Low Inflation, Pass-through, and a Discrete Inflation-targeting Framework for Monetary Policy in China

Chengsi Zhang *

Abstract
The performance of inflation in China over the past few decades has been remarkable. This paper characterizes the statistical nature of the inflation series in China over the past quarter of a century and presents an interesting scenario of large decline in inflation pass-through accompanied with low inflation since the end of the 1990s. How should monetary policy in China be conducted under these new economic conditions? We propose a discrete inflation-targeting framework for monetary policy, which is likely to be suitable for the regime of low inflation and inflation pass-through. The advantages and caveats of adopting such a framework are also discussed.

Key words: inflation pass-through, inflation targeting, monetary policy

JEL codes: E31, E52, E64

I. Introduction
Inflation is one of the most important nominal variables affecting decisions made by central banks around the world. The People’s Bank of China (PBOC) specifies “stable prices” as one of its fundamental goals, highlighting the importance of inflation in monetary policy design in China. This emphasis on the importance of inflation is hardly surprising that either extraordinarily high or low inflation across the economy can induce considerable uncertainty among economic agents regarding future inflation, and, in turn, hinder healthy economic growth and adversely affect economic development. A good example is the hyperinflation in the late 1980s and the mid-1990s, during which time severe inflation

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prevailed across the economy in China. The extraordinary high inflation environment is viewed as the chief culprit for the temporary economic turmoil and downturn of business and consumers’ confidence (Shang, 2000; Zhong, 2005).

In retrospect, the performance of inflation in China over the past 2 decades has been particularly remarkable. Figure 1 shows the (annualized) growth rate of the consumer price index (CPI) for China from the first quarter of 1981 to the second quarter of 2006. It shows that CPI inflation was low before the mid-1980s, but rose from the late 1980s, dropping sharply around 1990–1993, and shooting up thereafter until 1996. Since then, CPI inflation has been subdued and relatively stable.

The significant variations of inflation in China since the early 1980s have spurred researchers to seek a good understanding of the statistical nature of inflation series in relation to monetary policy analysis. The level of inflation and the degree of inflation pass-through are two of the most important statistical indicators relating to monetary policy analysis.

The level of inflation is a familiar indicator that often influences the general direction of monetary policy design, through interest rates adjustment. The second indicator, the degree of inflation pass-through, is increasingly attracting the attention of researchers and policy designers. Taylor (2000), Willis (2003) and Zhang (2007) discuss implications of inflation pass-through on monetary policy analysis for the USA, and Zhang and Liu (2007) tackle the same topic in the case of China.

Inflation pass-through relates to the time taken for inflation to return to its baseline after a shock, which will be discussed more thoroughly in the following section. Inflation

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**Figure 1. Consumer Price Index Inflation in China: 1981:Q1 to 2006:Q2 (%)**


*Notes:* The plot is based on the author’s calculation: inflation = 400×([ln(P_t) – ln(P_{t-1})]), where P_t denotes the raw data of quarterly consumer price index (CPI).
pass-through can effectively influence the monetary policy transmission mechanism through
dynamic interactions with output, interest rates and inflation in aggregate demand and
aggregate supply. As discussed in Fuhrer (1995), any economic model failing to take this
pass-through effect into account can produce misleading policy prescriptions. In addition,
recent contributions by Svensson (2000) and Zhang et al. (2006) show that the degree of
inflation pass-through is closely related to inflation-targeting framework for monetary policy
analysis.

Therefore, the present paper first focuses on these two statistics, which are crucial in
monetary policy analysis. We then discuss several issues relating to how monetary policy
should be conducted in the current climate of low inflation and inflation pass-through in
China. In particular, we propose a discrete inflation-targeting (DIT) framework, which might
be worth considering by Chinese authorities given the statistical evidence of large
reductions in inflation and inflation pass-through when applied over 1999-2006.

The remainder of the paper is organized as follows. Section II presents statistical
evidence of a large decline in the level of inflation and the degree of inflation pass-through
since the late 1990s in China. Section III introduces a theoretical background, as well as
prerequisites and international experiences of adopting inflation targeting as a monetary
policy framework. Section IV provides the empirical finding in the current study with the
inflation-targeting framework and proposes a DIT system for a monetary policy framework
in China. In Section V, we discuss the advantages and caveats of adopting the DIT system in
China. Section VI concludes the paper.

