that had been prevalent in Europe after World War I. However, the combination of cheap money and government spending on war reparations in several European nations drove up inflation rates, forcing central banks to eventually hike interest rates in order to contain the inflation.

- **The assignment problem: the role of monetary policy**

Following the war, policymakers were concerned with preserving full employment. One challenge they had was whether they could accomplish both internal balance, or full employment, and external balance, or a balanced balance of payments (BOP), even in the event that the currency rate remained fixed, as was required under the Bretton Woods System. When the exchange rate was maintained stable, Mundell and Fleming discovered that the two tools needed to achieve the two objectives were monetary and fiscal policy. If monetary policy was allocated to the outward balance and fiscal policy to the internal balance, both goals might be met. This implied that in the event of a BOP deficit, the rate of interest would increase, and in the event of a surplus, it would decrease. In a similar vein, a rise in unemployment would result in a decrease in the budget deficit, and vice versa.

Phillips curve and policy

The discovery of the Phillips curve, which proposed a trade-off between the rate of inflation and unemployment, was a significant invention of the 1960s. Such a trade-off has significant effects on the exchange rate regime and monetary policy. It's possible that two nations may value inflation and unemployment differently. One nation may choose lower unemployment, which would lead to a more expansionary monetary policy and greater inflation. This greater rate of inflation would suggest that its products will eventually run a current account deficit and lose their competitiveness in global markets, rendering the fixed exchange rate unfeasible. This was a defense of adjustable exchange rates.

Stagflation in the 1970s

The 1970s saw a radicalization of the policy-making process. Large budget deficits from the Vietnam War and the social programs that then-President Johnson designed led to higher US inflation, which was subsequently exported to foreign nations via the fixed exchange rate system. Additionally, it caused the US BOP to have very high, unsustainable deficits. Due to the global economy's very quick expansion up to 1973, there was a lot greater demand for basic commodities, especially oil, which saw substantial price increases in 1973 and 1974. Since the rising inflation was a supply-side issue and contractionary monetary policy would have affected the demand side, it was not addressed by this kind of policy. To keep the level of economic activity constant, central banks pursued a policy of cheap money. However, the rate of inflation continued to rise.

TARGETING INFLATION, CREATING EMPLOYMENT, AND ECONOMIC DEVELOPMENT

Inflation targeting (IT) has become the prevailing belief in mainstream macroeconomic thinking. The method has now been embraced by twenty four central banks (CBs), and other more, especially those in developing nations, are shown significant interest in emulating it. First implemented by New Zealand in 1990, the regulations governing the IT regime have had a significant impact. Both the Central Banks (CBs) of developed and developing economies have stated that their sole objective is to maintain price stability with the lowest possible inflation rate. The prevailing belief is that maintaining price stability is a prerequisite for achieving long-term growth and employment, whereas a significant level of inflation is detrimental to the economy over time. The IT policy framework primarily includes the public declaration of inflation objectives, together with a trustworthy and responsible commitment by government policy authorities to attain these aims. Advocates of an appropriate inflation goal often argue for the maintenance of price stability, but there is less consensus over the definition of this word and its exact measurement. Most practitioners often accept the definition of Alan Greenspan, the former Governor of the US Fed, which states that price stability is achieved when inflation is low enough that people and companies do not need to consider it when making their daily choices. According to Feldsein (1997), price stability is defined as a sustained inflation rate of zero over a lengthy period of time. Furthermore, inflation targeting is often linked to the implementation of suitable modifications in the central bank legislation, which bolster the autonomy of the institution.

Paradoxically, central banks have shifted their focus away from addressing job creation, even as the challenges of global unemployment, underemployment, and poverty have become more important as crucial global concerns. According to the ILO, almost 186 million individuals were

unemployed in 2003, marking the greatest recorded level of joblessness. The employment to population ratio, which is a metric used to gauge unemployment, has seen a decline over the last decade, dropping from 63.3% to 62.5%. Moreover, there is a substantial worldwide issue about the caliber of work, in addition to the decline in the ratio of available jobs to demand. According to the International Labour Organization (ILO), over 22% of workers in developing countries earn less than $1 per day, while 1.4 billion people (equivalent to 57% of the workforce in developing countries) earn less than $2 per day. In order to achieve the Millennium Development Goal of reducing the proportion of working individuals living in poverty by half by the year 2015, it will be necessary to have consistent and strong economic development. According to the ILO, in order to decrease the proportion of people living in extreme poverty (earning $1 a day) by half by 2015, the average annual real GDP growth must be at least 4.7%. To achieve the same reduction in the proportion of people living in moderate poverty (earning $2 a day), a much higher level of GDP growth is required. As to the International Labour Organization (ILO), out of the seven areas analyzed in this study, only the three Asian regions and the Middle East and North Africa region are projected to achieve the $1 objective. Additionally, only the East Asia region is on track to cut working poverty by half, as measured by $2. Furthermore, according to the IMF analysts' estimation, in order to achieve the millennium development target of decreasing poverty by half by 2015, it is necessary for the economic growth to be maintained at a rate of 7% per year or higher.

