

BOFIT Discussion Papers  
2 • 2005

likka Korhonen — Paul Wachtel

# A note on exchange rate pass-through in CIS countries



Bank of Finland, BOFIT  
Institute for Economies in Transition

# BOFIT personnel 2005

## Economists

### **Mr Pekka Sutela, head**

Russian economy and economic policy  
Russia's international economic relations  
China in the world economy  
Pekka.Sutela@bof.fi

### **Mr Gang Ji, economist**

Chinese economy and economic policy  
Gang.Ji@bof.fi

### **Mr Juuso Kaarevirta, economist**

Chinese economy and economic policy  
Juuso.Kaarevirta@bof.fi

### **Ms Tuuli Koivu, economist**

Chinese economy and economic policy  
Editor-in-Chief of *BOFIT China Review*  
Tuuli.Koivu@bof.fi

### **Mr Iikka Korhonen, research supervisor**

Exchange rate policies in transition economies  
Monetary policy in transition economies  
Editor-in-Chief of *BOFIT Discussion Papers*  
Iikka.Korhonen@bof.fi

### **Ms Anna Mahlamäki, economist**

Russian economy and economic policy  
Anna.Mahlamaki@bof.fi

### **Mr Simon Ollus, economist**

Russian economy and economic policy  
Simon.Ollus@bof.fi

### **Mr Jouko Rautava, economist**

Russian economy and economic policy  
Editor-in-Chief of *BOFIT Online*  
Jouko.Rautava@bof.fi

### **Ms Laura Solanko, economist**

Russian regional issues  
Public economics  
Editor-in-Chief of *BOFIT Russia Review*  
Laura.Solanko@bof.fi

### **Ms Merja Tekoniemi, economist**

Russian economy and economic policy  
Merja.Tekoniemi@bof.fi

## On leave of absence

Mr **Vesa Korhonen**, email: Vesa.Korhonen@ecb.int

Ms **Seija Lainela**, email: Seija.Lainela@formin.fi

Mr **Jian-Guang Shen**, email: Jian-Guang.Shen@ecb.int

## Information Services

### **Mr Timo Harell, editor**

Press monitoring  
Editor-in-Chief of *BOFIT Weekly*  
Timo.Harell@bof.fi

### **Ms Liisa Mannila, department secretary**

Department coordinator  
Publications traffic  
Liisa.Mannila@bof.fi

### **Ms Päivi Määttä, information specialist**

Institute's library  
Information services  
Paivi.Maatta@bof.fi

### **Ms Tiina Saajasto, information specialist**

Statistical analysis  
Statistical data bases  
Internet sites  
Tiina.Saajasto@bof.fi

### **Ms Liisa Sipola, information specialist**

Information retrieval  
Institute's library and publications  
Liisa.Sipola@bof.fi

## Contact us

Bank of Finland  
BOFIT – Institute for Economies in Transition  
PO Box 160  
FIN-00101 Helsinki

Phone: +358 10 831 2268  
Fax: +358 10 831 2294  
E-mail: bofit@bof.fi  
Internet: www.bof.fi/bofit

BOFIT Discussion Papers  
2 • 2005

likka Korhonen – Paul Wachtel

## **A note on exchange rate pass-through in CIS countries**

BOFIT Discussion Papers  
Editor-in-Chief Iikka Korhonen

BOFIT Discussion Papers 2/2005  
10.6.2005

Iikka Korhonen and Paul Wachtel  
A note on exchange rate pass-through in CIS countries

ISBN 951-686-990-4  
ISSN 1456-4564  
(print)

ISBN 051-686-991-2  
ISSN 1456-5889  
(online)

Multiprint Oy  
Helsinki 2005

# Contents

Abstract.....	5
Tiivistelmä .....	6
1 Introduction.....	7
2 Brief literature survey .....	8
3 Data .....	10
4 VAR estimation results.....	13
5 Pass-through calculations and discussion.....	14
6 Concluding remarks .....	21
References.....	23
Appendix.....	24

All opinions expressed are those of the authors and do not necessarily reflect the views of the Bank of Finland.

Iikka Korhonen and Paul Wachtel

## A note on exchange rate pass-through in CIS countries

### Abstract

We assess the extent and speed of exchange rate pass-through in the countries of the Commonwealth of Independent States (CIS). We do this in the framework of vector autoregressive regressions, utilising impulse functions and variance decompositions with monthly data that starts in 1999 in order to avoid periods of very high inflation and the Russian crisis. We find that exchange rate movements have a clear impact on price developments in the CIS countries. The speed of the pass-through is also fairly high: in most cases the full effect is transmitted into domestic prices in less than 12 months. Unlike in many other emerging market economies, an additional effect from US prices on to domestic prices is not significant. The extent of the exchange rate pass-through is usually much higher than in our benchmark group of emerging market countries. Variance decomposition shows that the relative share of exchange rates in explaining changes in domestic prices is higher in the CIS countries than in the benchmark group. Our results indicate that policy-makers in the CIS countries need to pay more attention to exchange rate movements than in many other emerging market countries.

