Endogenous Exchange Rate Pass-Through When Nominal Prices Are Set in Advance

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Summary

This paper develops a model of endogenous exchange rate pass-through in an open economy macroeconomic framework. The analysis is particularly focused on the feature that both exchange rate pass-through and the equilibrium exchange rate are simultaneously determined, and interact with one another. Exchange rate pass-through is endogenous because firms choose the currency in which they set their export prices, in advance of price setting. But at the same time, the volatility of the nominal exchange rate is itself determined by the aggregate degree of exchange rate pass-through. This two-way interaction between exchange rate volatility and pass-through can give rise to multiple equilibria. But there is a unique equilibrium rate of pass-through under the condition that exchange rate volatility rises as the degree of pass-through falls. We show that the relationship between exchange rate volatility and the underlying structural parameters of the economy may be substantially affected by the presence of endogenous pass-through. In addition, we highlight a link between monetary policy and exchange rate pass-through. Our key results show that pass-through is related to the *relative* stability of monetary policy. Countries with relatively low volatility of money growth will have relatively low rates of exchange rate pass-through, while countries with relatively high volatility of money growth will have relatively high pass-through rates.