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## The exchange rate pass-through in the new EU member states

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### ABSTRACT

This paper aims to complete our understanding of the relationship between changes in nominal effective exchange rates and prices in the new EU member states. I investigate the exchange rate pass-through to import, producer and consumer prices for ten Central and Eastern European countries with quarterly data from January 1996 to December 2011. In a first step, the pass-through estimates are derived from a dynamic panel data model through the generalized method of moments. A statistically significant exchange rate pass-through to consumer, producer and import prices is found, both in the short and long run. In a second step, I proceed to an individual analysis, country by country, and find support for an increased heterogeneity in the exchange rate pass-through estimates. In a third step, I assess the drivers of the estimated exchange rate pass-through coefficients and find support for a significant impact of exchange rate volatility, inflation volatility, import dependence, and the output gap, as well as the global outlook.

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## 1. Introduction

In this paper, I study the exchange rate pass-through to consumer, producer and import prices for ten new EU member states (NMS<sup>1</sup>).

One of the major channels through which the exchange rate traditionally affects economic performance is through its impact on prices. The main direct effect occurs through the impact on import prices, which further reverberates along the pricing chain to consumer prices.<sup>2</sup> These price

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<sup>1</sup> Bulgaria, Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Romania, Slovenia and Slovakia.

<sup>2</sup> Domestic currency depreciations can increase import prices, which, in turn, may translate into domestic price inflation.

changes give rise to important indirect and second-round effects through their impact on real income, consumer spending and trade flows, with feedback effects on overall price pressures.

From a policy point of view, knowledge of the link between nominal exchange rates and inflation in the new EU member states is important for several reasons.

First, knowledge of the exchange rate pass-through dynamics has important monetary policy implications. For instance, in the case of inflation targeting countries, the extent and the timing of the pass-through is important both for forecasting inflation and for the monetary policy decision-making process. In these countries, regular adjustments of the interest rate are needed in order to counteract deviations from the inflation target caused by changes in the nominal exchange rate.

Second, policy discussions about exchange rate options in countries with fixed exchange rate regimes can necessitate some knowledge about the exchange rate pass-through. After the outbreak of the 2007 global economic and financial crisis, and once it started to affect the Central and Eastern European region in late 2008, there was a big debate on the pros and cons of devaluing the currency in some countries with fixed exchange rates. Quantitative knowledge of the exchange rate pass-through is extremely important in such policy discussions since the beneficial effects of devaluation on competitiveness are likely to be limited if the pass-through is assessed to be high.

Third, nominal exchange rate fluctuations can have a short-term character but can equally be structural when associated with the real appreciation trend experienced by the catching-up economies. The pressure of real exchange rate appreciation and the real convergence process are closely related – this phenomenon is usually called the Balassa-Samuelson effect (Égert, 2011). Besides, during the process of real convergence, the NMS face inflationary pressures caused both by demand factors (i.e. reduction in interest rates, credit growth, property investments, etc.) and supply factors (i.e. inter-sectoral differences in productivity that might determine a higher inflation in the non-tradable sectors). In the catching-up countries with a nominal trend appreciation of the currency (such as Slovakia before it adopted the euro at the beginning of 2009), knowledge of the link between nominal exchange rates and inflation may shed light on the degree to which inflation convergence vis-à-vis the euro area is sustainable, an issue that is crucial for the assessment of the convergence criteria.<sup>3</sup> A high pass-through associated to a strong appreciation before joining the EU might raise some doubts on the sustainable nature of inflation. This issue was largely debated in the 2008 Convergence Report on Slovakia, when empirical evidence of the limited size of the Slovak pass-through played a decisive role in supporting the inflation criteria's sustainability.<sup>4</sup>

At the same time, developments in the nominal exchange rate play an important role. If the exchange regime is fixed, as is the case for instance in a monetary union, the real appreciation passes exclusively through an inflation differential. On the contrary, in a flexible exchange regime with inflation targeting we might observe a tendency of appreciation in the nominal exchange rate, as the inflation target, if credible, makes the existence of a sensible inflation differential less probable.

My study is focused on a sample formed by the new EU member states.

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<sup>3</sup> The convergence criteria (also known as the Maastricht criteria) are the criteria for European Union member states to enter the third stage of the European Economic and Monetary Union (EMU) and adopt the euro as their currency. These criteria are based on Article 121(1) of the European Community Treaty and are related to: inflation rate (no more than 1.5 percentage points higher than the average of the three best performing (lowest inflation) member states of the EU); government finance (the ratio of the annual government deficit to gross domestic product (GDP) must not exceed 3 percent at the end of the preceding fiscal year, the ratio of gross government debt to GDP must not exceed 60 percent at the end of the preceding fiscal year); exchange rate (applicant countries should have joined the exchange-rate mechanism (ERM II) under the European Monetary System (EMS) for two consecutive years and should not have devalued its currency during this period); and long-term interest rates (the nominal long-term interest rate must not be more than 2 percentage points higher than in the three lowest inflation member states).

<sup>4</sup> The Slovak authorities re-evaluated the central parity rate twice: in March 2007 (+8.5 percent) and in May 2008 (+17.6 percent). The size of the appreciation of the Slovak koruna was unique for an ERM II member state and caused doubt as to the sustainability of inflation, as indicated in the 2008 ECB Convergence Report: "In recent years inflation has been dampened, in particular, by the trend appreciation of the exchange rate of the Slovak koruna. Available assessments suggest that the appreciation of the koruna has reduced inflation over the past year". The quantitative effect is nevertheless uncertain and depends on the pass-through estimates; this makes a precise and reliable estimation of the exchange rate pass-through for the countries entering the ERM II with a floating exchange rate (Hungary, Poland, Czech Republic and Romania) important.

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