Key words: exchange rate pass-through, inflation, exchange rate regime, transition countries  
JEL: E31, E42, F31, F42

---

Iikka Korhonen, Bank of Finland, Paul Wachtel, <sup>\*</sup> Stern School of Business, New York University

---

<sup>\*</sup> We would like to thank Anna Dorbec and Lucio Vinhas de Souza for useful comments on earlier drafts of the paper. We have also benefited from discussions in the BOFIT/CEFIR workshop in Moscow and the sec-

---

likka Korhonen and Paul Wachtel

## A note on exchange rate pass-through in CIS countries

### Tiivistelmä

Tässä työssä tutkitaan valuuttakurssimuutosten välittymistä hintoihin Itsenäisten valtioiden yhteisön (IVY) alueella. Analyysissa käytetään vektoriautoregressiivisiä malleja ja niistä johdettuja impulssivasteita sekä varianssihajotelmia. Tutkimuksessa käytetty tilastoaineisto alkaa vuoden 1999 alusta, minkä ansiosta vältetään sekä hyvin voimakkaan inflaation että Venäjän talouskriisin periodit. Tulosten mukaan valuuttakurssien vaihtelulla on ollut selvä vaikutus hintojen kehitykseen IVY-maissa. Valuuttakurssimuutoksien vaikutus hintoihin on myös varsin nopea; lähes vaikutus voidaan havaita hinnoissa alle 12 kuukaudessa. Toisin kuin monissa muissa kehittyvissä talouksissa, Yhdysvaltain kuluttajahintaindeksin muutokset eivät vaikuta IVY-maiden hintoihin. IVY-maissa valuuttakurssimuutosten vaikutus hintoihin on keskimäärin selvästi suurempi kuin useimmissa kehittyvissä talouksissa. Varianssihajotelmat paljastavat myös, että IVY-maissa valuuttakurssit selittävät selvästi suuremman osan hintojen vaihtelusta kuin muissa kehittyvissä talouksissa. Tuloksien mukaan IVY-maiden on kiinnitettävä enemmän huomiota valuuttakursseihin talouspolitiikassaan kuin muiden kehittyvien talouksien.

Asiasanat: valuuttakurssien vaikutus hintoihin, inflaatio, valuuttakurssijärjestelmä, siirtymätaloudet



# 1 Introduction

The 12 CIS countries (the former Soviet Union less the Baltics) are a widely disparate group of transition countries. The CIS includes both some very large economies (e.g. Russia and the Ukraine) and some very small countries (e.g. Moldova); some countries are very closely tied to the developed world through the energy industry (e.g. Kazakhstan) and some are very isolated (e.g. Armenia). All of the CIS countries experienced several years of very high inflation in the early 1990s although the median annual inflation rate fell to 44% in 1996 and has been below that ever since. The median has been below 10% since 2002 and annual inflation rates in excess of 20% are rare exceptions (Wachtel and Korhonen, 2004). Our intent in this note is to examine one of the important influences on this remarkable disinflation, the behaviour of exchange rate pass-through. We will examine the extent and speed of exchange rate pass-through on the domestic price level in the CIS countries, which will provide some indication of their integration in the world economy. The issue could not be examined before because many of these countries were highly unstable through most of the 1990s and reliable monthly inflation data were often unavailable. Moreover, even the larger, more developed CIS countries were buffeted by the Russian financial crisis in 1998. However, there are now approximately six years of post crisis data, which warrant a closer examination of the economic integration of the CIS countries in the world economy.

In the following sections we examine the relationships among domestic inflation, foreign inflation and the exchange rate movements for a number of CIS countries and compare the results with those for a benchmark group of emerging market economies.<sup>1</sup> In our empirical work we emphasise comparability across specifications. Therefore we do not try to model individual country experiences in great detail, but hope to find some general trends among these countries that we will compare to a benchmark group of emerging market countries. First, we examine the stationarity of the individual series. Not surprisingly, they all seem to be non-stationary, a result that would be observed for most developed economies as well. Second, we test for the existence of a cointegrating relationship among the three variables in each country. The presence of a cointegrating relationship would indicate the stationarity of the real exchange rate, which would usually be observed

---

<sup>1</sup> Due to a lack of data, we had to omit several smaller CIS countries.

among most developed economies. The results for the CIS countries are mixed; there is little indication of the existence of stationarity in the real exchange rate. Since there are no cointegrating relationships, we estimate vector autoregressive (VAR) models without error correction terms. VAR systems are estimated for each country by using the log differences of the variables and the estimates are then used to examine the pass-through relationships using impulse response functions and variance decompositions.

We find that the adjustment of domestic price levels to exchange rate shocks tends to be quite fast, although far from complete. However, the extent of the pass-through seems to be clearly higher in the CIS countries than in our comparison group of other emerging market countries.

The paper is structured as follows. In the next section we provide a brief literature survey on exchange rate pass-through, concentrating on contributions relating to transition and emerging market countries. In section three we discuss the data and note its time series properties. In section four we estimate the VAR models, which form the basis for our pass-through calculations. These calculations are performed and discussed in section five, which is followed by our conclusions.

## 2 Brief literature survey

The literature on exchange rate pass-through and the law of one price reflects considerable surprise that economies generally have appeared to be less fully integrated with each other than could be anticipated. The law of one price is violated by large margins and the exchange rate pass-through is far from complete in developed as well as developing countries. In the 1980s explanations focused on microeconomics, pricing behaviour (e.g., the currency used for invoicing, the role of mark-up pricing and competitive strategy). In the 1990s research interest focused on macroeconomic influences such as the role of macro stability, exchange rate regimes, stabilization policies and financial crises on the pass-through. The empirical literature originally focused on the major developed economies but more recent work has examined developing economies, including the transition economies but not the CIS countries.

