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ROMER WAS RIGHT ON OPENNESS AND INFLATION: EVIDENCE FROM SUB-SAHARAN AFRICA

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Romer (1993) documents a negative relation between trade openness and inflation and offers an explanation based on time-inconsistency of monetary policy, but subsequent research casts doubt on the negative relationship and the explanation. This paper contributes to this debate by estimating the effect of openness to international trade on inflation with panel data from Sub-Saharan Africa. Employing instrumental variable techniques that correct for endogeneity bias of trade openness, the empirical evidence suggests that within-country variations in trade openness restrict inflation: a 1 percentage point increase in the ratio of trade over gross domestic product is associated with a decrease in inflation of approximately 0.08 percentage points per year. These results are robust to additional controls, different measurements of trade openness and alternative instruments. Finally, we inspect the time-inconsistency mechanism of the negative-relationship between trade openness and inflation.

JEL classification codes: C23, E31, E52, F41
Key words: trade openness, inflation, instrumental variables

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I. Introduction

Whether or not trade openness restricts inflation has been a widely debated question. In his seminal paper, for the first time, Romer (1993) observes that there is a negative correlation between trade openness and inflation. Subsequently, the negative relationship is called into question by several scholars. For example, Terra (1998) argues that the negative relation between trade openness and inflation in Romer (1993) largely depends on his data sample during the debt crisis period when most countries are heavily indebted. Temple (2002) even cautions that the direct evidence for Romer's negative correlation is not at all strong.

The above-mentioned empirical studies are based on cross-section data. One weakness of the cross-sectional regression design is the omitted variable bias. For instance, Terra (1998) shows that both the time period and the unobservable country-specific characteristics have an important influence on the relation between openness and inflation. While the effects of these characteristics of the countries and time period may be purged by including country fixed effects and year fixed effects, the cross-sectional regression design makes it infeasible to do so. The panel data methodology appears to be the most appropriate for dealing with this type of problem, because it allow us to detect effects that are either typical of certain countries or changing over time. Hence, we apply rigorous panel-data estimation techniques.

Sachsida, Carneiro and Loureiro (2003) are the first to use panel data to study the relation between openness and inflation. They find that the negative relation still holds, but they do not control for time effects and other important variables that may determine inflation. Controlling for time and country fixed effects, Alfaro (2005) finds that openness does not play a role in restricting inflation in the short run, which runs counter to Romer (1993). In this paper, we empirically examine how trade openness affects inflation. Using panel data on a sample of 46 Sub-Saharan Africa (SSA) countries during the period 1985-2012, we find that there is a negative causal relationship between trade openness and inflation.[1] Therefore, our paper contributes to the debate by reinforcing the view of Romer (1993) that trade openness restricts inflation.

Even though we can control for country-specific and year effects in panel data, the causal effect of trade openness on inflation is still not easy to identify empirically. The previous studies do not find a good way to solve the endogeneity issue, failing

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[1] Table A in the Appendix presents the list of 46 SSAs.

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