II. Statistical Evidence of a Large Decline
in Inflation and Inflation Pass-through

1. Average Inflation Rates
From Figure 1, it is evident that the level of CPI inflation in China was much lower in the late
1990s than in previous periods. Not surprisingly, the mean (average) values of inflation
over different periods changed substantively. Table 1 reports mean values of the quarterly
CPI inflation using a 5-year moving window, from 1981Q1.

The average inflation rate between the mid-1980s and the mid-1990s was very high
(above 10 percent), dropping substantially to less than 2 percent from the late 1990s.
Hence, it appears that the average inflation rate in China declined since the late 1990s.

To provide a more intuitive illustration on the large reduction in average inflation rates
over the mid-1990s, Figure 2 plots a rolling mean of the CPI inflation over the fixed 5-year
moving window. That is, the figure depicts average values of inflation over 5 years, with
Table 1. Mean Values of the Consumer Price Index Inflation over Six Different Periods

<table>
<thead>
<tr>
<th>Periods</th>
<th>Mean values (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Whole Sample</td>
<td>6.08</td>
</tr>
<tr>
<td>1986:Q1–1990:Q4</td>
<td>10.65</td>
</tr>
<tr>
<td>1996:Q1–2000:Q4</td>
<td>1.74</td>
</tr>
<tr>
<td>2001:Q1–2006:Q2</td>
<td>1.33</td>
</tr>
</tbody>
</table>

Source: The author’s calculation based on raw data from the NBS (2005).

Figure 2. Rolling Mean of Consumer Price Index Inflation in China: 1981: Q1 to 2001:Q3 (%)

Source: Author’s calculation.
Notes: The rolling mean values are computed sequentially using a 5-year rolling window spanning the period of 1981:Q1 to 2006:Q2. The graph plots the starting points of each 5-year window and the end point on the graph corresponds to 2001:Q3 because of the 5-year window adjustment.

the sample starting from the first quarter of 1981 to the final quarter of 1985, followed by the second quarter of 1981 to the first quarter of 1986, the third quarter of 1981 to the second quarter of 1986, to the third quarter of 2001 and the second quarter of 2006. The distinct drop around 1996 depicted in Figure 2 highlights the large reduction in average inflation rates since the late 1990s.

2. The Inflation Pass-through
What do economists mean when they talk about the “pass-through” of inflation? It refers to the tendency for inflation to stay away from its average level for an extended period when perturbed (Fuhrer, 1995). For instance, when inflation has deviated from the rate that policy-makers desire, its return to the expected level will take quarters or years, which
indicates a strong “pass-through” effect.

One intuitive measure of inflation pass-through is its autocorrelation function (ACF) or equivalently correlogram. The ACF describes the correlation of inflation time series with its own lagged values. Figure 3 displays the ACFs for CPI inflation of China before and after the late 1990s. As the figure shows, the CPI inflation before 2000 exhibits a high degree of pass-through: the ACF dies out (cut to zero) slowly with nearly 8 quarters.

In contrast, the ACF for inflation over the most recent period (2001-2006) shows less degree of pass-through: the correlogram diminishes within one-year period (4 quarters). In practice, we vary samples and the finding appears to be robust: that the degree of inflation pass-through measured by the ACF witnesses a reduction over the most recent period 2001-2006.

A more formal measure of inflation pass-through provided in the published literature (e.g. Taylor, 2000) is the sum of coefficients on lagged inflation variables in an autoregressive

**Figure 3. Autocorrelation Functions for Consumer Price Index Inflation in China**

![ACF plots](a) ACF: 1981:Q1-2000:Q4  
(b) ACF: 2001:Q1-2006:Q2

**Source:** Author’s calculation.  
**Notes:** The dotted lines in each panel denote upper and lower bounds of two standard deviations of the corresponding ACF (autocorrelation function).
(AR) process. For example, Taylor (2000) and Zhang (2007) use AR models to investigate the changes in inflation pass-through in the USA. Here, we follow the standard literature and use a simple AR(4) process to estimate inflation pass-through as follows:

\[ \pi_t = c + \alpha_1 \pi_{t-1} + \alpha_2 \pi_{t-2} + \alpha_3 \pi_{t-3} + \alpha_4 \pi_{t-4} + \epsilon_t \]  

(1)

where \(\pi_t\) denotes the rate of inflation, \(c\) denotes a constant, \(\alpha_i (i = 1, \cdots, 4)\) refers to individual coefficients on lagged inflation variables, and \(\epsilon_t\) is a stochastic shock. The lag order of 4 appears to be a reasonable choice for quarterly data analyzed here. Alternative lag orders in Equation (1) specified by more formal econometric criteria do not change our baseline finding and, hence, we do not report the alternative results to facilitate expositions here.