Goldberg and Knetter (1997) summarize the extensive literature on pass-through and the law of one price and show why incomplete pass-through persists even as trade and economic integration increase. More recent developments including macroeconomic explanations are summarized by Frankel, Parsley and Wei (2005). They note that smaller countries, countries with a higher presence of foreign firms and less developed countries generally tend to have a higher pass-through of exchange rates on to prices. Moreover, there has been a downward trend in the extent of pass-through, which is partly due to the global decline in inflation. Careful analysis using disaggregated price data carried out by Frankel, et al. and Campa and Goldberg (2004) provide some explanations for the pass-through results. In addition to technical issues like the composition of imports, both strategic pricing in segmented markets and the stability of the macro environment play explanatory roles. However, much of the typically less than full pass-through and the trend remain unexplained.

The size of the pass-through is important for less developed economies because it has implications for the effectiveness of independent monetary policy. In transition economies, where price liberalization led to substantial inflation in the 1990s and where real exchange rate appreciation occurred with disinflation, the size of the pass-through is important to policy-makers.

A few papers have examined the interrelationships among exchange rates and inflation in the transition economies with time series methodologies that are similar to ours. Dibooglu and Kutan (2001) use cointegration tests and VAR models to analyze the relationship between real exchange rates and inflation in Poland and Hungary with monthly data for the 1990s. They find that nominal shocks (pass-through) had a greater impact on the real exchange rate in Poland than in Hungary. Coricelli, Jazbec and Maston (2003) estimate the exchange rate pass-through for four advanced transition economies and find that the pass-through is larger when there is less exchange rate management. Ganey et al. (2002) report similar results in ten transition economies.

To our knowledge, no one has studied these issues with data from the CIS countries. The pass-through relationships in these countries will indicate the extent of their integration in the world economy and also shed light on the efficacy of different approaches to monetary policy management.

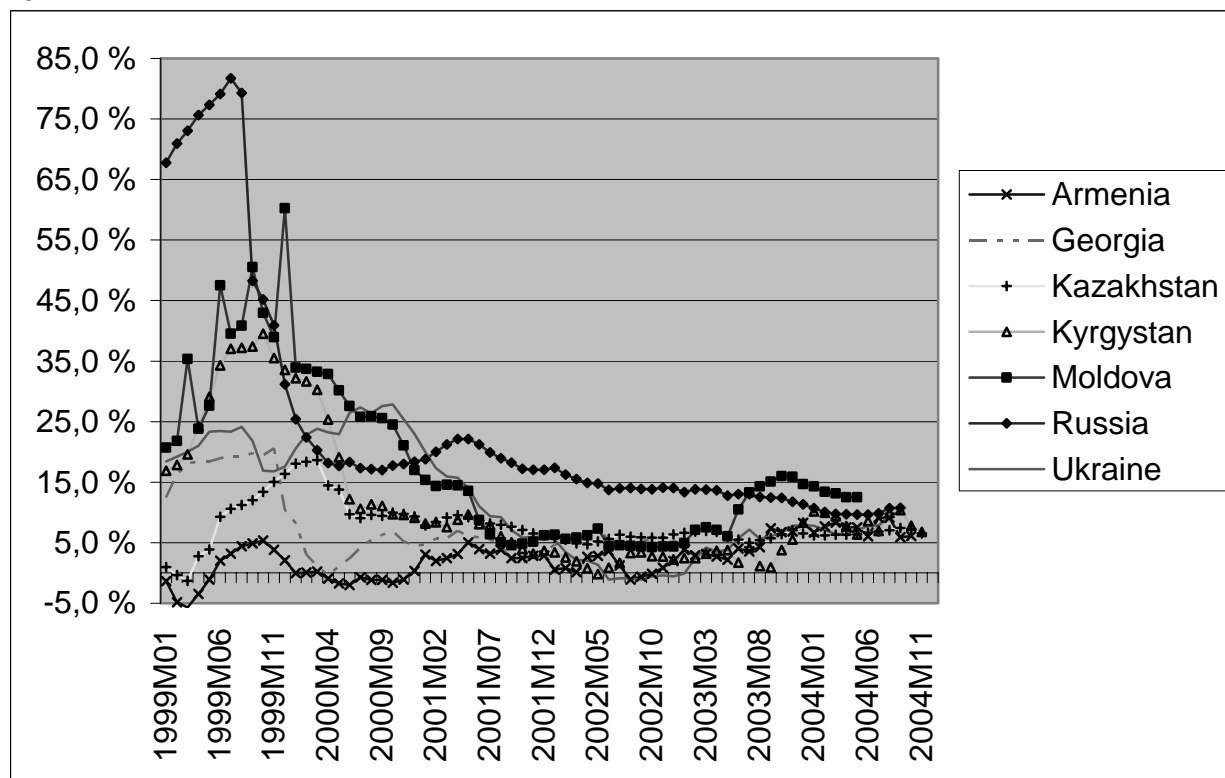
### 3 Data

We use monthly data from the beginning of 1999 until November or December 2004 in our estimations. Even though this is a fairly short sample (six years), we prefer to concentrate on this shorter sample than to include the period prior to the Russian crisis of August 1998. The crisis marked such a dramatic change in the exchange rate regime of Russia and several other CIS countries that it would most likely be futile to include data from the previous period in our estimations. Furthermore, by concentrating on more recent data, the analysis is hopefully more relevant for future policy discussions as well. The obvious downside of limiting the data sample in this way is that we have settled for fairly parsimonious model specifications.

All the data were taken from the IMF's International Financial Statistics database. To study exchange rate pass-through in the CIS countries, we used consumer price indices. While it would be preferable to examine import prices and consumer prices, separate import price indexes are not available for all of the CIS countries. The exchange rate is the monthly average exchange rate against the US dollar. This choice is motivated by the fact that many, if not most, CIS countries have continued to orientate their exchange rate management towards the US dollar. Also, their economies are still heavily dollarised, making the dollar exchange rate one of the most important relative prices in the economy.

