# Price Setting and Exchange Rate Pass-through: Theory and Evidence

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## Summary

A large empirical literature has documented evidence of very low pass-through from exchange rates to consumer prices, both in industrial countries as well as some emerging market economies. But the explanation for this phenomenon has by no means been resolved. On the one hand, low pass-through could come about because of pricing-to-market behavior on the part of exporting firms, or a substantial local content in the final goods price of imports. But alternatively, low pass-through could be generated by the preponderance of sticky nominal prices in international trade. This paper develops a simple model of a small open economy in which the second explanation is highlighted. Exchange rate pass-through is determined by the frequency of price changes of importing firms. But this, in turn, is determined by the monetary policy rule of the central bank. 'Looser' monetary policy, which implies a higher mean inflation rate, and a higher volatility of the exchange rate, will lead to more frequent price changes and a higher rate of pass-through. The model implies that there should be a positive, but non-linear, relationship between pass-through and mean inflation, and a positive relationship between pass-through and exchange rate volatility. In a sample of 122 countries, this is strongly supported by the data. Our conclusion is that, at least partly, low exchange rate pass-through is a result of short-term price rigidities.