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Investigating asymmetric effects of monetary shocks on the exchange rate and trade balance, with an emphasis on inflation targeting

Naser Elahi[a], Farshid Salimi[b,*], Elahe Masoomzadeh[b]

[a] *Associate Professor, Department of Economics, Mofid University Qom*
[b] *PhD student in Economics, Mofid University Qom*

Abstract

Monetary shocks are proposed as a means of economic control in the world's economic systems. The exchange rate and its changes, as one of the macroeconomic variables and the price of foreign currency in the domestic currency, have a significant effect on other macroeconomic variables such as inflation, production, exports, imports, balance of payments and so on. Vast changes in exchange rates can affect the country's macroeconomic variables by affecting the supply and demand of the economy. Thus, according to the proposed issues, this study intends to use the 18-year experience of inflation targeting framework adopted by industrial and developing countries so as to investigate the relationship between monetary shocks on the real exchange rate and the trade balance in some of these countries. The results of the extended torque models' estimates for developed countries indicate that the real exchange rate stabilization policy and trade expansion and trade balance improvement in the studied developed countries have been studied and is a function of the stabile and long-term macro-economic policies and has been properly implemented. The results also showed a positive relationship between gross domestic production and the real exchange rate and existence of a liquidity shock and inflation increases the real exchange rate in the countries studied in the research. Results in developing countries also show that liquidity and rising prices and inflation do not move in a same direction.
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Keywords: monetary shock, exchange rate, trade balance, inflation targeting

* Corresponding author Tel.: +989141864927
E-mail address: Farshid.Salimi@Ymail.com

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1. Introduction

Monetary shocks are proposed as a means of economic control in the world's economic systems. Proper understanding of how these shocks affect the economic system is a good guidance to determine the appropriate policies to influence other macroeconomic variables. To implement a successful monetary policy, the monetary authorities are required to properly evaluate the time and the impact of these policies on economic variables. To this end, understanding economic conditions at the time of implementing the monetary policy is of particular importance. The exchange rate and its changes, as one of the macroeconomic variables and the price of foreign currency in the domestic currency, have a significant effect on other macroeconomic variables such as inflation, production, exports, imports, balance of payments and so on. Vast changes in exchange rates can affect the country's macroeconomic variables by affecting the supply and demand of the economy. If the exchange rate is set properly, it can have a positive effect on the balance of payments and strengthening the country's external competitiveness and conversely, inappropriate regulation can cause the reduction of economic efficiency, the misallocation of economic resources, the loss of international reserves, weakening production incentives in agriculture and industry and severe macroeconomic imbalances. It is clear that each of these results alone or in community can at least halt, if not defeat, countries' economic development program. Therefore, the appropriate rate of exchange in any country, whether developed or developing, is of particular importance.

In most developing countries, according to their unconventional and irregular structure, the effects of monetary shocks on real and nominal variables are not completely known and despite various theories and schools, adaption of the effects of monetary policy of these countries with different views needs accurate studies. In general, acceptance of the government's financial performance and limitation of the role of money only in support of the financial measures in this group of countries affects the importance of knowing about the influence of money in the economy; in other words, monetary policy are only marginally raised in the economy and changes in the quantity of money, as the most important demand-side policy, is heavily influenced by exogenous factors such as the deficit, the volatility of oil-related income (oil-producing developing countries), and others with the help of monetary policy. Different monetary policies and methods such exchange rate targeting, money targeting, and inflations targeting are employed by different countries in order to prevent problems and prevent inflation and also in order to achieve the mentioned goal to guide and lead their monetary policy. Inflation targeting is the latest monetary system that has become popular in recent years and is a framework for conducting monetary policy. This system, in the first step, was limited to industrialized countries and New Zealand, Canada, the UK and Sweden adopted this system in the early 1990s. In most cases, adoption of this framework was a reaction to problems faced by these countries in implementing monetary policy based on the implementation of a fixed exchange rate or as an objective, but since the late 1990s, a significant number of developing countries also officially accepted inflation targeting as a nominal anchor.

Under inflation targeting, low and stable inflation is explicitly and directly targeted as the main objective of monetary policy. Although other goals such as full employment or low fluctuations in the exchange rate can also be pursued as a secondary objective, but the problem is that other frameworks of monetary policy are trying to indirectly affect inflation by targeting exchange rate or considering inflation as just one of the goals of monetary policy. To implement the policy of inflation targeting in the first place, a method for predicting future inflation is essential, then as a framework for monetary policy, inflation rate for the next periods should be targeted and monetary policy instruments according to inflationary pressures should be determined explicitly. Thus, according to the proposed issues, this study intends to use the 18-year experience of inflation targeting framework adopted by industrial and developing countries, so as to investigate the relationship between monetary shocks on the real exchange rate and the trade balance, with an emphasis on inflations targeting in some of these countries.

2. Literature Review

Each country and each economic system has certain economic goals and is working to get them. In most advanced industrial and developing countries, the goal of most governments is full employment and fight against

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