In addition, we have used inflation data from the US and oil prices (Brent in US dollars) in our VARs. Inflation in the US was used to represent price pressures emanating from the rest of the world. For the European emerging markets, we have also estimated the models with euro exchange rates and euro area inflation. Finally, oil prices have been included as a source specific of price (and exchange rate) fluctuations. This may be especially relevant for some CIS countries. All the variables have been used in their log form. Figure 1 plots 12-month inflation rates in our sample of CIS countries.

Figure 1. Annual inflation in seven CIS countries



We have checked the stationarity of the time series with unit root tests. Our a priori expectation is that consumer price indices and exchange rates in the CIS countries are non-stationary. Inflation has been relatively high until recently and, while nominal exchange rates have often been heavily managed, they have tended to reflect the large inflation differential relative to the US. Also, the price of oil in this period shows a clear upward trend, implying non-stationarity.

Table 1 shows the results from unit root tests for seven CIS countries.<sup>2</sup> The data has been seasonally adjusted (X-12 procedure in EViews 5.0) prior to the unit root testing. The first column shows the ADF unit root test in which a significant result indicates that non-stationarity can be rejected. The null hypothesis for the KPSS test is stationarity. Most of the tests imply non-stationary levels. In some cases structural breaks (such as the exchange rate crisis in Argentina at the beginning of 2002) seem to affect the validity of the tests.

<sup>2</sup> Unit root tests for our benchmark emerging market countries also confirm the non-stationarity of the series in levels. The/Those results are not reported here, but are available from the authors upon request.

Taking into account also our theoretical priors, we conclude that the variables are indeed non-stationary. Therefore, we estimate the VARs in log-differences.<sup>3</sup>

Table 1. Unit root tests for the levels of variables

		ADF (constant as exogenous variable)	KPSS (constant as exogenous variable)
Armenia	CPI	3.428	0.848***
	Exchange rate	-1.439	0.367*
Georgia	CPI	-1.350	0.922***
	Exchange rate	-2.042	0.189
Kazakhstan	CPI	-2.841*	1.104***
	Exchange rate	-4.543***	0.499**
Kyrgyzstan	CPI	-3.353**	0.987***
	Exchange rate	-4.512***	0.245
Moldova	CPI	-7.322***	0.953***
	Exchange rate	-2.002	0.614**
Russia	CPI	-2.641*	1.087***
	Exchange rate	-3.120**	0.712*
Ukraine	CPI	-4.124***	0.494**
	Exchange rate	0.019	0.828
Oil		-2.869*	0.679**

\*, \*\* and \*\*\* denote rejection of the null hypothesis at the 10%, 5% and 1% significance levels, respectively. In the ADF test, the null hypothesis is that the time series is non-stationary, while in the KPSS test the null is that of stationarity.

<sup>3</sup> In addition, we tested for co-integration between domestic and foreign prices as well as the exchange rate in the CIS countries. In the majority of cases no co-integrating relationship could be found. In some cases a relationship may have been present, but its statistical significance was marginal at best. Also, in these cases the estimated long-run coefficients did not have any clear economic meaning. This may be because the time span is simply too short. Therefore, we proceed from the assumption that there are no long-run relationships in the data, and using a simple VAR is the best modelling strategy.

## 4 VAR estimation results

To maintain comparability across different countries, we start our estimation always with a similar set-up. All the data are in logs, and consumer prices have been seasonally adjusted. We start with a four-variable VAR, in which the variables are the first difference of the oil price, the first difference of the US consumer prices (to reflect international price movements), the first difference of the exchange rate (local currency per one US dollar) and the first difference of local consumer prices. The initial lag length is arbitrarily set at six (mainly in order to preserve degrees of freedom). Thereafter, we allow the data to determine the appropriate lag length and whether foreign prices are to be included in the final specification.

First, we look at the residuals. Obvious outliers (more than three standard deviations from the predicted value) are handled with dummies. Usually we can find a clear rationale for the timing of dummies. For example, sometimes even seasonally adjusted consumer prices exhibit spikes at the beginning of the year, if administratively set prices are adjusted more (or less) than is usually the case. Then we check whether foreign prices (i.e., US consumer prices) have a statistically significant effect (at the 10% significance level) either on domestic prices or on the exchange rate. If this is not the case, US prices are dropped. (We believe that neither CIS nor other emerging market countries' variables affect US prices.) After this, the optimal lag length is determined by Wald tests of lag exclusion. The resulting VAR specifications are once more checked for large outliers in the same manner as before. Details of resulting VAR specifications can be found in Table 2. Almost by construction, we have ensured that there are no large outliers. However, it should be noted that almost all VARs have only one or two dummies, which indicates that the basic specifications work reasonably well. In most cases the lag length is quite short, only two or three.

Table 2. Preferred VAR specifications

	Lag length	US prices included	Number of dummies
Armenia	2	no	2
Georgia	2	no	1
Kazakhstan	4	no	3
Kyrgyzstan	4	yes	1
Moldova	1	no	1
Russia	2	no	2
Ukraine	2	no	6
Brazil	1	no	3
Bolivia	3	no	1
Chile	3	no	0
Colombia	2	no	2
Croatia	3	yes	0
Czech Rep.	3	no	1
Hungary	2	yes	2
Indonesia	3	yes	3
Mexico	4	yes	0
Paraguay	4	yes	1
Peru	2	yes	1
Philippines	2	yes	0
Poland	2	yes	0
Romania	3	no	2
South Africa	3	yes	2
Slovenia	5	yes	0
Slovakia	6	yes	2
Thailand	4	yes	2
Turkey	3	no	3
Uruguay	6	yes	1

## 5 Pass-through calculations and discussion

Next, we use impulse response functions from the estimated VARs to assess the degree of pass-through in the CIS countries. In each of the VARs a one-unit shock is used to examine both the speed and extent of the pass-through. Because the series are in logs, this corre-



sponds to a 1% shock to the original variables. We can then calculate how large a fraction of the 1% innovation in the exchange rate is transmitted to the domestic prices.

