

Real exchange rates and inflation in exchange-rate-based stabilizations: an empirical examination

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Abstract

Numerous explanations have been advanced for why real exchange rates typically appreciate after the nominal exchange rate is stabilized, but few of them have been directly tested. This paper uses an error-correction model of Mexican inflation to decompose the real appreciation of the peso during 1988–1994 into that part attributable to the peso's initial undervaluation, that part explained by growing domestic demand, and that part attributable to backward-looking inflation. The results indicate that the effects of backward-looking inflation were highly transitory, but that both the expansion of domestic demand and the initial undervaluation of the peso were important in boosting domestic prices and, hence, appreciating the real exchange rate. © 2001 Published by Elsevier Science B.V.

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1. Introduction

In recent years, a substantial literature has developed to explain various trends associated with the use of fixed nominal exchange rates to reduce high rates of

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inflation. These trends include an appreciation of the real exchange rate, strong growth of output and aggregate demand, and a widening of trade and current account deficits (Kiguel and Liviatan, 1992). Such developments are of considerable interest, among other reasons because highly valued exchange rates and large current account deficits may contribute to vulnerability to financial crisis among emerging market economies.

This paper focuses on the reasons why real exchange rates tend to appreciate during exchange-rate-based stabilization programs. According to one set of explanations that have been proposed, various aspects of exchange-rate-based stabilization lead to higher aggregate demand, thereby raising prices of non-tradeable goods, and appreciating the real exchange rate (see Calvo and Vegh, 1993; Uribe, 1995; Roldos, 1995; Mendoza and Uribe, 1996; Erceg and Levin, 1996). A second broad approach toward this issue holds that, at the outset of exchange-rate-based stabilization programs, inflation is slow to decline to international levels due to overlapping contracts, imperfect credibility, or backward-looking expectations. During the period when domestic inflation exceeds international inflation, even as the nominal exchange rate is fixed, the real exchange rate appreciates (see Rodriguez, 1982; Edwards, 1993; Dornbusch and Werner, 1994).

In both of the approaches to explaining real exchange rate appreciation described above, the real exchange rate is assumed to be at a steady-state level prior to the beginning of the exchange-rate-based stabilization. A third and alternative explanation for the real exchange rate's subsequent appreciation, which is not as well explored in the literature, may be that as a consequence of balance-of-payments pressures and resultant high rates of exchange rate depreciation prior to stabilization, the real exchange rate may start out more depreciated than its domestic market-clearing level. Once the nominal exchange rate is stabilized, excess demands for non-tradeable goods may drive up their prices — thereby appreciating the real exchange rate — until equilibrium in the domestic goods and labor market is restored.

Notably, there have been few attempts to test directly any of the basic hypotheses outlined above. Some analysts have developed numerical simulation models and compared the predictions of these models against actual trends in economies undergoing exchange-rate-based stabilization (see Reinhart and Vegh, 1995; Rebelo and Vegh, 1995; Mendoza and Uribe, 1996; Erceg and Levin, 1996). However, such tests are at best highly indirect, insofar as they rely on calibrated parameters and attempt only to match broad features of model simulations with the predictions of particular theories. Conversely, Dornbusch and Werner (1994) use an estimated model of Mexican inflation to show that fixing the exchange rate when inflation is high will generate significant real exchange rate appreciation because inflation is slow to adjust, but they do not test this hypothesis against alternative explanations.

The object of this paper is to use direct econometric evidence to distinguish between the three explanations outlined above for real exchange rate appreciation

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