By construction, \(\sum \alpha_i\) associated with Equation (1) measures the degree of inflation pass-through. Table 2 summarizes the simple ordinary least squares (OLS) estimates of pass-through for the CPI inflation in China over the whole sample and several sub-periods. The inflation pass-through over the entire sample is as high as 0.90 and it remains high until the end of the 1990s. Nonetheless, as Table 2 shows, the sum of the coefficients on the lagged dependent variables is merely 0.60 in the later period of 2001–2006.

To assess the sensitivity of the preceding finding and avoid possible spurious comparison among arbitrary subsamples, we design rolling estimates for the measure of inflation pass-through over a 10-year moving window. Note that the 10-year window (40 observations) appears to balance well between finite sample concern and our interest in investigating changes in inflation pass-through over time.

By construction, in each moving window (sample), an AR(4) process is estimated and a pass-through estimate is obtained by OLS. In turn, Figure 4 plots the rolling estimates of inflation pass-through starting from the subsample of 1981:Q1 to 1990:Q4, with a 10-year moving window until 1996:Q1 to 2006:Q2. From the figure, it is clear that the degree of inflation pass-through over the most recent periods undergoes a large reduction.

<table>
<thead>
<tr>
<th>Periods</th>
<th>Pass-through</th>
</tr>
</thead>
<tbody>
<tr>
<td>Whole sample</td>
<td>0.90</td>
</tr>
<tr>
<td>1981:Q1 to 1990:Q4</td>
<td>0.83</td>
</tr>
<tr>
<td>1991:Q1 to 2000:Q4</td>
<td>0.92</td>
</tr>
<tr>
<td>2001:Q1 to 2006:Q2</td>
<td>0.60</td>
</tr>
</tbody>
</table>

Source: Author’s calculation.

Note: The reported values of pass-through are ordinary least square estimates of the AR(4) process.
To summarize the statistical evidence documented in the foregoing 2 subsections, inflation pass-through has been much lower when the inflation rate has been lower in China. The important implications of the low inflation and low inflation pass-through on monetary policy analysis will be discussed in the following sections.

### III. Inflation Target: Theory and Prerequisites

The inflation target system is a relative new monetary policy framework, which stems from high inflation experienced by many countries around the world during the 1970s and 1980s. Unsatisfactory experience with setting other targets prompted this innovation in most of these industrialized countries. To date, inflation targeting has been explicitly adopted in more than 20 nations since 1990, including New Zealand, Canada, the UK, Finland, Sweden, Australia and Spain. Recent studies in Bernanke and Mishkin (1997) and Zhang et al. (2006) indicate that the USA might also have implemented an implicit inflation target since the turn of the century.

In theory, inflation targeting is straightforward. When a nation adopts inflation targeting as a monetary policy strategy, the central bank will explicitly pursue low inflation as the nation’s primary intermediate and long-term target. In practice, the nation may announce a numerical target level for inflation or band at or within which the authority of the country commits to maintain inflation.

In most industrialized countries that are implementing inflation-targeting policy, their central banks develop a methodology for forecasting the future path of inflation. The forecast is compared with the objective inflation rate. The monetary authorities then determine adjustment procedures based on the difference between the forecast and their

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**Figure 4. Rolling (10-year window) Estimates for the Consumer Price Index Inflation Pass-through, 1981:Q1 to 1996:Q3**

*Source:* Author’s calculation.

*Notes:* The graph plots the estimates corresponding to the starting points of every 10-year window. The end-point on the graph corresponds to 1996:Q3 because of the 10-year window adjustment.
inflation target. For example, a central bank might use a forward-looking operating procedure to adjust a short-run target (e.g. interest rates) in response to deviations between the central bank’s forecast and the specified inflation target.

It should be noted that many economists advocating inflation targeting regard this strategy as a framework for monetary policy rather than a monetary policy rule. For example, the new Chairman of the Federal Reserve System, Ben Bernanke, argues that inflation targeting should not be considered as an ironclad policy rule, but a framework that brings transparency and coherence of monetary policy (Bernanke and Mishkin, 1997). From this perspective, in the next section, we will combine the specific feature of inflation performance with the development and relative independence of central banking in China since the late 1990s and propose a discrete inflation targeting framework for monetary policy.