We are interested in both the speed and extent of the pass-through. If the pass-through is very fast, domestic monetary policy can do little to affect the real exchange rate even in the short-run. This is even more true if changes in the nominal exchange rate are reflected one-to-one in the consumer prices. To assess these issues, we calculate a) how much of the one-unit exchange rate shock has been transmitted to the consumer prices at 12 and 24-month horizons, and b) how much of the final pass-through (at the 24-month horizon) has taken place at the 6 and 12-month horizons. In other words, first we try to calculate the extent of the pass-through and then its speed. We can then compare the speed and extent of the pass-through in the CIS countries to those of other emerging markets, as VARs have been estimated with the same specification.

Table 3 summarizes the results based on the VAR specifications in Table 2 from our first attempt at impulse responses. Some general conclusions seem to emerge. First, in the CIS countries the extent of the pass-through seems to be higher than in most countries in our comparison country group. Of course, this comparison group is not some randomly drawn sample of countries, but rather a handful of fairly advanced emerging market countries, both in terms of per capita GDP and at least somewhat functioning financial markets. In the majority of the emerging market cases the extent of the pass-through is almost negligible.

There are a handful of countries where the extent of the pass-through is roughly comparable to that of the CIS countries: Peru, Slovenia, South Africa, Turkey and Uruguay. It may be hard to find a common denominator for these countries, but some observations on their exchange rate policies may be offered. Slovenia has pursued a crawling peg regime against the euro, and the objective of its central bank appears to have been to keep the real exchange rate constant. Shocks to the exchange rate have, therefore, been accommodated by the central bank. In South Africa the exchange rate depreciated markedly during the latter half of 2001, although it quickly reversed its trend. Such a large depreciation may lead to faster and more complete pass-through. Turkey experienced an exchange rate crisis in the beginning of 2001, and the Turkish lira depreciated more than 20% in one month. Although the level of the exchange rate stabilised fairly quickly, the exchange rate has been much more volatile since the crisis. High volatility may lead to fuller pass-through. Also Uruguay experienced an exchange rate crisis in early 2002. A sharp depre-

ciation of the exchange rate was followed by higher volatility. Therefore it appears that in our benchmark group a high level of exchange rate pass-through is mostly associated with large depreciations and their aftermaths. In the CIS countries no such obvious link can be detected.

The high pass-through observed in Romania appears not to be caused by any large depreciation of the Romanian leu. During 1999-2001 the Romanian currency depreciated quite steadily against the US dollar, while since 2001 the leu has been quite stable. Therefore, the observed pass-through may be caused by two factors. In the first period Romanian exchange rate policy targeted the real exchange rate, i.e., the policy was very similar to the one in Slovenia. This may explain the observed pass-through. Also, the high pass-through may be caused by Romania's relatively high degree of dollarisation.

In the CIS countries the extent of the exchange rate pass-through is reasonably high, with the exception of Georgia. Even in a relatively large country like Ukraine, a 1% increase (i.e., depreciation) in the exchange rate is associated with an increase of 0.64 percentage points in the inflation rate. However, one should note that in Armenia and Moldova the extent of the exchange rate pass-through is lower, in Armenia clearly so.

However, results from our very basic pass-through exercise are not very intuitive for a small number of countries. In the uniform set-up that we use, depreciation of the exchange rate is associated with *lower* inflation in Kazakhstan, Russia, Bolivia, Mexico and Indonesia. Moreover, the absolute size of the impulses is implausibly large in the case of Indonesia and Kazakhstan. Merely noting the five countries affected by this problem, one could guess that prices of raw materials, and especially energy, may have something to do with the result. In recent years (practically throughout our sample period), oil prices have increased quite rapidly. In our VARs the price of oil may be interacting with the nominal exchange rate and domestic consumer prices in surprising ways. Higher oil revenues put pressure on the real exchange rate to appreciate. However, central banks in many CIS countries (including Russia) have tried to limit the nominal appreciation of their currencies, leading ultimately to higher inflation. Therefore part of the real appreciation comes from the nominal exchange rate, part from domestic prices. In the data it may seem that currency appreciation is correlated with higher inflation, which is somewhat counter-intuitive, unless one takes into account the effects of oil prices.

For these five countries we also experimented with alternative specifications. When we leave out also oil prices from the VAR specifications, impulse responses in Russian and

Mexican VARs are more in line with the results from other countries, i.e., depreciation of the exchange rate increases inflation. In Russia a 1% increase in the exchange rate increases inflation by 0.2 percentage points during the following 24 months. This effect is fully realised already after 12 months. Therefore, including oil prices in a major oil-producing country may bias the results somewhat. In Mexico the extent of the pass-through after 24 months is very similar to other countries, 0.03. However, the same adjustment does not change the situation in Bolivia, Indonesia or Kazakhstan.

