Available online at www.sciencedirect.com

ScienceDirect

Procedia Economics and Finance 38 (2016) 438 – 445

Procedia Economics and Finance

www.elsevier.com/locate/procedia

Istanbul Conference of Economics and Finance, ICEF 2015, 22-23 October 2015, Istanbul, Turkey

Pass-through Effect from Exchange Rates to the Prices in the Framework of Inflation Targeting Policy: A Comparison of Asia-Pacific, South American and Turkish Economies

Murat KARAGÖZ[a]*, Baki DEMİREL[b], Emre Güneşer BOZDAĞ[c]

[a]*Yıldız Technical University, Istanbul, Turkey*
[b]*Gaziosmanpaşa University, Tokat, Turkey*
[c]*Gazi University, Ankara, Turkey*

Abstract

Most of the emerging market economy in 90s faced to grave crisis. After these crises, the monetary policies of emerging market economies gave up to use exchange rates as an anchor. For such markets inflation targeting became a new policy. Exchange rates' overshooting effects in the markets and consequential troubles are important causes of these political changes. The study aims at comparatively measuring the pass through impacts of exchange rates to the prices in Asia Pacific, Latin (South) America, and Turkey economies, which implement inflation targeting regime, but have the variable traits in dollarization and inflation experiences For calculating of pass-through effects from exchange rates to domestic prices, the model that is used in the study has five variable factors. Analysis of model is base of VAR approach. Due to cross section series are used in addition to time series, Panel VAR model has been used. Upon obtained findings, it can be said that pass-through effect in Asia Pacific economies is lower than pass-through effect in Latin America and Turkey. This result also complies with the examined pass-through effect literature.[†]

Peer-review under responsibility of the Organizing Committee of ICEF 2015.

Keywords: Inflation Targeting, Pass-Through Effects, Exchange rates, Prices

JEL Classification: G14, G15, G18

* Corresponding author. Tel.:+90-212-683-6829.
E-mail address: mkaragoz@yildiz.edu.tr
† We want to thanks to Barış Alparslan (*Yıldırım Beyazıt University, Ankara, Turkey*) for his helps to the study, in MPRA version.

Peer-review under responsibility of the Organizing Committee of ICEF 2015.
doi:10.1016/S2212-5671(16)30215-5

1. Introduction

There are two basic forms that are remarkable when crisis in Mexico (1994), South East Asia (1997), Russia (1998), Brazil (1999), Turkey (2000–2001), and Argentina (2001) are discussed. The first characteristic form is that exchange rate systems prior to crises are the mixed systems (Malaysia, Thailand) in form of crawling peg exchange rate system (Brazil, Indonesia, Mexico, Russia, and Turkey) or crawling band exchange rate system (Malaysia and Thailand). The second characteristic form is that all of these economies have poor control of financial liberties‡.

One of the biggest problems was the dollarization fact for these countries, especially Latin American economies and Turkey that, implemented mixed exchange rate system pursuant to aforesaid crises after. The inflation that could not be adjusted in defiance of nominal anchor reduced both the power of central bank and currency value in those countries. Overshooting effects of exchange rates due to financial crises caused economical and financial turmoil. Many of the emerging economies due to the problems such as financial credit facility, domestic-foreign borrowing and foreign trade deficit after this effect, gave up on exchange rate nominal anchoring and changed their policy to inflation targeting (Devereux, et al., 2006; Reinhart, 2006).

Two basic factors have the impacts on the policies that are carried out by these emerging market economies. The first factor is that foreign funds, which are used as the financing of economic growth, cause unbalance on assets and equities depending on possible fluctuations in domestic free interest rates. The “original sin” and “sudden stop” problems that are mentioned in Eichengreen & Hausmann (2003), Calvo and Reinhart (2002), and Calvo (1999) cause aforesaid balance sheet vulnerabilities. The second factor is the sensitivity of the prices to the changes in exchange rates. In the studies of Calvo & Reinhart (2002), Choudhri & Hakura (2003), prices’ upward trend in emerging markets are higher than industrialized economies’ markets after the exchange rate-oriented shocks. These findings show that pass-through effects from the exchange rate to the prices in the emerging markets is higher than developed markets.

On the other side, the existence of dollarization lead to strong pass-through effects, then, raises the vulnerabilities in economy and also prevents the price stabilizations. In the event of being financial systems not deep and having got importees high share in total consumption basket, transmission mechanism is indirectly and negatively affected by pass-through effect (Bhattacharya et al., 2011; Kandil & Morsy, 2009). When it is accepted that a strong and positive correlation is available between dollarization-pass-through effect and dollarization-inflation§, the success in inflation may cause to decline in dollarization and accordingly in pass-through effect (Taylor, 2000).

In this study, a comparison is carried out between the countries that have different experience about dollarization and inflation, represent the emerging market economies. In this way, this study aims at contributing the literature that analyzes the pass-through effect. Related literature is analyzed in the first part of study. Obtained findings are examined in third part while the applied model and data set are specified in the second part. The relation of the study with the literature is specified in the conclusion part where the results of analysis are evaluated.

2. Background

The examination of pass-through effect with regards to developing and developed countries economies has been carried out for especially nineties. McCarthy (2000) “whether a relation exists between inflation falling and changes in exchange rate” can be considered as a beginning of such researches in this scope.

‡ Frankel (1999), Fischer (2001), Calvo & Reinhart (2002), Hausmann and et al. (2002), Calvo et al. (2003), and resultant literature is the basic promoter of this point of view.

§ Goldfajn and Werlang (2000), Hausmann et al. (2000), Cabellero et al. (2004), Muinhos (2004) and following literature.