

# Estimating the elasticity of consumer prices to the exchange rate: an accounting approach <sup>\*</sup>

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## Abstract

We analyse the elasticity of the household consumption expenditure (HCE) deflator to the exchange rate, using world input-output tables (WIOT) from 1995 to 2019. In line with the existing literature, we find a modest output-weighted elasticity of around 0.1. This elasticity is stable over time but heterogeneous across countries, ranging from 0.05 to 0.22. Such heterogeneity mainly reflects differences in foreign product content of consumption and intermediate products. Direct effects through imported consumption and intermediate products entering domestic production explain most of the transmission of an exchange rate appreciation to domestic prices. By contrast, indirect effects linked to participation in global value chains play a limited role. Our results are robust to using four different WIOT datasets. As WIOT are data-demanding and available with a lag of several years, we extrapolate a reliable estimate of the HCE deflator elasticity from 2015 onwards using trade data and GDP statistics.

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*Keywords:* input-output linkages, spillovers, global value chains, cost-push inflation

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## Introduction

This paper studies on the elasticity of the household consumption expenditure (HCE hereafter) deflator to the exchange rate. We analyse the composition and determinants of the HCE deflator elasticity using world input-output tables (WIOT hereafter) covering twenty years of data, from 1995 to 2019. For the sake of robustness, we use several datasets (WIOD, two distinct releases of the OECD TiVA database and the MRIO database developed by the Asian Development Bank). We perform an accounting exercise based on information contained in WIOTs with large matrices inversion. We make two assumptions to simplify our computations. First, we assume a full exchange rate pass-through to import prices. Hence, we do not consider the fact that the pass-through might be incomplete, as suggested by a large body of literature (see for example Berman et al. (2012)). As a result, our estimates provide an upper bound of the HCE deflator elasticity. Using alternative pricing assumptions would entail lower values. Second, we suppose that all pricings occur using the currency of the producing country, despite the well-documented role of dominant-currency pricing (Gopinath et al. (2020)). As a consequence of these two assumptions, we also assume that the impact of the exchange rate fluctuation is proportional across sectors. Despite these simplifying assumptions, our estimates provide an accounting-based gauge of how large the elasticity of consumer prices to the exchange rate could be, considering direct and indirect import content in consumption and global value chain linkages. This accounting approach helps identifying which countries and sectors are under pressure to adjust their prices when subject to an exchange rate variation.

Our contribution to the literature is fourfold. First, we analyse the evolution of the elasticity of the HCE deflator to the exchange rate. We document differences across countries. We pay particular attention to the heterogeneity observed in the euro area, reflecting different degrees of openness to trade.

Second, building on sectoral data, we examine which sectors experience higher spillovers from an appreciation of the national currency. We focus on the main components of the HCE deflator, i.e. manufacturing goods, services, food and energy. We analyse the contribution of these different products to the HCE deflator elasticity and document cross-country heterogeneity in the elasticity.

Third, we look into the determinants of the HCE deflator elasticity and the role of global value chains in the transmission of an exchange rate appreciation. We identify the main channels

through which the exchange rate impacts the HCE deflator when production processes are global. We find that the main transmission channels are: *i*) the prices of imported final goods sold directly to domestic consumers and *ii*) the prices of imported inputs entering domestic production. These two channels explain three-quarters of the transmission of an exchange rate appreciation to domestic prices. By contrast, other channels reflecting the impact of global value chains (such as the price of exported inputs feeding through imported foreign production) play a more limited role, with marked cross-countries heterogeneity. Hence, only one-fourth of the elasticity of the HCE deflator to the exchange rate is attributable to participation in global value chains.

Fourth, we show that a precise assessment of the HCE deflator elasticity to the exchange rate can be estimated for recent years without resorting to WIOTs. The construction of World Input-Output tables is data-demanding and WIOTs are typically released with a lag of several years. As a result, WIOT are not available for the most recent years. For instance, the latest WIOD dataset dates back to 2014. Although the MRIO dataset covers most recent years, it suffers from data quality issues in 2018. To address the data gap in WIOTs, we extrapolate the HCE deflator elasticity from 2015 onwards using up-to-date GDP statistics and trade data on consumption and intermediates. We obtain a reliable estimate the HCE deflator elasticity up to to 2019. The rest of the paper is organised as follows. Section 2 reviews the data sources and outlines the main differences between the various WIOT databases. Section 3 presents the methodology and the data sources. In section 4, we estimate the elasticity of the HCE deflator to the exchange rate up to 2019 and analyse its determinants. In section 5, we use up-to-date GDP and trade data to estimate the elasticity of the HCE deflator for the most recent years.

