Inflation Targeting and Real Interest Rate Parity: A Bias Correction Approach

Jaebeom Kim
Department of Economics
Oklahoma State University
Stillwater, OK 74078, USA
Email: jb.kim@okstate.edu

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Abstract

This paper examines whether inflation targeting (IT) matters for real interest rate parity (RIP) by contrasting real interest rates across traded and non-traded goods by a bias corrected approach under cross-sectional dependence. The main question in this study is if IT macroeconomic policy helps provide favorable evidence for RIP. A number of panel data studies of OECD countries provide favorable evidence for long-run PPP. The important factor to be considered for the finding is, as many studies point out, under IT a high degree of transparency and accountability of monetary policy by the central banks does not limit the variability of inflation but also those of the real exchange rate at a long horizon, and thereby eventually stabilizes real exchange rates to a significant amount relative to the cases under alternative monetary policy. If this is the case and PPP does hold better with countries under IT, then it is likely to result in favor of RIP.

One issue of fundamental and empirical importance in this study is to what extent behaviors of goods markets as well as capital markets across countries can be measured in terms of a degree of integration. The answer to the question depends on how big the economic integration between the markets is across economies. Because of the high persistence of interest rates as well as goods prices, least squares (LS) estimates of the parity seem to suffer from a downward bias in the persistent coefficient, implying that the parity condition will be estimated spuriously to be less persistent than they actually are. While this potential bias has been recognized in the time series literature since Kendall (1954), no empirical study so far has employed bias corrected estimation together with the role of IT for RIP condition. Thus, the question of whether IT plays a significant role for RIP after all together with other factors such as price indices and bias corrected cross-sectional dependence in the panel data would be important and interesting.

For this purpose, we formally assess the evidence on RIP for two sets of data for traded and non-traded goods, durable goods' and service consumptions as well as PPI and CPI, using panel unit root tests with and without cross-sectional dependence. The bias correction method of recursive mean adjustment (RMA) proposed by So and Shin (1999, 2004) is employed under cross sectional dependence. The empirical results show that inflation targeting plays an important role in providing favorable evidence for long-run RIP.

Keywords: Real interest parity; inflation targeting; cross-sectional dependence; panel unit root.

JEL Classification: F30, F31.