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Exchange Rate Channel and Economic Growth: Empirical Investigation in a Developing Country's Setup

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Abstract: Developing economies are different than developed economies in many aspects, i.e., in terms of institutional framework and political situation etc. Thus, the monetary policy needed in developing countries is also different than developed countries. The goal of this study is to investigate exchange rate channel of monetary transmission mechanism in a developing country's setup. The variables included in our analysis are interest rate, exchange rate, exports, consumer price index and gross domestic product. Johansen cointegration technique is applied to analyze the long run relationship among variables while multivariate VECM granger causality test is used to explore the direction of causality among the set of our variables. We use annual data ranging from 1980 to 2015 while taking account of the limitations of time series data. Our findings suggest that output has a negative long run relationship with exchange rate and interest rate, positive relationship with exports and no statistically significant relationship with inflation. Interest rate granger causes all four of our variables thus showing the power of this policy tool. Exchange rate causes exports, consumer price index and output which means exchange rate is the second most powerful variable in our analysis. Output is granger caused by interest rate, exports and exchange rate which confirms the sensitivity of output to these variables. Consumer price index is granger caused by all four of our variables and came out to be the most sensitive variable in our analysis.

Keywords: Exchange rate channel; Monetary transmission mechanism; Interest rate; Exchange rate; Inflation; Exports; Output; Economic policies; Cointegration; Granger causality.

1. Introduction

Since the seminal work by Friedman (1968), the role of monetary policy in macroeconomic stabilization is an inconclusive issue. Besides the development on theoretical grounds, a substantial body of empirical literature has contributed to the ongoing debate by providing significant evidence on how monetary policy impacts economic growth, prices and exchange rates. Undoubtedly, the implementation of the floating exchange rate system, financial reforms, the trade liberalization and comparatively more independent central banks have improved the significance of monetary policy. For further theoretical debates about monetary transmission mechanism, see Goodfriend (2005). Recent empirical work such as Bernanke *et al.* (2005), Bernanke and Mihov (1998), Eichengreen and Charles (1995) and Sims (1992) have significant contributions in the measurement of monetary policy and its innovations. These studies mostly apply the vector autoregressive (VAR) methodology to explore the response of macroeconomic variables to monetary policy shocks. Even though the findings of these papers provide significant evidence on the effect of changes in monetary policy on macroeconomic variables, such as real economic activity, price levels and exchange rates, there are various measurement problems and inconsistencies. These inconsistencies mostly include price, liquidity and exchange rate puzzles. In developing economies, monetary policy is more complicated and challenging because of the lack of well-developed financial markets and weak channels of monetary transmission. Due to the small financial markets and relatively weak channels of monetary transmission in developing economies, the relationship between money supply and macroeconomic variables tends to be weak and inconsistent. In particular, most of the empirical studies have focused on developed economies. Therefore, we know relatively little about how monetary policy shocks affect macroeconomic variables, i.e., output, price levels and exchange rates, respond to in developing economies. Yet, understanding the effects of monetary policy on macroeconomic variables of developing economies is of importance to policymakers and academicians in order to enhance macroeconomic

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