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Following the Leader? The Relevance of the FED Funds Rate for Inflation Targeting Countries*

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Paper Highlights

Our paper contains theoretical and empirical contributions to understand the monetary policy design in emerging and developed economies. In particular:

1. We derive an efficient CPI inflation-based Taylor rule in the context of a small open economy model.
2. The policy rule derived can be used to understand the way in which monetary policy is conducted in inflation targeting countries.
3. We use panel data techniques to empirically estimate a policy rule like the one we derived, for a set of 23 emerging and developed economies.
4. We conclude that, despite the difference between emerging and developed countries, central banks react to expected CPI inflation as well as to the foreign interest rate (Fed funds rate).
5. In the case of emerging economies the response to foreign variables is, as suggested by theory, zero once CPI inflation is replaced by domestic inflation.

Abstract

In a New-Keynesian model for a small open economy, we derive a CPI inflation-based Taylor rule that implements the flexible price allocation. We conclude that, in this rule, the natural rate of interest should be linked to the foreign interest rate and to domestic productivity shocks. This rule ensures that the CPI real rate moves in order to induce movements in consumption that are coherent with the flexible price allocation. The empirical evidence shows that inflation-targeting central banks respond to movements in the Fed funds rate, besides reacting to expected CPI inflation and to the domestic output gap. This is true for developed and emerging economies. Furthermore, we find that in emerging countries the response to foreign variables is not different from zero, as suggested by theory, when domestic inflation, rather than CPI inflation, is introduced in the policy rule.

JEL classification: E52, E58, F41

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