Furthermore, the economic liberalization of China and India, together with the disintegration of the Soviet Union, has resulted in the inclusion of an additional 1.5 billion individuals into the global workforce. This implies an almost twofold increase in the worldwide workforce and a halving of the global capital-labor ratio. As developing nations become more prominent in global manufacturing trade, about 90% of the labor involved in world goods commerce consists of low-skilled and unskilled workers. These workers often face marginalization and frequent violations of their fundamental worker rights in informal marketplaces. In such circumstances, several emerging nations have seen deindustrialization, significant informalization, and subsequently, a decline in the status of wage-labor, leading to a deterioration in income distribution and an escalation in poverty. Several of these occurrences have coincided with the introduction of neoliberal conditions that demand fast liberalization of trade and premature deregulation of the local financial markets.

The rise of finance has led to a substantial amount of data indicating that the worldwide expansion of financial activities has become a fundamental cause of instability and unpredictability in the global economy. The main issue is that the current process of "financial globalization" seems to mainly shift diminishing investment resources and scarce employment opportunities across nations, rather than facilitating the rapid accumulation of capital on a worldwide level. In essence, the global economy is experiencing a sluggish growth rate that is insufficient to create an adequate number of employment, and it is also dedicating a lesser share of its revenue towards investments in fixed capital.

Macroeconomic Record of IT

The concept of "full-fledged" inflation targeting encompasses five key elements: the lack of alternative nominal anchors, such as exchange rates or nominal GDP; a firm institutional commitment to maintaining price stability; the absence of fiscal dominance; policy independence in terms of instruments used; and a high level of policy openness and accountability. In reality, while only a few central banks achieve the "ideal" of being fully committed to targeting inflation, many others primarily prioritize combating inflation at the expense of other objectives. Furthermore, the implementation of inflation targeting often involves amendments to the central bank legislation that bolster the autonomy of the central bank. The majority of the current literature on the performance of IT has primarily examined whether there has been a decrease in systemic risks and volatility in IT economies, and whether inflation has actually decreased as a result of adopting the framework itself or due to a set of external factors that were welcomed. There is some consensus that IT has been linked to decreases in inflation. However, the current data indicates that IT has not resulted in inflation levels lower than those achieved by non-targeting industrial countries that have chosen other monetary systems. Furthermore, despite the efforts of domestic monetary policy to lower inflation, the expected improvements in employment have often not been realized. Additionally, for several nations that have adopted this conventional method, there has been no major boost in economic growth. In terms of policy quality, it is often stated that the establishment of central bank independence has led to enhancements in communication and openness. Advocates also contend that there has been an enhancement in accountability. It is difficult to comprehend the assertion that accountability has improved in situations where "independent" central banks autonomously choose the target inflation rate without any democratic procedures. Despite the limited availability of research time, the inflation targeters have released inflation reports, central bank meeting minutes, and inflation projections generated by central bank econometric models. The financial community, both local and foreign, welcomed all of these initiatives to enhance the establishment of expectations about future pricing. Moreover, there has been a decrease in the impact of exchange rate pass-through effects, resulting in a reduction in consumer prices' susceptibility to sudden changes.

CONCLUSION

In this study report done at PERI and Bilkent University, we have argued that the prevailing dogma of central banking is unlikely to be optimum or desirable, particularly for developing nations. This prevailing belief is founded on a number of erroneous assumptions: firstly, that even moderate levels of inflation result in significant drawbacks; secondly, that an economy thrives most effectively in a low inflation setting, leading to substantial economic growth and employment; and thirdly, that there are no feasible alternatives to the current monetary policy that prioritizes inflation. Indeed, the majority of instances characterized by modest rates of inflation have little or negligible costs. On the contrary, there are feasible alternatives to inflation targeting, both in the past, at today, and in the future. In the past, governments in both developed and developing regions had central banks that had diverse objectives and strategies, aiming to achieve both economic progress and stability. Presently, very prosperous economies like Argentina, China, and India possess central banks that use a diverse range of instruments to effectively regulate their economies for the aim of growth. The PERI/Bilkent project and PERI's UNDP work in South Africa, Kenya, and Ghana indicate the existence of many "real targeting" methods as alternatives to inflation targeting.

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