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Asymmetric exchange rate pass-through in an emerging market economy: The case of Mexico

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Abstract

This paper applies a nonlinear Autoregressive Distribute Lag to examine the exchange rate pass-through into consumer price inflation in Mexico. Overall, the evidence confirmed that ignoring the asymmetric (sign) effect of exchange rate movements on inflation may lead to incorrect inferences and policy conclusions. Exchange rate fluctuation is transferred to prices level more during currency depreciation than appreciation. We compare the macroeconomic performances between pre- and post-inflation targeting, and our findings reaffirmed that the pass-through has weakened significantly after launching inflation targeting in 2001. This result implies that low inflation in the sample period examined is good for Mexico because exchange rate pass-through declines after 2001. Consumer prices have become less responsive to exchange rate movements. We further observe a revival (strengthening) of oil price pass-through to domestic inflation in the post-inflation targeting period.

Keywords: exchange rate pass-through; inflation, asymmetry ARDL, Mexico

JEL classification: C32, E31, F31

Abstract

1. Introduction

The level of inflation is one of the main reasons that lead to high/low exchange rate pass-through (ERPT) to the consumer price index (CPI). The adoption of an independent monetary and inflation targeting (IT) policy require a low ERPT since low pass-through results in a less consequence of exchange rate fluctuation.\(^1\) Taylor (2000) in an influential paper conjectured that the degree/extent of ERPT is dependent on the level of inflation environment. Specifically,

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\(^1\) Here, ERPT refers to the degree to which exchange rate fluctuations influence traded price and, through them, other domestic prices. In other words, it provides an estimate of how exchange rate changes are fed into the overall consumer and wholesale price indices.
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