How important are nominal shocks for real exchange rate fluctuations? Evidence from inflation targeting emerging market economies

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Abstract

This study compares the importance of the nominal shocks in explaining the real exchange rate fluctuations before and after the adoption of inflation targeting regime in emerging market economies. We follow the structural VAR methodology proposed by Clarida and Gali (1994) to identify the macroeconomic shocks that determine fluctuations in relative output growth, relative inflation and the real exchange rate. The structural decomposition shows that real shocks account for most of the variation in the real exchange rate. Furthermore, findings indicate that the explanatory power of the nominal shocks in the real exchange rate fluctuations have increased after the implementation of the inflation targeting regime.

***JEL Classification**:* C32, F31, F41.

***Keywords**:* Real Exchange Rate, Monetary Shocks, Nominal Shocks, Real Shocks, Structural Vector Autoregression (SVAR), Emerging Market Economies, Inflation targeting regime.

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