

Importing credible monetary policy: A way for transition economies to fight inflation?

Elham Mafi-Kreft, Steven F. Kreft*

*Business Economics and Public Policy, Indiana University, Kelley School of Business, 1309 East Tenth Street,
Bloomington, IN 47405, USA*

Received 19 June 2004; received in revised form 21 December 2005; accepted 4 January 2006

Available online 2 May 2006

Abstract

In the 1990s, transition economies were rearranging their monetary regimes. This paper compares the chosen regimes based on the level of discretionary power and the ability to control inflation. Results show that non-discretionary regimes produce lower and more stable inflation.

© 2006 Elsevier B.V. All rights reserved.

Keywords: Transition economies; Currency board; European Monetary Union; Exchange rate regime

JEL classification: E58

1. Introduction

Following their independence in the late 1980s, almost all transition economies established a central bank to enact a national monetary policy. As mentioned by Schuler (1996), the conventional view among monetary economists was that every independent country should have its own central bank in order to conduct independent monetary policy. In contrast, around the time of the independence movement, 11 countries gave up their monetary sovereignty to the European Central Bank. Clearly the real difference in these two movements revolves around the degree of discretionary monetary policy.

* Corresponding author. Tel.: +1 812 856 4965; fax: +1 812 855 3354.

E-mail address: skreft@indiana.edu (S.F. Kreft).

Table 1

Difference in mean and difference in variance tests (1995–2001)

	Mean	Variance
<i>Inflation</i>		
Flexible regime	93.43	8332.46
Hard peg regime	11.31	239.21
Flexible regime–hard peg regime	82.12***	8093.25***
Statistical difference test	$t=3.93$	$F=34.83$
<i>Rate of depreciation in the real value of money</i>		
Flexible regime	0.24	0.02
Hard peg regime	0.09	0.01
Flexible regime–hard peg regime	0.15***	0.01**
Statistical difference test	$t=2.96$	$F=2.81$

The aim of this paper is to test whether transition economies with non-discretionary monetary regimes, i.e. hard pegs, (defined as adopting a currency board or maintaining a de facto exchange rate peg) experience more stable and lower inflation than the transition economies with discretionary regimes, i.e. flexible regimes, (defined as having flexible exchange rates). These definitions are developed from the exchange rate regime flexibility index of [Bubula and Otker-Robe \(2002\)](#), which assigns values from 1 to 13, where we consider 1–4 as hard peg regimes and 5–13 as flexible regimes. We also test to see whether transition economies that are on the fast track to join the European Monetary Union (EMU) experience lower levels of inflation.¹

2. Panel analysis of the determinants of inflation

The contribution of this paper is that it is the first to explicitly focus on the transition countries' ability to maintain stable and low inflation by comparing the structure of their monetary institutions. For general comparison we conduct a difference in mean and difference in variance test for the inflation of two groups of transition economies: (i) hard peg regimes and (ii) flexible regimes, over the time period 1995–2001.² The results reported in [Table 1](#) show that the hard peg regimes experienced significantly less volatile and lower inflation when compared to the flexible regimes.

Looking at [Table 1](#), it is evident that our sample is characterized by high variance and high overall inflation. We want to conduct a study of the impact that monetary regimes have on inflation, but our analysis might be biased by the high variation in inflation. Following [Cukierman, Miller, and Neyapti \(2002\)](#) we correct for this potential bias by capturing inflation as the rate of depreciation in the real value of money. [Table 1](#) also contains the difference in mean and difference in variance test for the rate of depreciation in the real value of money and results are identical to those using inflation.

To further analyze the impact of monetary regimes, we collected panel data on 25 transition economies, from 1995–2001, and our analysis builds off of the standard model of inflation. We expect that the transition economies with hard peg regimes will better control inflation. Testing the effect of

¹ We define countries being on the 'fast track' to join the EMU as those countries that joined the European Union in 2004.

² The inflation data come from the IMF and included 26 IMF classified transition economies, six of which had hard peg regimes.

Download English Version:

<https://daneshyari.com/en/article/5062523>

Download Persian Version:

<https://daneshyari.com/article/5062523>

[Daneshyari.com](https://daneshyari.com)