Another potential source of errors in our calculations is the choice of exchange rate. For reasons of comparability, the US dollar was used for all the countries. Many emerging market countries around the globe have used the US dollar as a reference currency in their exchange rate policy, and dollarisation remains widespread. However, it may very well be that the euro is more relevant at least for European emerging markets.<sup>4</sup> Many of these countries had by 1999 started to anchor their exchange rates on the euro (and earlier the D-mark). Also, in many Eastern European countries cash euros (and earlier D-marks) are widely used. Therefore, we replicate the VAR estimations and pass-through calculations for European countries with the euro area inflation and exchange rates against the euro. The results are reported in the Appendix.

First, Table A1 reports the preferred specifications as in Table 2. Then, Table A2 gives the corresponding calculations for the extent and speed of the exchange rate pass-through. For our benchmark group, we can see that the pass-through from the euro exchange rate to consumer prices is clearly higher in the countries which have generally oriented their economic policies towards the EU and the euro area: Croatia, the Czech Republic, Hungary, Slovenia and Slovakia. However, the speed of the pass-through appears to be slower. The exception is Poland, where the extent of the pass-through actually declines. In Romania and Turkey it is also clearly lower, as these countries have pegged their currencies at least informally mainly to the US dollar. These results show that the choice of the relevant exchange rate can have a large influence on the estimated pass-through. Nevertheless, European CIS countries seem to be quite clearly within the dollar's zone of influence. The pass-through from euro exchange rates is lower in Moldova and Ukraine. In Russia the negative pass-through observed already with the rouble/dollar rate is somewhat smaller in

---

<sup>4</sup> Of course, for many smaller CIS countries also the pass-through from the rouble exchange rate into prices might be relevant. However, given the observed exchange rate policy of Russia during the period under study, it might be difficult to disentangle the effects of the US dollar and the rouble rates. Therefore, we do not pursue this issue further.

absolute size. It appears that if the pass-through is important in the CIS countries, it relates to the US dollar, not to the euro.

Table 3. Extent and speed of exchange rate pass-through

	Extent of pass-through		Speed of pass-through	
	12 months	24 months	6 months	12 months
Armenia	0.25	0.25	1.03	1.00
Georgia	0.14	0.14	1.05	0.99
Kazakhstan	-2.01	-4.00	0.19	0.50
Kyrgyzstan	1.35	1.62	0.61	0.83
Moldova	0.49	0.49	1.02	1.00
Russia	-0.42	-0.42	0.80	1.01
Ukraine	0.63	0.64	0.79	0.98
Brazil	0.02	0.02	1.00	1.00
Bolivia	-1.49	-1.71	0.50	0.87
Chile	0.07	0.07	1.00	1.00
Colombia	0.05	0.05	0.98	1.00
Croatia	0.06	0.06	1.04	0.99
Czech Rep.	0.03	0.03	1.04	1.00
Hungary	0.06	0.06	0.69	0.94
Indonesia	-0.97	-1.51	0.27	0.64
Mexico	-0.09	-0.10	0.72	0.88
Paraguay	0.01	0.01	1.03	0.96
Peru	0.20	0.20	1.05	0.98
Philippines	0.03	0.03	1.00	1.00
Poland	0.09	0.09	0.81	1.00
Romania	0.88	1.13	0.44	0.77
South Africa	0.17	0.19	0.66	0.92
Slovenia	0.16	0.18	0.65	0.87
Slovakia	0.05	0.05	-0.06	0.93
Thailand	0.01	0.01	1.55	0.94
Turkey	0.31	0.38	0.56	0.83
Uruguay	0.30	0.31	0.40	0.96

We also used variance decomposition from the VARs to assess the relative importance of different variables in affecting the domestic inflation. Variance decompositions tell us how large a share of variation in any endogenous variable can be explained by stochastic innovations of that and the other variables of the VAR. In variance decompositions the variables are ordered so that oil comes first, US prices (if present) are second, followed by bilateral exchange rates and finally domestic prices. This means, e.g., that concomitant shocks to US prices, bilateral exchange rates and domestic prices do not affect oil prices, while oil affects all the other variables also contemporaneously. In the same vein, shocks to US prices affect exchange rates and domestic prices, but in the same period the causality does not run the other way.

Table 4 offers the results of variance decompositions. We can see that the largest effect of the exchange rate on domestic prices can be found in two very small CIS economies, Kyrgystan and Moldova, as well as in Uruguay, where the exchange rate depreciated markedly during the sample period. Otherwise, shocks to the exchange rate tend to have only a modest effect on inflation, sometimes smaller than oil prices.

Table 4. Results of variance decomposition, relative effect on domestic prices after 24 months

	Oil	US prices	Exchange rate	Domestic prices
Armenia	0.50		4.57	94.93
Georgia	11.08		7.76	81.16
Kazakhstan	1.86		0.20	97.94
Kyrgyzstan	6.19	13.62	29.14	51.04
Moldova	5.86		59.94	34.19
Russia	6.45		3.96	89.59
Ukraine	6.73		2.70	90.56
Brazil	9.33		4.89	85.79
Bolivia	13.39		6.27	80.34
Chile	8.73		17.91	73.37
Colombia	0.19		6.80	93.01
Croatia	11.50	12.19	9.09	67.22
Czech Rep.	2.98		7.32	89.70
Hungary	7.72	3.78	14.85	73.65
Indonesia	13.53	0.47	14.37	71.64
Mexico	21.19	12.92	10.03	55.86
Paraguay	17.66	8.87	10.69	62.78
Peru	20.82	15.86	4.23	59.08
Philippines	5.12	0.47	9.98	84.44
Poland	4.82	3.27	9.22	82.69
Romania	3.90		32.57	63.53
South Africa	3.26	7.18	20.43	69.12
Slovenia	13.12	8.59	20.42	57.87
Slovakia	15.99	14.06	13.26	56.69
Thailand	32.85	9.68	1.61	55.86
Turkey	11.11		18.16	70.73
Uruguay	12.79	3.49	43.04	40.68

## 6 Concluding remarks

In this note we have assessed exchange rate pass-through in the CIS countries. As a benchmark we have used a fairly large number of emerging market countries. Exchange rate pass-through was examined in a framework of simple VAR models. A common parsimonious modelling strategy was chosen because of limited data availability and in order to maintain comparability across the countries.

