Exchange Rate Pass-Through and the Inflation Environment in Industrialized Countries: An Empirical Investigation

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Abstract

This paper investigates the question of whether a transition to a low-inflation environment, induced by a shift in monetary policy, results in a decline in the degree of pass-through of exchange rate movements to consumer prices. It differs from previous empirical work in its focus on the identification of changes in the inflation environment and its use of a panel-data approach. Evidence from a panel-data set of 11 industrialized countries over the period from 1977 to 2001 supports the hypothesis that exchange rate pass-through declines with a shift to a low-inflation environment brought about by a change in the monetary policy regime. More specifically, our empirical results suggest that pass-through to import, producer, and consumer price inflation declined following the inflation stabilization that occurred in many industrialized countries in the early 1990s. Interestingly, however, we find no evidence of a decline in pass-through following a similar episode of inflation reduction in the 1980s. Several potential explanations for this finding are discussed focusing on the important issue of the credibility of new monetary policy regimes.

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