Exchange rate pass-through and monetary policy in Croatia

Andreas Billmeier, Leo Bonato

1. Introduction

Monetary policy in Croatia has been successful in reducing inflation by using the exchange rate as the nominal anchor. This policy, defined as strict exchange rate targeting,
is characterized by a very low tolerance of exchange rate movements and a marked activism of the central bank in foreign currency markets. Strict exchange rate targeting has been successful in ending hyperinflation and stabilizing the economy in the mid-1990s and also delivering low inflation thereafter. Recent changes in the legislative framework and moves towards a more extensive use of market-based instruments suggest that this policy may have to be revised in the future. By specifying price stability as the primary objective of monetary policy, the new Croatian National Bank (CNB) law reduces the emphasis on the exchange rate. The liberalization of the capital account, which is required for the accession process to the European Union (EU), is already testing the ability of the CNB to maintain tight control on the exchange rate. The development of financial markets provides new policy instruments, and the progressive reduction of the role of reserve requirements opens up new opportunities for a more active use of open market operations by the CNB. Hence, exchange rate fluctuations will be more pronounced in the future so that the CNB should be more tolerant of these fluctuations.

This new policy requires information about the transmission mechanism of exchange rate movements passing through to domestic inflation. Exchange rate appreciations or depreciations have a direct impact on inflation by changing the price of tradables expressed in domestic currency. By altering the relative price of domestic and foreign goods, the exchange rate also affects inflation indirectly through changes in economic activity. Small, open economies that are price takers in the world market may expect exchange rate movements to feed into the domestic price level, although prices at various stages of the production chain are affected differently. Ceteris paribus, import prices should move identically with the exchange rate due to the law of one price. Once inputs are added, the corresponding price measure should reflect the weight of imports in the production process. However, estimated pass-through may deviate from this benchmark for several reasons. Strategic pricing by foreign companies may cause no pass-through.¹ The existence of menu costs associated with price adjustment ensures that mere noise in the exchange rate, as long as it is regarded as stationary and small relative to a threshold, will not be reflected in price changes.² Expectations and different forms of indexation may also affect the final result.

Disregarding the wealth of channels through which the exchange rate can affect inflation, the available empirical evidence from advanced economies indicates low and decreasing pass-through (McCarthy, 2000). The pass-through appears to be endogenous to different regimes and tends to be smaller when inflation is low, which indirectly confirms the importance of expectations in the transmission mechanism (Choudri and Hakura, 2001). However, Ross (2000) and Kuijs (2002) do not find evidence of low pass-through in transition economies. This result may be due to the lack of credibility of the monetary authorities and to structural elements, e.g., the price-taking nature of domestic firms on international markets. Two features of the Croatian economy affect the magnitude of the pass-through. First, compared with other transition countries, Croatia is an intermediate

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¹ Consider a German car manufacturer exporting to the US. If the US dollar depreciates, the law of one price predicts a rise in the dollar price, ceteris paribus. To maintain her market share, the exporter may not change the dollar price, but accept a reduction in the profit margin instead.

² In general, this threshold will be positively correlated with past volatility in the exchange rate.
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