

Exchange Rate Pass-Through in a Small Open Economy: Panel Evidence from Hong Kong

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Summary

The transmission of exchange rate changes to import prices is the subject of active discussion in both academic and policy-making circles. Besides the obvious implications for the path of domestic inflation and the possible response of monetary policy, analysts are interested in pass-through because exchange rate changes can potentially impact domestic market structure (Baldwin 1988, Froot and Klemperer 1989). More recently, studies have considered whether pass-through can impact domestic market structure in ways that influence optimal monetary policy (see e.g., Taylor 2000, Campa and Goldberg 2000).

At a more fundamental level, the rate of exchange rate pass-through is a key determinant of real exchange rate movements. In a recent study, Parsley (2001) finds that typically over 95% of real exchange rate movements among East Asian countries are attributable to failures of the law of one price. The only exception is for Hong Kong – where the corresponding number is only 50 to 75%. Hong Kong's experience with pass-through is of interest due both to its long-standing peg to the U.S. dollar, and to its very high degree of price flexibility (Zitzewitz 2000). On the one hand, this suggests that we should expect a higher degree of pass-through to Hong Kong than is typically found. However, working against this is the anecdotal evidence of widespread invoicing in U.S. dollars. If Hong Kong's imports are invoiced in U.S. dollars, bilateral variation in non-dollar exchange rates might have little impact on Hong Kong prices.

This paper presents estimates of exchange rate pass-through derived from a panel of very disaggregated import unit-values to Hong Kong. The estimation approach builds on that utilized by Knetter (1989, 1993) to study export pricing and pricing to market. The three-dimensional data set examined comprises Hong Kong's top eight floating exchange rate trading partners, and twenty-one of the top five-digit SITC imports since 1992. Pass-through estimates for Hong Kong imply relatively faster import price adjustment than is typically found for larger, less open economies. Specifically, it is not possible to statistically reject the hypothesis that exchange rate changes are fully passed through to import prices within one year. These compare to the 30% to 65% into the U.S. market found by other studies. These estimates are robust to a number of sensitivity tests. Finally these results confirm, from a different perspective, findings by Parsley (2001) that deviations from the law of one price play a relatively smaller role in real exchange rate movements for Hong Kong than for other East Asian countries.