Chapter 1

Introduction

The effects of monetary policies on capital formation, consumption and current account are always of great interest to macroeconomists. Inflation targeting in various forms has been adopted by a number of industrialized countries, and the usefulness of low inflation targeting is still one of the most controversial issues nowadays. The present paper studies the effects of inflation targeting for a small open economy, by working out the effects of changes in inflation targeting on the important macroeconomic variables.

There are several theoretical literatures which study the effects of inflation targeting on macroeconomic variables in a small open economy with cash in advance constraints on consumption. The cash-in-advance economic model earliest used by Stockman (1981). Mansoorian and Mohsin (2004) extend the framework of Stockman (1981) and Albel (1985) to incorporate endogenous labor supply. They construct the model by using CIA constraints on consumption to study the effects of monetary policies on employment, capital accumulation, consumption, and the term structure of interest rate. Their results show that a permanent increase in the inflation rate will lead to reductions in employment, investment, and consumption. In addition, Mansoorian and Mohsin (2006) re-examine the effects of inflation targeting for a small open economy with cash in advance constraints. They show that an increase in the inflation rate reduces consumption, labor supply, and investment whereas the policy leads to a current account surplus. However, the influence of the relationship between consumption and labor in the utility function is ignored in Mansoorian and Mohsin (2006).

Chang and Chu (2008) re-examine the robustness of Mansoorian and Mohsin's results. They find that the relationship between consumption and labor in the utility function has impacts on the long-run equilibrium and dynamic adjustment process if the relationship between consumption and labor supply in the utility function is explicitly taken into account. They also find that if consumption and labor are separable, the economy moves along the stable path instead of adjusting along unstable trajectories as illustrated in Mansoorian and Mohsin (2006) during the adjustment period before reverting to the initial inflation rate. If consumption and labor are substitute, there exists one possibility that the shadow price of investment may increase at the instant of a rise in the inflation rate such that capital stocks accumulate during the periods when the shadow price of investment is greater than one. Finally, capital stock may accumulate and the country runs a current account deficit during the dynamic adjustment process if consumption and labor are complements, and the shadow price of assets may increase.

In our study, we attempt to study the effects of an unanticipated and anticipated permanent increase in the inflation rate with Mansoorian and Mohsin's framework. However, we will take the relationship between consumption and labor in the utility function into account. We find that the steady-state effects of an unanticipated permanent increase in the inflation rate are consistent with the results in Mansoorian and Mohsin (2006) except for consumption. Moreover, we further discuss the effect of an anticipated permanent increase in the inflation rate. Anticipated monetary policy was earliest discussed by Gray and Turnovsky (1979), and Wilson (1979). Through our study, we prove that a longer time length between the announcement and implementation of policy brings about a smaller impact change in the shadow price of assets at the instant of announcing policy change.

This paper is organized as follows. Chapter 1 is the introduction. Chapter 2 is the model setting. Chapter 3 examines the effects of an unanticipated and anticipated change in the inflation rate. Finally, the major findings are summarized in chapter 4.