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Inflation, openness, and exchange-rate regimes The quest for short-term commitment

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Abstract

This paper further tests Romer's [Romer, D., 1993. Openness and inflation: theory and evidence. Quarterly Journal of Economics 58, 869–903] extension of Kydland and Prescott's [Kydland, F., Prescott, E., 1977. Rules rather than discretion: the inconsistency of optimal plans. Journal of Political Economy 85, 473–491] predictions for dynamic inconsistency problems in open economies. In a panel data set of developed and developing countries from 1973 to 1998, I find that openness does not play a role in restricting inflation in the short run. On the other hand, a fixed exchange-rate regime plays a significant role. The results are robust to controlling for other variables that determine inflation, performing sensitivity analysis, and using a de facto exchange-rate regime classification.
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1. Introduction

The 1990s probably will be remembered, among other things, as the decade in which average inflation came under control around the world. According to the IMF, average inflation in industrialized economies between 1982 and 1991 was 4.9%; at the end of

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Table 1a
Inflation in selected regions of the world

	Average									
	1982–1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP deflator										
Advanced countries	4.9	3.2	2.7	2.2	2.3	1.8	1.7	1.4	0.8	1.4
Consumer prices										
Advanced countries	4.9	3.5	3.1	2.6	2.6	2.4	2.1	1.5	1.4	2.3
Developing countries	45.1	42.8	48.7	55.3	23.2	15.4	10.0	10.6	6.9	6.1
Africa	19.5	47.1	39.1	54.7	35.3	30.2	14.6	10.9	12.3	14.2
Asia	9.7	8.6	10.8	16.0	13.2	8.3	4.8	7.7	2.5	1.9
Western Hemisphere	163.0	150.1	195.2	200.2	36.0	21.2	12.9	9.8	8.9	8.2

Source: World Bank, *World Development Indicators*, 2001.

1999, it was 0.8% as measured by the GDP deflator (Table 1a). More remarkably, average inflation in developing countries went from 45.1% between 1982 and 1991 to 6.9% in 1999. The 1990s also will be remembered as the "globalization" decade. Trade of goods as a percentage of PPP GDP went from 21.2% in 1988 to 28.3% in 1998 (Table 1b). This increase is even more striking when analyzed as a percentage of goods production, which increased from 71.9% in 1988 to 92.1% in 1998. Although concerns remain about lingering tariffs, nontariff barriers, and other protectionist practices, it is hard to deny that the global economy has become more integrated.

The obvious question is then: Are these events related? Romer's (1993) work shows that inflation and openness are negatively and significantly correlated. Using Kydland and Prescott (1977) and Barro and Gordon (1983) type models, Romer argues that the negative openness–inflation relationship arises from the dynamic inconsistency of discretionary monetary policy. Romer's empirical work, using cross-country averages spanning more than a decade (beginning in 1973), tests the long-run commitment effect of openness on restricting the usefulness of discretionary monetary policy. The question remains, however, whether openness or other mechanisms bind in a short-term horizon. In this paper, I test whether openness serves as a commitment mechanism for restraining inflation in the short run. In addition, I consider the role of other variables that affect the short-term dynamics that drives inflation and the time inconsistency problem, in particular the exchange-rate regime.

Table 1b
Integration with the global economy: trade in goods

	% Share of PPP GDP		% Share of goods GDP	
	1988	1998	1988	1998
World	21.2	28.3	71.9	92.1
Low income	6.8	8.3	38.6	62.5
Latin America and Caribbean	9.4	19.1	52.3	74.5
Sub-Saharan Africa	15.4	16.8	73.2	99.5
High income	28.3	38.3	75.2	95.1

Source: World Bank, *World Development Indicators*, 2001.

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