## 1 Related literature

**Exchange rate pass-through to domestic prices** A large body of literature documents the exchange rate pass-through (ERPT hereafter) to domestic prices. The pass-through depends, among other things, on trade openness, integration in international production chains, firms' pricing strategies and the currency of invoicing for trade.

In the euro area, Özyurt (2016) shows that the pass-through is partial and has declined in the 2000s. This decline coincided with the increasing share of emerging economies in world trade and the accession of China to the WTO. The lowest degree of pass-through is found for Germany, most likely reflecting the large size of the country and the high share of local currency pricing.

By contrast, Ortega and Osbat (2020) find that the ERPT to euro area import and consumer prices has been stable since the 1990s.

The choice of invoicing currency determines the extent of the response of prices to an exchange rate movement. An exporter can price its products either in its own currency ('producer currency pricing' paradigm), in the destination's currency ('local currency pricing' paradigm), or in a third 'dominant' currency (see Ortega and Osbat (2020) for a discussion of the literature). The invoicing decision is an active channel through which producers adjust their prices in relation to their own market power and to local competitive pressures. While prices fixed in the local currency are irresponsive to the bilateral exchange rate between the local currency and the currency of the producer, prices in the producer or dominant currency have a higher ERPT. A large body of empirical literature suggests that the vast majority of trade is invoiced in a small number of 'dominant currencies,' with the U.S. dollar playing a major role. The 'dominant currency paradigm' (Gopinath et al. (2020)) implies that for non-U.S. countries, the exchange rate pass-through into import prices (in home currency) should be high and driven by the dollar exchange rate as opposed to the bilateral exchange rate, whereas for the U.S. the pass-through into import prices should be low.

The ERPT also depends on integration in global value chains. Based on Belgian firm-product-level data, Amiti et al. (2012) find that import intensity and market share are key determinants of the ERPT to export prices. Although we do not estimate the ERPT (we rather assume a full exchange rate pass-through), our approach provides an accounting-based gauge of how large the exchange rate pass-through could be, considering direct and indirect import content in consumption. In this respect, the elasticity we compute can be regarded as an upper bound.

**The Input-Output model applied to a change in production costs** The Leontief's production model (or Input-Output model, I-O thereafter) analyses the impact of a demand shock in a closed economy (Leontief, 1951). The trade in value-added analysis reconciles international trade statistics with national I-O tables, thus allowing to extend Leontief's analysis to an international context. Leontief's production model has a dual: the cost-push price model, which helps analysing the consequences of a change in production prices. Using this framework, Cochard et al. (2016) analyse the effects of costs on prices ("cost-push inflation") and show a higher impact for more open countries.

Supply-driven price models have a number of well-documented limitations (Folloni and Migliorina, 1994) and rely on a number of simplifying assumptions. Firms' margins are assumed to be fixed. Prices only adjust to absorb cost changes. Production techniques are fixed during successive production cycles. Inputs substitution caused by change in relative prices (for instance, between countries producing the same goods) is not accounted for. Although global value chains are often internal to multinational firms, supply-driven price models assume a unique pricing system based on market prices and independent of firms' strategies. Despite these shortcomings, supply-driven price models provide a measure of the vulnerability of each sector to price or productivity shocks (Acemoglu et al., 2012; Carvalho, 2014). Hence, though unrealistic, these models help identifying which countries and sectors are under pressure to adjust their prices when subject to exogenous cost shocks.

## 2 Data

In this paper, we perform an accounting exercise based on information contained in WIOTs with large matrices inversion. WIOTs are an extension of the national input-output tables. National input-output tables measure the relationships between the producers of goods and services (including imports) within an economy and the users of these goods and services (including exports). The national tables specify, in line, for each industry, the use of their product as intermediate or final use. In a national table, final use includes exports alongside domestic final uses, whereas exports are not a final use in world input-output tables. WIOTs show which foreign industry produces a good for a specific final use, and which foreign industry or final user uses the exports of a given country.

