Is Money Growth Still Useful for Predicting Inflation in Korea?

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Whether monetary aggregates still serve as a useful indicator for predicting the inflation rate during the current low inflation period is of primary concern to the monetary authority, but it remains an open question. This paper addresses this question by employing a variant of models of inflation such as the P-star model and the modified Phillips curve and investigating which model is superior in both in-sample fits and out-of-sample forecast performances. The evidence suggests that the modified Phillips curve augmented to include the excess money growth and actual velocity growth provides relatively good in-sample fits over the post-crisis period (1999 Q1 - 2006 Q2) as well as during the pre-crisis one (1972 Q1 - 1997 Q4). What is of particular importance is that the modified Phillips curve performs best in predicting the one-quarter-ahead and one-year-ahead inflation rates and even the two-year-ahead one for the post-crisis period as well as over the pre-crisis period. In addition, the encompassing test strongly supports the hypothesis that excess money growth along with actual velocity growth in the modified Phillips curve has additional predictive content for future inflation during the recent post-crisis period in particular. The evidence underscores the practical relevance of excess money growth along with actual velocity growth, rather than just actual money growth, in conducting a more effective monetary policy.