Exploring the role of exchange rate in inflation targeting: Evidence from Thailand

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Abstract

This paper develops a small-scale, structural general equilibrium model for the Thai economy. Using Bayesian estimation, we evaluate the conduct of monetary policy under inflation targeting regime. Specifically, we focus on three main issues. First, we investigate whether exchange rate movements are incorporated in the monetary policy formulation. Second, we conduct welfare evaluation under alternative monetary policy settings. Third, we explore how the varying degree of openness could affect the transmission mechanism. Using data over the past 20 years, we find that the Bank of Thailand adjusted policy interest rate in response to exchange rate movements and this helped to reduce both output and inflation fluctuations from global shocks and improves welfare. While higher degree of openness is found to flatten the slope of the Phillips curve, it does not necessarily reduce monetary policy effectiveness. This is because openness also affects the policy coefficients in the central bank's endogenous reaction function.