Aggregating national input-output tables into world input-output tables is challenging for a number of reasons. National input-output tables vary widely in terms of detail and scope, and are therefore not fully consistent. Furthermore, the availability of year-specific national input-output tables is limited, especially for developing economies.

This paper uses several multi-year WIOTs for the sake of robustness: the World Input Output Database (WIOD), the multi-regional input-output tables (MRIO) developed by the Asian Development Bank (ADB) and the Trade in Value Added Database (TiVA) from the OECD-ICIO.

## 2.1 The World Input Output Database (WIOD)

The World Input Output Database (WIOD) is hosted and updated by the University of Groningen (Netherlands). It benefits from the financial support of the European Commission. The WIOD contains time series of inter-country input-output tables from 2000 to 2014. It provides WIOTs that reconcile national input-output tables (or supply-use tables) with bilateral trade statistics. The WIOD covers 43 countries (of which 28 members of the European Union, see Table 1) accounting for 85% of global GDP (see Table 1). It contains information for 56 industries (see Online Appendix A). It provides annual WIOTs expressed in U.S. dollars at basic prices. Market exchange rates were used for currency conversion (Timmer et al., 2015).

Europe	Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, Switzerland, United Kingdom
North America	Canada, United States
Latin America	Brazil, Mexico
Asia-Pacific	Australia, China, India, Indonesia, Japan, Korea, Taiwan
Other	Russia, Turkey

Tab. 1: Geographical coverage of WIOD

## 2.2 The Asian Development Bank's MRIO database

The Asian Development Bank's MRIO database is an extension of WIOD for 2000 and 2007-2019. WIOD provides disaggregate information for a limited number of Asian economies. The Asian Development Bank (ADB) has augmented the WIOD with details for nineteen additional Asian economies<sup>1</sup>. This wider geographical coverage comes at the price of a less precise industrial disaggregation (35 vs 56 sectors in WIOD). The conceptual framework of the MRIO database (and hence the methods used in the construction of the tables) are similar to those of WIOD. Its main advantage is to be updated up to 2019.

<sup>1</sup> The MRIO database includes the following additional economies: Bangladesh, Bhutan, Brunei Darussalam, Cambodia, Fiji, Hong Kong, Kazakhstan, Kyrgyz Republic, Lao People's Democratic Republic, Malaysia, Maldives, Mongolia, Nepal, Pakistan, Philippines, Singapore, Sri Lanka, Thailand and Viet Nam.

### 2.3 The Trade in Value Added (TiVA) database

The Trade in Value Added (TiVA) database is compiled by the OECD. It builds on the OECD harmonised country-level input-output tables to provide matrices of inter-industrial flows of goods and services in current prices (U.S. dollars). We use two versions of TiVA (see OECD (2018) on the differences between the two datasets.). The 2016 edition of the TiVA database (third revision) includes 64 economies covering OECD, EU28, G20, most East and South-east Asian economies, a selection of South American countries and the Rest of the world (see Table 2). The industry list includes 34 sectors, among which 16 manufacturing and 14 services sectors. It covers the period 1995-2011 and is based on the 1993 system of national accounts. The fourth revision, released in 2018, includes 65 economies (see Table 2) and 36 sectors and covers the 2005-2015 period. It is based (like WIOD and MRIO) on the 2008 system of national accounts.

Europe	Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, Switzerland, United Kingdom
North America	Canada, United States
Latin America	Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico (differentiating between three (Rev. 3) or two (Rev. 4) Mexico), Peru
Asia-Pacific	Australia, Cambodia, China (differentiating between four (Rev. 3) or three (Rev. 4) China), Hong Kong SAR, India, Indonesia, Japan, Kazakhstan (in Rev. 4), Korea, Malaysia, New Zealand, Philippines, Singapore, Taiwan, Thailand, Viet Nam
Other	Brunei, Israel, Morocco, Russia, Saudi Arabia, South Africa, Tunisia, Turkey

Tab. 2: Geographical coverage of TiVA revisions 3 (2016) and 4 (2018)