Perhaps the most important issue in adopting inflation targeting as a monetary policy framework is to understand the prerequisites for implementing this strategy. Debelle et al. (1998) propose two prerequisites for adopting an inflation target; namely, a degree of independence of monetary policy and absence of commitment to a particular level for the exchange rate.

It is worth pointing out that independent monetary policy does not necessarily rule governments out of being involved in an inflation-targeting strategy. In contrast, Thomas (2006) shows that in many successful nations an inflation target is set by both the government and the central bank.

Another two important requirements for implementing inflation targeting, according to the existing international experience and modern macroeconomic theory, are an economic environment of low inflation and inflation pass-through. First, according to a case study in Thomas (2006), of the eight countries to first successfully adopt the inflation-targeting strategy, six of them (Chile and Israel were unsuccessful) maintained low inflation rates (less than 5 percent) in the year prior to implementation. Second, the relative degree of inflation pass-through critically influences monetary policy analysis. For example, Fuhrer (1995) proposes that any economic model failure to take this pass-through effect into account can induce misleading policy prescriptions. Svensson (2000) and Zhang et al. (2006) indicate that low inflation pass-through is an important prerequisite for an inflation-targeting framework in monetary policy design. Interestingly, the seminal work by Clarida et al. (1999) also suggests that forward-looking operating procedure of monetary policy analysis requires low inflation pass-through. Given the fact that inflation-targeting strategy entails forward-looking operation (Thomas, 2006), it is plausible that low inflation pass-

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1 The eight countries are New Zealand, Chile, Canada, Israel, the UK, Sweden, Australia and Spain.
through is an important prerequisite for adopting inflation target as a monetary policy framework.

**IV. Discrete Inflation-targeting Framework for Monetary Policy in China**

**1. Has China Satisfies the Prerequisites of Adopting an Inflation Target?**

To summarize the prerequisites of adopting an inflation target introduced in the preceding section, there are four major prerequisites to be considered; namely, relative independent monetary policy, absence of commitment to a particular level for the exchange rate, low inflation, and low inflation pass-through.

A nation satisfying these prerequisites could choose to conduct its monetary policy in a framework of inflation targeting. International experience also shows that most industrial economies that have used such a framework have achieved successfully in adjusting their monetary policy objectives. Many countries have adopted an inflation target from a starting point of low inflation, low inflation pass-through, relative independence of their central banks, and considerable floating exchange rate.

Inflation targeting is particularly appealing to China given the recent large decline of inflation and inflation pass-through. Since the late 1990s, the average inflation rate and inflation pass-through have been remarkably low. The statistical evidence presented here shows that the performance of inflation in China has clearly satisfied two of the four major requirements for the use of an inflation target as a monetary policy framework; namely, low inflation and low inflation pass-through.

In regard to central bank independence, China has made steady progress towards independent monetary policy. In particular, the *Central Bank Law* of 1994 confirmed the PBOC to be the central agent of monetary policy, prudential supervision and the lender of last resort. This mandate resembles, more or less, the fundamental role of the Federal Reserve System in the USA. Indeed, as the central bank of China, the PBOC has achieved considerable success in inflation prevention, sustainable economic growth, bailing out illiquid financial institutions and regulating depository institutions. The strengthening of the interest rate channel and greater PBOC autonomy since the late 1990s indicate a potentially more effective monetary policy than the pre-1990 era.

After being implemented in China for decades, the fixed exchange rate was abandoned in 2005. On 21 July 2005, China decided to (slightly) revalue the RMB by pegging the RMB to a basket of currencies, granting the RMB some flexibility against the US dollar. The revocation of the RMB pegging to the dollar allows the currency to regain its leverage on
the economy. Although the current strategy is still a managed floating regime, it is an important step in China’s move towards a complete flexible exchange rate policy.

In addition, the managed floating policy has defended the government’s control on the overall economy and expanded the floating range of the RMB. Because capital flow in China is not entirely liberalized, the managed exchange rate regime in China does not subordinate its monetary policy to a particular exchange rate objective. Hence, it is feasible for the PBOC to adopt such an inflation-targeting system.

Moreover, the new exchange rate system in China allows the PBOC to be more active and be less influenced by non-market factors. It is foreseeable that the independence of the PBOC in establishing monetary policy will be enhanced under the steady progress to a market-oriented exchange rate system. Therefore, the reform of exchange rate policy in 2005 may be viewed as a double-edged sword, which reinforces the suitability of adopting an inflation-targeting framework as monetary policy in China.