We find that changes in exchange rates have a clear effect on consumer prices in the CIS countries. Moreover, this effect was larger than in the benchmark group. Changes in exchange rates are reflected in domestic prices fairly rapidly, usually in less than 12 months. This may reflect the high degree of dollarisation in many CIS countries. Also, several CIS countries are very small and dependent on foreign goods. However, in our sample of countries there appears to be no correlation between openness and the extent of the pass-through<sup>5</sup> (see Figure 2). However, if one looks only at countries where the extent of the pass-through is over 0.1, a positive correlation does emerge. This implies that other factors explain most of the pass-through, but if it is present, it may be stronger in more open economies.

It may also be that the extent of the pass-through is influenced by the level of inflation. Many previous studies have found the inflation rate to be negatively correlated with the extent of the pass-through. Figure 3 looks at the average inflation between 1999-2002 and the extent of the pass-through. Now some positive correlation seems to emerge, although it is far from perfect. This would imply that a regime of high (and possibly volatile) inflation encourages economic agents to follow more closely exchange rate changes in their pricing decisions.

We also find that prices in the CIS countries are largely driven by their own dynamics, which is not surprising given that the liberalization of prices took place during our sample period. Since inflation has fallen dramatically in most of these countries, domestic policy must have been successful in changing expectations.

Our results have also some clear policy implications. Policy-makers in the CIS countries need to pay attention to their exchange rates, as they have an effect on inflation

---

<sup>5</sup> Estimates for the extent of the pass-through in Figures 2 and 3 are 24-month values taken from Table 3.

developments. Even though the degree of exchange rate pass-through is perhaps lower than expected, it is still higher than in many other emerging market economies.

Figure 2. Relationship between openness and pass-through

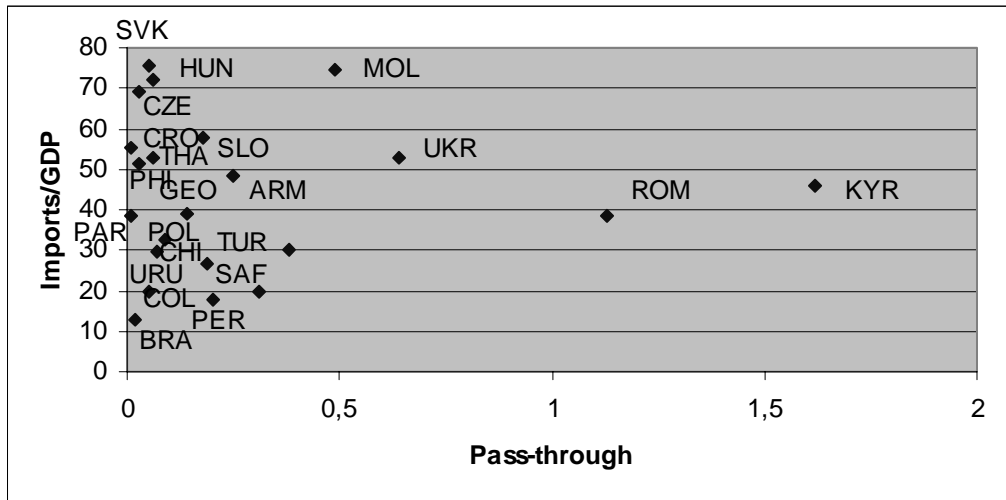
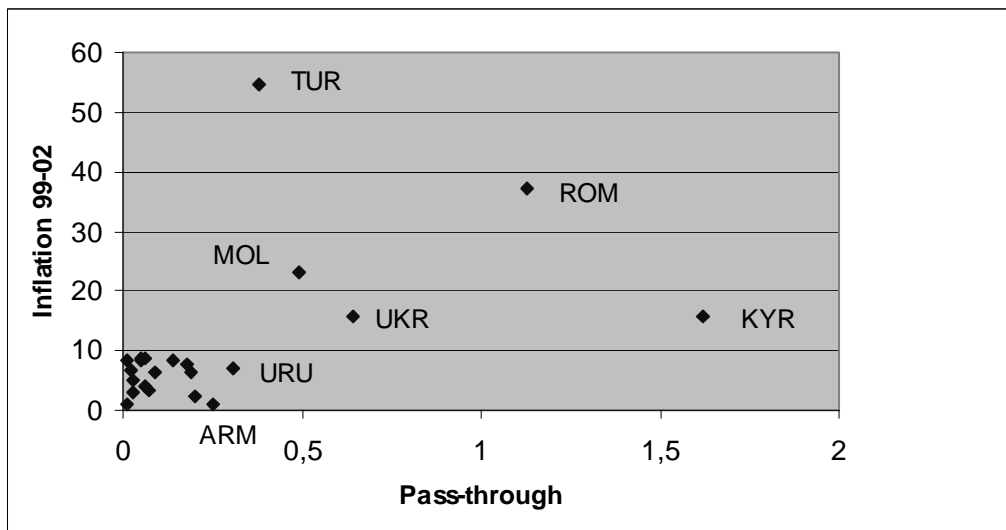


