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GLOBAL FACTORS DRIVING INFLATION AND MONETARY POLICY. A GLOBAL VAR ASSESSMENT

Abstract:

How much do central banks (CB) have to consider global developments? This paper examines the nexus between inflation and Central Bank's interest rate policy proposing that both are subject to global influences. First, it looks at the role of inflation among other factors for monetary policy. Second, it looks at the drivers of inflation by itself. Hereby, the role of specific macroeconomic spillovers from trade partners are explicitly regarded, with the aim to assess e.g. to which extent inflation is driven by other countries inflation or whether monetary policy is influenced by other countries interest setting. Going beyond existing studies, we identify different functional types of macroeconomic spillovers, their country origin, and show short and long run effects.
The empirical study covers OECD countries and EMEs for the period 1995 - 2016. To model external linkages and to account for variable uncertainty, we use Bayesian global vector autoregression (GVAR). First, with respect to monetary policy, we can show that besides inflation, particularly in certain advanced countries, such as the US, the EA and the UK, CBs clearly consider output development in their interest setting. Most strikingly, we find that in advanced countries CBs consider primarily global developments, notably interest policies of other CBs. Second, we find that inflation is not only determined by domestic factors such as monetary policy, but also by external ones, namely price developments in other countries, oil prices and the exchange rate. Again, the impact of global factors appears predominately in advanced countries.

Keywords:

Monetary policy; Inflation; Global VAR

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