Of course, one might question the suitability of the inflation-targeting framework in China. Interestingly, international experience in implementing the inflation-targeting system has shown that the involvement of government in inflation-targeting design appears to be an important contribution to the success of this policy. A good example is the UK, whose inflation-targeting policy has been successfully implemented through the involvement of its government (Thomas, 2006). Therefore, the integration of the central bank and Central Government of China in policy design to adopt and implement an inflation-targeting framework should result in a positive outcome.

2. Discrete Inflation-targeting Framework

As discussed in the previous sections, inflation targeting should be taken as a framework rather than a fixed rule, a view also shared by Bernanke et al. (1999). Given China’s current economic conditions, we propose a DIT framework for monetary policy in China.

Specifically, a target band (not a fixed number), namely 1.5–4.5 percent of CPI inflation (or core CPI if obtainable), should be set by both the Central Government and the PBOC to obtain desired efficacy in implementing the inflation-targeting framework. The PBOC maintains the features of a discrete policy by adjusting output growth and employment rates through short-run interest rate adjustment. Both the government and the central bank monitor effects of the “discrete” policy, forecast future inflation, and fine-tune the desired

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2 The reform of exchange rate policy in 2005 in China can be viewed as a double-edged sword because, on the one hand, the managed floating exchange rate system does not confine monetary policy in China to a fixed exchange rate target; on the other hand, the central bank obtains more flexibility to intervene in the economy.

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inflation-targeting band for the next period based on the expected inflation forecasts.

In the long run, a stable and low inflation environment accompanied by sustainable economic growth and tolerable unemployment rate (e.g. 5 percent) is expected. By so doing, the government and the central bank of China also provide a reliable nominal anchor without which inflation expectations might vary greatly and macroeconomic forecasting and control would be extraordinarily difficult.

The main reason for advocating a target set by both the government and the central bank is that the Chinese economy has a long central-planning tradition. A target band set by both the government and the central bank will ensure the public reliability of the inflation objective, which the authorities determine to achieve.

It should be noted that the lower bound of the targeting band should not be too low (e.g. zero). The current level of inflation in China is fairly low (approaches zero) and an inappropriate low inflation target might induce further downturn of aggregate inflation, which might cause a liquidity trap. In a liquidity trap, monetary policy is hardly effective because the bank demand for excess reserves is perfectly elastic with respect to interest rates, rendering the central bank incapable of increasing money supply. According to Fisher’s (1896) equation, a liquidity trap involves inflation and inflation expectations equal to the real interest rate. Therefore, it is crucial not to set an inappropriately low inflation target.

Meanwhile, the Central Government and the PBOC should put more efforts in improving the transparency of central bank behavior and increasing effective communication between the central bank and the public. That is, the central bank should do more to help the public correctly interpret the intention of monetary policy. This strategy can increase the credibility of the central bank and build up public confidence in the future economy, which is fundamental for a forward-looking operating procedure in the inflation-targeting framework.

V. Advantages and Caveats of Implementing the Discrete Inflation-Targeting in China

1. Advantages of Implementing Discrete Inflation-targeting
As discussed in Thomas (2006), the first notable advantage of adopting an inflation-targeting framework as monetary policy is the nominal anchor for monetary policy. To maintain a reasonably low level of inflation expectations, most economists agree that a nominal anchor is needed. An inflation target, in particular when using the DIT framework, can tie down inflation expectations and assure subdued inflation in the future economy. This ensures that monetary policy does not drift too much in response to short-term economic
developments and is consistent with long-term policy objectives.

Until the year 2005, China had been anchoring monetary policy using exchange rates by pegging the RMB to the US dollar. The PBOC adjusted money aggregate and interest rates to maintain stable economic conditions. In retrospect, most serious inflation in the history of China appear to be associated with or followed by rapid increases in the quantity of money. Figure 5 presents a time series of CPI inflation in conjunction with growth rates of M1 and M2 over the post-1981 period. It is not difficult to see that the severe inflation of the late 1980s and the mid-1990s were led by high growth rates of both M1 and M2. It is also unsurprising to observe that low monetary growth since the mid-1990s was followed by subdued inflation.

Therefore, by targeting the inflation rate, the central bank of China can provide an effective nominal anchor for monetary policy and, in the meantime, enhance its efficiency in adjusting its intermediate target of monetary aggregates.