### 2.4 Comparison of the different databases

All four databases are constructed using similar assumptions (OECD (2018); OECD and WTO (2011); Timmer et al. (2015)). For example, all start with the construction of harmonised country-specific supply-use tables (SUTs) that are then transformed into world input-output tables. All databases use the "import proportionality assumption" to allocate specific bilateral imports to using industries. National input-output statistics provide how much of each product firms use for intermediary consumption and investment. However, the breakdown of these into domestic and imported product is not available. Hence, the construction of world input-output tables requires allocating imports to using industries. The import proportionality assumption assumes that the proportion of intermediates that an industry purchases from abroad is equal

to the ratio of imports of intermediates to the total domestic demand of intermediates in that product. This assumption can be misleading. Feenstra and Jensen (2012) find that shares of imported materials differ substantially across U.S. industries. Based on Asian input-output tables, Puzzello (2012) finds that the proportionality assumption understates the use of foreign intermediate inputs. All databases, however, rely on the BEC (Broad Economic Categories) classification to map detailed six-digit products into intermediate use, final consumption and investment (Dietzenbacher et al., 2013).

One explicit difference between the databases is that WIOD and MRIO assume that the input mix is independent from the destination market. The TiVA databases do not rely on this assumption for two countries (Mexico and China). Instead, the TiVA databases use different input-output tables for the exporting, import processing and domestic-market oriented sectors of these countries (or at least two of those, depending on the country and the version of the TiVA database). Despite this difference, we obtain similar results with TiVA, WIOD and MRIO, which probably reflects the fact that we do not focus on Mexico and China.

Another difference relates to the method for harmonising national data and trade statistics. WIOD and MRIO rely on the shares of imported inputs provided by national account, contrary to TiVA. As a result, TiVA is closer to international trade statistics than WIOD. This explains why the share of imported inputs is smaller in TiVA for some countries (other than China and the USA). All computations in this paper have been conducted with the four databases. For ease of exposition, we use the WIOD as a baseline, since it covers the largest number of industries.

### 3 The PIWIM model

Based on initial work from the OFCE (Observatoire Français des Conjonctures Économiques) Cochard et al. (2016), we have developed the PIWIM model (Push-cost Inflation through World Input-output Matrices).

#### 3.1 Defining the impact of a change in prices using an I-O model

To identify which countries are most affected by a change in prices through value-added and vertical international trade flows, we need a large structural matrix that integrates input flows between sectors, both within each country and between countries. This matrix traces the sectoral and geographical origin of inputs.



The standard I-O model relies on input-output tables registering transactions of goods and services (domestic or imported) at current prices. The I-O tables describe the sale and purchase relationships between producers and consumers within an economy. Each column indicates, for each industry  $j$ , the intermediate consumption of goods and services from the various sectors. By extension, a "world" I-O table (WIOT) describes the sale and purchase relationships between producers and consumers in the whole world, differentiating between sectors in different countries. The WIOT has, on its diagonal, country blocks recording flows of domestic transactions of intermediate goods and services between domestic industries. The "bilateral" blocks outside of the diagonal represent international flows of intermediate goods and services via bilateral sectoral exports and imports.

Traditionnaly, WIOTs are interpreted in a Leontief framework using Leontief production functions to analyse the evolution of quantities in the economy. Here, we assume a Cobb-Douglas production function: the technical coefficients correspond to the share of each input in total costs. We derive a price equation, following De Soyres et al. (2018).

We define  $N$  as the product of the number of countries ( $I$ ) and the number of sectors ( $J$ ),  $\mathcal{A}$  the matrix of technical input coefficients of dimension  $(N, N)$ , and  $Y$  the gross output vector of dimension  $(1, N)$ .

In each sector of each country, a representative firm uses domestic production factors ( $V$ ) and domestic and imported intermediates  $m$  according to a Cobb-Douglas technology:

$$Y_n = V_n^{\gamma_n} \times \prod_{n'=1}^{n'=N} m_{n,n'}^{a_{n,n'}} \text{ with } \gamma_n + \sum_{n'=1}^{n'=N} a_{n,n'} = 1$$

Where  $\gamma_n$  is the share of domestic production factors,  $a_{n,n'}$  the share of output from (country,sector)  $n'$  in the total production of (country,sector)  $n$ .

