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**EDITORIAL**

**Exchange rate pass-through mechanism**

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MANY small and open countries in Asia and elsewhere have historically been averse to allowing more than a moderate degree of exchange rate flexibility because of concerns about how such movements might feed into domestic prices. To be sure, small and open economies are most potentially vulnerable to exchange rate pass-through into domestic prices in view of the high share of tradable goods, high import content of domestic production and exports, and generally high degree of integration with the global trading system. Nonetheless, the actual extent of such exchange rate pass-through into domestic prices appears to have been fairly low in recent times. In other words, there seems to be a growing degree of disconnect between exchange rate changes and domestic consumer prices in general, or, for that matter, even into wholesale or import prices.

Of course, part of the reason for this lack of significant exchange rate pass-through may be because monetary authorities take countervailing action to keep inflation within its target (i.e. tighten monetary policy) when the exchange rate depreciates. However, the low exchange rate pass-through may occur independent of monetary policy intervention, if exporters choose to absorb a portion of the exchange rate change. In other words, firms may engage in "pricing-to-market", which effectively implies that firms with market power are able to sell the same product at different prices in different markets or countries.

There are a number of reasons why firms might choose to engage in strategic pricing in international trade in response to exchange rate variations.

First, if an import destination has a history of low inflation and relatively stable prices, exporters to that nation may refrain from passing on exchange rate changes substantially, especially when the magnitude of the exchange rate change is small. In view of the costs associated with changing prices and potential loss of reputation and market share by

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unilaterally raising prices, exporters may be more willing to absorb the exchange rate effects and keep domestic prices unchanged. As such, there may be a virtuous cycle of low inflation, small exchange rate changes and low exchange rate pass-through.

Second, is the duration of exchange rate changes. With frequent and temporary exchange rate movements (which occur with a flexible exchange rate regime), exporters may be more willing to accept a temporary cut in profit margins to maintain market share, particularly with rising price competition worldwide.

Third, and potentially most important, is the extent of competition in the import market. If exporters do not face much competition, then exporters may be somewhat less responsive to fluctuations in the value of the exporter's currency against the buyers. Conversely, if the destination market is highly competitive, firms attempt to guard their market share by absorbing exchange rate changes by accepting lower mark-ups. The willingness to accept lower domestic unit prices in turn leads to lower levels of exchange rate pass-through. In general, a country with large and highly competitive markets such as the US experiences far lower pass-through than smaller economies.

Fourth, different industries also experience varying degrees of exchange rate pass-through. For instance, manufactured goods experience lower exchange rate pass-through than agriculture products. Thus, at a macro level, the changing composition of a nation's imports -- away from raw materials and energy imports towards manufacturing imports -- may be among the main factors in explaining the relatively lower degrees of exchange rate pass-through in both developed and developing countries over time.

Sixth, and in relation the above, when thinking about trade in manufactured goods, especially in Asia, it is important to pay close attention to the role of cross-border "production fragmentation". This refers to the dispersion of separate production blocks of an integrated production process across different countries. Thus, merchandise trade no longer just involves final goods and services, but also the international exchange of parts and components (PCAs). PCA trade is characterized by low domestic value-added, intense competition, and US dollar currency invoicing, all of which seem to have worked in tandem to reduce the extent of exchange rate pass-through even further.

In conclusion, policy makers are particularly concerned about the extent and speed of exchange rate pass-through. If pass-through is low, adjustment in the exchange rate to improve the trade balance may be relatively ineffective. This is a concern in the case of the persistent US trade deficit despite secular

declines in the US dollar. Conversely, low exchange rate pass-through implies that there may be less need to be concerned about the potential inflationary consequences of exchange rate fluctuations.

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