Second, adopting the DIT framework will help the PBOC to increase its transparency and credibility. High transparency increases the efficiency and effectiveness of monetary policy in China. With increased transparency comes enhanced central bank credibility. Once the PBOC gains more credibility, the public will be more inclined to make long-term commitments and the overall economy will, in turn, be better off.

Another important advantage of adopting the DIT framework in China is to avoid a liquidity trap. As discussed in the preceding section, because a liquidity trap can lead to the failure of interest rate adjustment policy of the central bank, it is crucial that inflation and inflation expectations are prevented from occurring at below zero or above 10 percent.

\[\text{Figure 5. Money Growth and Inflation in China, 1981: Q1 to 2005:Q4 (\%)}\]

\[\text{Source: CPI is from NBS (1998–2005) and money aggregates are from IMF (2006).}\]
\[\text{Note: CPI, consumer price index.}\]
By targeting an appropriate level of inflation, the PBOC can keep inflation and inflation expectations at proper distances from such levels and take measures to react to incipient warnings of extraordinary decline in inflation and inflation expectations.

Finally, the DIT framework can combine the strengths of the functions of both central bank and the central government. Because the proposed DIT framework for China involves both the PBOC and the central government, it might be more efficient for the authorities to convey the intention of monetary policy to the business and the public. Therefore, we would expect a more effective monetary transmission mechanism under such a policy framework.

2. Caveats for Adopting the Discrete Inflation-targeting Framework

There are three relevant caveats of adopting the DIT framework for monetary policy in China. First, it should be noted that adopting the inflation-targeting framework by no means implies that inflation is the only variable that monetary policy should focus on. Upon adopting the proposed DIT system, the authority should not neglect the importance of output stability. In particular, China has experienced great success in output growth since the end of the 1990s. The DIT framework should not place less emphasis on the importance of aggregate output. For instance, consider a simple societal loss function:

$$L = \delta (\pi_t - \pi^*)^2 + (1-\delta)(Y_t - Y^*)^2$$

(2)

where $L$ is the loss to a society, $\pi_t$ denotes inflation rate, $\pi^*$ denotes an inflation targeting band, $Y_t$ refers to aggregate output, $Y^*$ is the potential (full-employment) output level, and $\delta$ represents relative weights that society places on inflation and output. In this setup, the society cares about deviations from both inflation and output. In considering its loss function, the PBOC should have an appropriate balance between the weights on inflation ($\delta$) and output ($1-\delta$). If the PBOC places excessive priority on achieving the desired inflation target, it might bring about unstable and inappropriate levels of output and employment.

Second, successful implementation of the DIT framework in China entails a reliable inflation forecasting mechanism. Because the outlook of future inflation in the DIT system plays a critical role in determining the inflation-targeting band for the ensuing period, it might cause severe adverse effects on the effectiveness of the monetary policy if a good forecasting system is absent.

Third, a proper fine-tuning interval must be carefully chosen. Too frequent changes in the inflation target (either level or band) might cause a severe credibility crisis for the
central bank. The public might be confused by the irregular announcements of targeting level or band and, consequently, lose confidence in the central bank’s credibility. Because credibility is one of the most important factors in a successful inflation-targeting system, the loss of credibility will eventually lead to the failure of the DIT framework.

VI. Conclusions

Given the remarkable development of China’s economy since the late 1990s, having an effective monetary policy framework has become increasingly important. Employing modern principles of inflation targeting for monetary policy in light of the current state of low inflation and inflation pass-through in China, we propose a discrete inflation-targeting framework to guide the operation of a new monetary policy regime.

The present paper proposes that low inflation and inflation pass-through in conjunction with the progressing central bank independence and managed floating exchange rate regime have equipped China with promising economic conditions for adopting such a discrete inflation targeting framework for monetary policy. Under such a framework, the management of money growth by the PBOC may continue to play an intermediate role in monitoring inflation, but the money aggregates target would not constitute a stand-alone nominal anchor. Instead, an inflation-targeting band might provide a better nominal anchor for monetary policy in China.

More research is warranted before we can proceed with an inflation-targeting framework for monetary policy in China. In addition, more questions relevant to the proposed inflation-targeting system need to be answered. For instance, what price index should be used in setting the target? What should be the appropriate band for the inflation target? To what extent should the central government be involved in setting the inflation target?

These questions are worth considering in future research. We hope that the current study will spur more interest and discussions in studies regarding China’s monetary policy framework, in particular the inflation-targeting framework.

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