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The Effects of Inflation Targeting on Market Integration with Survival Analysis

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Abstract

While Inflation Targeting (IT) policy is known to positively impact inflation rates and exchange rates—key factors in market integration—limited research has examined its direct effect on market integration. This study addresses this gap by analyzing the influence of IT policy on market integration between 28 inflation-targeting countries and the U.S. Unlike previous studies that focus on the Law of One Price (LOP) or Purchasing Power Parity (PPP) as an indicator of market integration, we use a novel approach. Specifically, we examine the duration of high price differential episodes (HPDEs) — periods when price differentials exceed trade costs — as a dynamic measure of market integration. Using survival analysis, we assess whether IT policy shortens the duration of these HPDEs after the implementation of IT policy. Our pooled analysis shows that IT policy does reduce HPDE durations, indicating a positive effect on market integration. However, the impact varies across countries. In nations with lower nominal exchange rate volatility, IT policy significantly shortens HPDE durations, promoting greater integration. Conversely, countries with higher exchange rate volatility do not experience a significant reduction. Overall, these findings suggest that while IT policy can promote market integration and enhance market efficiency, its success is largely contingent upon exchange rate stability. This suggests that in countries with high exchange rate volatility, IT policy may need to be complemented by additional measures to achieve stronger market integration.

Keywords

Inflation Targeting Policy, High price Differential Episode, Purchasing Power Parity, Survival Analysis