Exchange Rate Pass-Through in Thailand's Import Industries

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I. INTRODUCTION

Since the collapse of the Bretton-Woods exchange rate system in 1973, thousands of articles have been published about studies of the law of one price, purchasing power parity, exchange rate pass-through, and pricing-to-market. However, the term exchange rate pass-through, referring to the response of import prices to exchange rate change, has evolved considerably over time. Initially, the model of balance of payments assumed a one-for-one response of import/export prices to exchange rates as a "full" or "complete" exchange rate pass-through. However, several studies suggest that exchange rate pass-through is less than complete where the price of foreign products sold in the domestic market changes by a lower percentage than do exchange rates.[1] After a long period of debate over the law of one price, beginning in the late 1980s exchange rate pass-through studies in industrial organization emphasized the role of segmentation and price discrimination across geographically distinct product markets. The rise of imperfect competition and strategic trade theory led researchers to estimate exchange rate pass-through at the industry level. Incomplete pass-through occurs when the markup of prices over marginal costs changes with exchange rate changes and performs as a non-zero markup. Because the non-zero markup is a deviation from conditions of perfect competition, an incomplete exchange rate pass-through validates the shift toward models of imperfect competition.

Besides the industrial organization approach, understanding the properties of exchange rate pass-through has been extended to explain appropriate monetary policy and exchange rate regime optimality. This concept explains that, when prices are not very responsive to exchange rates or a lower degree of exchange rate pass-through, monetary policymakers cannot rely on exchange rates to provide the necessary monetary expansion. As a result, customers in that country do not interpret exchange rate changes as relative price changes, which makes policy ineffective for stabilizing growth.[2] Exchange rate pass-through is also important for trade economists with regard to whether or not currency devaluation would improve a country's trade balance. With the small extent of pass-through, the nation's balance of trade may not improve as a result of that government's currency devaluation. Economists argue that the reason that the trade balance does not improve immediately after the devaluation of a domestic currency may be related to the lag or gradual adjustment of trade flow, which is explained as the *J-Curve* Model.

Exchange rate pass-through in Thailand, however, does not gain much consideration, even though there were huge fluctuations in the value of the Thai Baht after the 1997 crisis. The floating Baht regime nonetheless had an impact on prices through trade and expectations, in the external sector, on financial stability, and on the functioning of foreign exchange markets. Figure 1 presents high volatility of Thailand after the 1997 financial crisis. This after-shock effect after 1997-crisis should therefore play an important role on country's international pricing. For these reasons, the purpose of this paper is threefold. First, it implements the estimation procedure of exchange rate pass-through coefficients of Thai import industries of both short-run and long-run coefficients. Second, this paper determines how the degree of exchange rate pass-through has been affected by the high volatility of the Baht currency since the 1997 crisis. Third, the policy implications and the policy debate are discussed in the context of pass-through rates as an effective indicator of three major economic policies: 1) policy development to foster market competition, 2) monetary policy, and 3) international trade policy.

The next section of this paper provides exchange rate pass-through estimation on short-term and long-term bases. Section III discusses the policy implications and policy debate, and Section IV concludes the paper.

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