Assuming perfectly competitive firms and prices set at the marginal cost, standard cost minimisation for each country leads to the following pricing system:

$$p_n = x_n \times w_n^{\gamma_n} \times \prod_{n'=1}^{n'=N} p_{n'}^{a_{n,n'}}, \forall n$$

With  $w_n$  the unit income of domestic production factors and  $x_n$  a constant depending only on parameters:

$$x_n = \gamma_n^{-\gamma_n} \times \prod_{n'=1}^{n'=N} a_{n,n'}^{-a_{n,n'}}$$

Using logs, we have:

$$\log(p_n) = \log(x_n) + \gamma_n \log(w_n) + \sum_{n'=1}^{n'=N} a_{n,n'} \cdot \log(p_{n'}), \forall n$$

Define  $P$  the vector of prices and  $Z$  a vector of  $\log(x_n) + \gamma_n \cdot \log(w_n)$ , both of dimension  $(1, N)$ :

$$\log(P) = Z + \log(P)\mathcal{A} \tag{1}$$

Suppose an exogenous change in input prices defined in log points (i.e. approximating percentages for small changes). Define  $\Delta^0 \log(P)$  the vector of dimension  $(1, N)$  computed as the difference between the original price vector  $\log(P^0)$  and the new vector  $\log(P^1)$ . Then:

$$\Delta^0 \log(P) = \log(P^1) - \log(P^0) = C,$$

with  $C$  the vector of dimension  $(1, N)$  that contains the direct effect of the change in prices expressed in log points.

$C$  directly affects the HCE deflator. In addition, firms face a change in their costs, which affects their prices according to equation 1. Hence, the price change is transmitted to country-specific industries that are using domestic input through the change in input prices. The higher the country-specific industries' reliance on those inputs, the higher the change in their production prices.

In a first step, the impact of the change in input prices on each country-specific industry's output prices amounts to  $\Delta^1 \log(P) = C\mathcal{A}$ .

In a second step, the impact of the change in input prices is passed on to all the country-specific industries using these inputs. For the  $k^{th}$  step, the increase in production prices amounts to  $\Delta^k \log(P) = C\mathcal{A}^k$ .

As the technical coefficients are smaller than 1, the effect of the change in input prices wears out as  $k$  increases. The overall effect of the change in input prices is equal to the sum of the initial change in prices and all the subsequent changes in each step. Let us call  $S$  the total effect of the change in input prices (in log points), a vector  $(1, N)$  composed of the elements  $s_{ij}$  measuring the total effect of the shock on the price of sector  $j$  in country  $i$ . We have:

$$S = C(I + \mathcal{A} + \mathcal{A}^2 + \dots + \mathcal{A}^k + \dots) = C(I - \mathcal{A})^{-1} \quad (2)$$

with  $(I - \mathcal{A})^{-1}$  the Leontieff inverse matrix. If the change in the input prices is small enough, the elements of  $S$  correspond to the elasticity of sectoral prices to a change in input prices. Using consumption shares to perform a weighted average of these elasticities yields the household consumption expenditure (HCE) deflator elasticity to a change in input prices <sup>2</sup>.

### 3.2 Accounting impact of an exchange rate variation on domestic prices

We are primarily interested in the impact of an exchange rate appreciation on consumer prices in the country whose currency's value is changing (country  $A$  by convention). We also estimate the inflationary impact on countries that directly and indirectly, through third countries linkages, consume inputs from country  $A$ . Hence, we will also analyse the impact of an appreciation of the US dollar. In both cases, implementing an exchange rate variation is more complex than implementing a change in production costs. The appreciation of the currency of country  $A$  leads to a fall in the national currency price of country  $A$ 's imports, while the foreign-currency price of its exports increases.

Suppose a world with two countries  $A$  and  $B$ , each having its own national currency, and using a third currency for international transactions, the dollar. Following a 5% appreciation of the currency of country  $A$  against the two other currencies, the prices of country  $A$  expressed in dollars increase by 5% compared to those of country  $B$  expressed in dollars. Country  $B$  pays more for its imports of inputs, in dollars as well as in national currency, since its exchange rate against the dollar has not changed. Conversely, the price of imported inputs in country  $A$  remains constant in dollars, since the prices of country  $B$  have not changed, and declines once expressed in country

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<sup>2</sup> The HCE deflator covers more products and has different sectoral weights than the headline consumer price index (CPI) as the former also encompasses, for example, the rental equivalent of real estate expenditures.

$A$ 's national currency. This has an impact on consumer prices expressed in national currency in country  $A$ .

