

Transmission of nominal exchange rate variation to domestic prices and monetary policy in Tunisia

Fatma Siala Guermazi* and Fatma Marrakchi Charfi**

Abstract:

Since the end of 1987, Tunisia had targeted a stable real exchange rate to maintain competitiveness, rather than a nominal exchange rate that would serve as an anchor for inflation expectations. Indeed, the monetary authorities adjust the nominal exchange rate to compensate for the differential of inflation relative to the trade partners. However, this strategy may lead monetary authorities to lose control on inflation, particularly as; Tunisia is opening its capital market to international capital flows becoming more vulnerable to external shocks. Besides, Tunisia is moving towards more flexible exchange rate regime and a monetary policy focused on preserving price stability, so understanding and quantifying nominal exchange rate changes transmission into inflation is of great importance. A monetary policy which is aiming to preserve price stability requires the estimation of inflation reaction to nominal exchange rate movements known as "Pass through".

The purpose of the paper is to assess this pass-through, in focusing on the relationship between inflation and the real exchange rate. It is important to make a distinction between the pass through of exchange rate changes into the price of non-tradables and into the domestic price of tradables. Based on the standard definition of the real exchange rate referred to as the domestic relative price of tradable to non-tradable goods and in line with S. Edwards' model (2006), we try to separate the reaction of the prices of tradables to variations in the nominal exchange rate of non-tradables prices. This question is addressed by estimating a VAR model, on a quarterly basis for the period 1980-2009, gathering national prices, nominal exchange rates, foreign prices and control variables as interest rate and a monetary aggregate. Results seem to show a small amount of pass-through due basically to the composition of Consumption Price Index (CPI) which is administrated for the 1/3 of its components in Tunisia.

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*Fatma Siala Guermazi
Faculty of Economic Science and Management, Tunis, Tunisia
University Tunis Elmanar

**Fatma Marrakchi Charfi
Faculty of Economic Science and Management, Tunis, Tunisia
University Tunis Elmanar