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International transmission of inflation under alternative exchange rate regimes Empirical evidence and its implications

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Abstract

This is a study of the transmission pattern of inflation under alternative exchange rate regimes, fixed and flexible, among the Group of Seven (G-7) countries and their subsets, including four members of the European Union (EU) and two countries from North America. Our key empirical findings are as follows. The price levels of several countries that we found move together as a cointegrated system, forming an equilibrium relationship under both fixed and flexible exchange regimes. Second, the speed of adjustment estimates show that the transmission of inflationary disturbances across countries is less pronounced under the flexible exchange rate regime than under the fixed exchange rate regime. Third, the US was found to be the main producer of inflationary innovations among G-7 countries, whereas the UK was found to be the main producer of inflationary innovations among the EU countries, regardless of exchange rate regime. © 2001 Elsevier Science Inc. All rights reserved.

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1. Introduction

Monetary policy decisions, such as the level of the Fed discount rate, are largely based on an examination of the domestic inflation rate. When the domestic inflation rate is prompted

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by inflationary innovations originating within a country, other things being equal, the country can maintain the autonomy of setting its economic policy. If a large portion of domestic inflation is due to inflation spillover from foreign countries, however, the domestic economic policy of the country needs to be reconciled with the foreign influence, which, in turn, could cause the country to lose its policy setting autonomy.

Before the implementation of a single common currency (called the "Euro") among the 11 European Union (EU) countries, there was concern about spillover of inflationary disturbances from one member country to another and about possible depreciation of the value of the "Euro." As a result, the EU specified the allowable level of inflation in the so-called convergence criteria and limited policy autonomy of member countries.[2]

Among many studies, which have focused on the merit of the alternative exchange regimes in the context of inflation spillover across countries and policy autonomy, Friedman (1953) provided one of the most important arguments for the flexible exchange rate regime by postulating an indirect linkage in the transmission of inflation across countries. According to the argument, under the flexible exchange rate regime, a country's inflationary shock is not directly transmitted to another country since most of the shock is absorbed by the exchange rate flexibility — change in the exchange rate. In essence, the argument predicts that transmission of inflationary disturbances across countries will be less pronounced under a flexible exchange regime than under a fixed exchange regime due to exchange rate flexibility. The implication is that a flexible exchange regime is less inflationary and respective countries may maintain the autonomy to set their domestic economic policies. Darby and Lothian (1989) documented empirical evidence for 20 OECD countries that flexible exchange regimes are accompanied by greater long-run monetary policy independence than fixed exchange regimes.

However, a drawback for the argument is that it ignored the effect of the increasing degree of world commodity market integration on the international transmission of inflation. As various barriers to international trade become dismantled and with the world commodity market becoming more integrated than ever before, the effect of exchange rate flexibility may not be sufficient enough to insulate transmission of inflationary disturbances across countries. It is possible that transmission of inflation can be more pronounced under the flexible regime than under the fixed regime when the effect of the increasing degree of commodity market integration plays a more important role than exchange rate flexibility.

The purpose of this research is to examine whether the transmission of inflationary disturbances across countries is less pronounced under the flexible exchange regime than under the fixed exchange rate regime in the spirit of Friedman (1953). We also compare the channels by which transmission of inflation occurs under alternative exchange regimes, fixed vs. flexible, for the Group of Seven (G-7) countries and two subsets of the G-7 countries composed of four EU countries and two North American countries, respectively. Specifically, the issues to be addressed in this research are as follows: Under the alternative exchange regimes, (1) do the price levels of several countries move together as a cointegrated system,

[2] To join the "Euro" currency system, the nominal inflation should be no more than 1.5% above the average for the three members of the EU with the lowest inflation rates during the previous year.

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