Pricing in International Markets: A 'Small Country' Benchmark

October 2001

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Summary

How do exchange rate changes impact firms engaged in international trade? This question lies at the heart of debates over how disturbances in one economy 'spill-over' into other linked economies. At the macroeconomic level, these spillovers affect unemployment, inflation, growth, the stability of the financial system, and ultimately involve discussions as to the appropriate domestic policy response – including a country's optimal exchange rate regime.

This study looks at one side of the international trade issue. Specifically, the focus here is on how exporters respond to exchange rate changes. Most existing evidence on pass-through is taken from G7 countries and finds that export prices (in the importing currency) respond less than fully to exchange rate changes. The notable exception is for exports from the United States. Existing evidence suggests that exporters from the U.S. apparently do not mitigate export prices in response to exchange rates, while other countries' exporters routinely pass-through less than 100% of exchange rate changes.

This study provides a benchmark by which to interpret the puzzling behavior of U.S. export prices. This study examines exchange rate pass-through in a 'small-country' context. The study uses a panel of disaggregated exports from Hong Kong to its major flexible exchange rate destinations since 1992.

Econometrically, the study overcomes many of the problems – such as measurement error and simultaneity bias – plaguing traditional estimation methods. The approach here fully utilizes the three-dimensional aspects of the panel data set (time, destination markets, goods). The empirical model is an analysis-of-covariance model, and it is estimated via a fixed-effects regression model.

Empirically, Hong Kong's export price behavior overwhelmingly supports the competitive paradigm. In only a few cases is there evidence of less than complete pass-through by Hong Kong's exporters. These results are in stark contrast to what other researchers have found for (non-U.S.) G7 countries. The panel data set also allows an additional question to be addressed. In particular, there is no evidence of differences in pass-through across export destinations. Thus, by inference, near complete pass-through by U.S. exporters suggests similar competitive behavior.