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The Effect of Oil Prices on Exchange Rates: A Case Study of the Dominican Republic

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THE EFFECT OF OIL PRICES ON EXCHANGE RATES: A CASE STUDY OF THE DOMINICAN REPUBLIC

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Oil imports represent a significant fraction of the trade balance for energy-dependent economies. In the case of small open economies with floating exchange rates, increasing world oil prices are expected to have a large impact on the relative value of the currency. This relationship between the price of oil and the exchange rate has been well-established by the literature for oil-producing countries but not for oil-importing countries. This paper uses the case of the Dominican Republic, an energy-dependent small open economy with a floating exchange rate, to illustrate this connection. Two types of econometric analysis are used: multivariate regression and cointegration. Data are in monthly observations for the period 1991- 2005 and come from the Central Bank of the Dominican Republic and from several domestic sources. The real exchange rate is regressed on several variables including the price of oil, the relevant interest rates, past values of the exchange rate, and a trade balance variable. Results for the multivariate analysis show that increasing world oil prices do indeed put depreciating pressure on the value of the Dominican Republic's peso. Thus, increasing world oil prices cause other non-energy imports to be more expensive for the Dominican Republic. Cointegration results show that this relationship is more relevant in the short run than in the long run.