Inflation Targeting and Inflation Persistence in Asia-Pacific

Stefan Gerlach

Institute for Monetary and Financial Stability
Goethe-University Frankfurt
Hong Kong Institute for Monetary Research

and

Peter Tillmann

Justus-Liebig-University Giessen Institute for Monetary and Financial Stability Hong Kong Institute for Monetary Research

August 2011

Summary

Asian economies have historically experienced relatively low and stable inflation rates (Gerlach et al. 2009). Nevertheless, in recent years a number of Asian central banks have adopted monetary policy frameworks involving explicit inflation targeting (IT). This policy choice reflects the same consideration that led to the introduction of IT in many advanced economies, including Sweden and the United Kingdom: the need to introduce a new anchor for monetary policy following the abandonment of a fixed exchange rate regime.

In this paper we explore how successful these policy choices have been, looking at data from economies with and without IT in a sample of economies in Asia-Pacific. The literature is ambiguous about the effects of IT in emerging economies. While it seems natural to judge success by computing the average inflation and its variance since the adoption of the inflation target, it is possible for the average inflation rate to be close to target, but deviations of inflation may nevertheless be large and protracted. Thus, the persistence of shocks to inflation matters also at low levels of inflation. We therefore use an alternative metric of success and study how persistent shocks to inflation are. The intuition is straightforward: deviations of inflation from target will be temporary if the central bank is effective in stablising inflation. In fact, a number of authors have argued that the persistence of inflation has fallen in many industrial countries in recent years, and have suggested that this is due to the greater focus on inflation stabilisation by central banks.

It is widely noted that the introduction of monetary policy strategies focused on achieving low and stable inflation has been associated in many countries with a sharp decline in the persistence of inflation shocks. Formally, this literature proceeds by estimating a low-order autoregression for the annual percentage change in consumer prices and studies the estimated sum of the autoregressive parameters. Applying this approach to a sample of Asia-Pacific countries which operate monetary policy with a range of strategies - including IT, exchange rate pegs and "eclectic" strategies - we find evidence that inflation persistence has declined in the economies using inflation targeting but not elsewhere.

The results of this paper also shed light on how to measure the success of alternative monetary policy strategies. While a comparison of the level of inflation reveals no differences across economies, a comparison of inflation persistence does. Measuring the performance of monetary policy strategies in terms of inflation persistence rather than the level of inflation shows that inflation targeting outperforms alternative strategies.