Abstract

This study investigates the effects of an anticipated inflation targeting in a small open economy based on the framework of Mansoorian and Mohsin (2006) with cash-in-advance constraints. It is shown that the steady-state effects of a permanent increase in the inflation rate on capital accumulation, labor and current account are consistent with the results in Mansoorian and Mohsin (2006). However, there is an ambiguous change in consumption depending on the relationship between consumption and labor in the utility function. If consumption and labor is with a large degree of substitution, consumption may rise. Moreover, there is an impact decrease in the shadow price of investment when the policy of targeting a higher inflation rate announces, and the degree of such decrease is inversely related to the time length between the announcement and the realization of policy. Prior to the execution of the policy, the capital stock decumulates and the current account may go through a deficit or surplus first and then deficit along the unstable trajectories depending on the relative impact between the change in the shadow price of investment and the shadow price of assets on the locus where the current account maintains in equilibrium. After the implementation of a higher inflation targeting policy, the capital stock continues to decumulate and the current account accumulates along the stable paths toward the new equilibrium. In addition, the relationship between consumption and labor also influences the dynamic movements of the shadow price of investment.

Keywords: anticipated inflation targeting, investment, current account, consumption.