Figure 3. Relationship between average inflation and pass-through





## References

- Campa, Jose Manuel and Linda S. Goldberg, "Exchange rate pass through in import prices," CEPR Discussion Paper 4391, 2004.
- Dibooglu, Selahattin and Ali M. Kutan, "Sources of real exchange rate fluctuations in transition economies: the case of Poland and Hungary," *Journal of Comparative Economics*, 29, 2001.
- Frankel, Jeffrey, David Parsley and Shang-Jin Wei, "Slow Passthrough Around the World: A New Import for Developing Countries," NBER Working Paper 11199, 2005.
- Ganev, Georgy, Krisztina Molnar, Krzysztof Rybinski and Przemyslaw Wozniak, "Transmission Mechanism of Monetary Policy in Central and Eastern Europe," CASE Report No.52, 2002.
- Goldberg, Pinelopi and Michael Knetter, "Goods prices and exchange rates: What have we learned?" *Journal of Economic Literature*, 35, September 1997.
- Wachtel, Paul and Iikka Korhonen, "Disinflation in Transition Economies," BOFIT Discussion Paper 5/04, 2004.

## Appendix

Table A1. Preferred VAR specifications

	Lag length	Euro prices included	Number of dummies
Moldova	2	yes	2
Russia	6	no	0
Ukraine	4	no	1
Croatia	5	no	0
Czech Rep.	6	yes	0
Hungary	3	yes	5
Poland	2	yes	0
Romania	5	no	3
Slovenia	5	no	1
Slovakia	5	no	3
Turkey	5	no	3

Table A2. Extent and speed of exchange rate pass-through with the euro rates

	Extent of pass-through		Speed of pass-through	
	12 months	24 months	6 months	12 months
Moldova	0.43	0.45	0.82	0.97
Russia	-0.24	-0.21	0.56	1.13
Ukraine	0.24	0.28	0.56	0.86
Croatia	0.09	0.14	0.33	0.68
Czech Rep.	0.09	0.07	0.59	1.31
Hungary	0.22	0.31	0.42	0.73
Poland	-0.03	-0.03	0.78	1.00
Romania	0.08	0.11	n/a	0.79
Slovenia	0.67	1.08	0.62	0.72
Slovakia	0.17	0.15	1.14	0.92
Turkey	0.13	0.12	1.09	1.06

- 2004**
- No 1 Balázs Égert: Assessing equilibrium exchange rates in CEE acceding countries: Can we have DEER with BEER without FEER? A critical survey of the literature
  - No 2 Leena Kerkelä: Distortion costs and effects of price liberalisation in Russian energy markets: A CGE analysis
  - No 3 Julius Horvath and Stanislav Vidovic: Price variability and the speed of adjustment to the law of one price: Evidence from Slovakia
  - No 4 Pertti Haaparanta and Mikko Puhakka: Endogenous time preference, investment and development traps
  - No 5 Iikka Korhonen and Paul Wachtel: Observations on disinflation in transition economies
  - No 6 Eugene Nivorozhkin: Financing choices of firms in EU accession countries  
*Published in: Emerging Markets Review (2005), ISSN 1566-0141. (Forthcoming.)*
  - No 7 John P. Bonin, Iftekhar Hasan, Paul Wachtel: Bank performance, efficiency and ownership in transition Countries
  - No 8 John P. Bonin, Iftekhar Hasan, Paul Wachtel: Privatization matters: Bank efficiency in transition countries
  - No 9 Balázs Égert and Kirsten Lommatzsch: Equilibrium exchange rates in the transition: The tradable price-based real appreciation and estimation uncertainty
  - No 10 Yuko Kinoshita and Nauro F. Campos: Estimating the determinants of foreign direct investment inflows: How important are sampling and omitted variable biases?
  - No 11 Akram Esanov, Christian Merkl, Lúcio Vinhas de Souza: Monetary policy rules for Russia
  - No 12 Greetje M.M. Everaert: The political economy of restructuring and subsidisation: An international perspective
  - No 13 Igor Vetlov: The Lithuanian block of the ECSB multi-country model
  - No 14 Michael Funke and Jörgen Rahn: Just how undervalued is the Chinese renminbi.  
*Published in: World Economy (forthcoming)*
  - No 15 Steven Rosefielde: An abnormal country
  - No 16 Juha-Pekka Koskinen, Tuuli Koivu and Abdur Chowdhury: Selecting inflation indicators under an inflation targeting regime: Evidence from the MCL method
  - No 17 Anna Dorbec: Liquidity provision in transition economy: the lessons from Russia
  - No 18 Iikka Korhonen: Does democracy cure a resource curse?
  - No 19 Bernadina Algeri: Trade specialisation patterns: The case of Russia
  - No 20 Jarko Fidrmuc and Iikka Korhonen: A meta-analysis of business cycle correlation between the euro area and CEECs: What do we know—and who cares?
  - No 21 Anatoly Peresetsky, Alexander Karminsky and Sergei Golovan: Probability of default models of Russian banks.
  - No 22 John Bonin and Paul Wachtel: Dealing with financial fragility in transition economies.
- 2005**
- No 1 Pertti Haaparanta and Jukka Pirttilä: Reforms and Confidence
  - No 2 Paul Wachtel and Iikka Korhonen: A note on exchange rate pass-through in CIS countries

Bank of Finland  
BOFIT – Institute for Economies in Transition  
PO Box 160  
FIN-00101 Helsinki

 + 358 10 831 2268  
bofit@bof.fi  
<http://www.bof.fi/bofit>