Note that, for the sake of simplicity, we make the strong assumption that producers completely pass the exchange rate appreciation on their production prices. We do not consider other relevant determinants of the exchange rate pass-through. For instance, pricing-to-market strategies of exporters aiming to defend their market shares would imply a lower exchange rate pass-through. Similarly, settlement and invoicing of imports in the domestic currency is another factor likely to weaken the elasticity of domestic prices to exchange rate movements. Assuming that only 60% of invoices in the euro area goods trade are denominated in foreign currency (see Ortega and Osbat (2020)) would entail lower elasticity values. To anticipate on our results (see Figure 9), reducing the exchange rate pass-through on consumption goods would entail lower elasticity values than reducing the pass-through on inputs. Our estimates thus provide an upper bound of the HCE deflator elasticity.

Back to our accounting approach, the change in the prices of imported goods is therefore transmitted to all domestic prices, both directly and through inter-industry linkages. These upward (downward) movements for country  $B$  (country  $A$ ) affect all input prices in both countries.

The effects of the change in prices spread over multiple simultaneous production cycles. The overall impact of the exchange rate appreciation in dollar terms is equal, for the shocked country  $A$ , to the decline in consumer prices directly due to the exchange rate fluctuation, plus direct and indirect decreases (via inter-industry linkages in the country), in national currency and then converted back into dollar terms, in the prices of inputs imported from  $B$  and disseminated to all branches. The overall impact on prices in dollar terms in country  $A$  is therefore lower than the initial exchange rate variation, as national currency prices are also affected. For country  $B$ , the final impact is equal to the cumulative direct and indirect effects of the higher prices of imported inputs.

In a global economy composed of  $I$  countries, each with  $J$  sectors,<sup>3</sup> the appreciation of a country's currency  $i$  against all other currencies translates into a rise in country  $i$ 's prices in dollars. The dollar price of each sector will vary in percentage (approximated as log point assuming that the exchange rate variation is small enough) by:  $c_{\$}^i$  for sectors in the shock-stricken country  $i$  and 0 in other countries.

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<sup>3</sup> Online appendix B explores the two-country, one-sector case and contrasts the effect of an exchange rate variation and the effect of a price variation

Hence, for each sector  $j$  in country  $i$  (see notation table):

$$\Delta^0 \log(p_{\$ij}) = \log(p_{\$ij}^1) - \log(p_{\$ij}^0) = c_{\$ij} = c_{\$}^i$$

And for each sector  $j$  in country  $k$  ( $k \neq i$ ),

$$\Delta^0 \log(p_{\$kj}) = \log(p_{\$kj}^1) - \log(p_{\$kj}^0) = c_{\$kj} = 0$$

The appreciation affects producers through changes in relative prices between countries and, therefore, through changes in input prices traded between the shock-stricken country  $i$  and other countries.

Consider first the direct impact on other countries of the rise in imported input prices from shocked country  $i$ . For any sector  $l$  of a country  $k$  ( $k \neq i$ ), the increase in producer prices depends directly on the quantity of inputs imported from the shock-stricken country  $i$ , weighted by the variation in level of the price of inputs in dollars (i. e. the exchange rate variation). If  $a_{kl,ij}$  is the share of inputs from the country  $i$ 's sector  $j$  needed in the production of country's  $k$  sector  $l$ , we have :

$$\Delta^1 \log(p_{\$kl}) = c_{\$}^i \cdot a_{kl,i1} + \dots + c_{\$}^i \cdot a_{kl,ij} + \dots + c_{\$}^i \cdot a_{kl,iJ} = \sum_{j=1}^J c_{\$}^i \cdot a_{kl,ij} = c_{\$}^i \cdot \sum_{j=1}^J a_{kl,ij} \quad (3)$$

For the shocked country, an appreciation of the currency has a disinflationary effect. In national currency, the prices of imported inputs fall in each sector by  $c^i = -\frac{c_{\$}^i}{1+c_{\$}^i}$ , or by  $-\frac{10}{1.1}\%$  with  $c_{\$}^i = 10\%$ .

We approximate these changes by their log point equivalent<sup>4</sup>. This decline then spreads to all domestic-input using sectors. In sector  $j$  of the shocked country  $i$ , this fall amounts in national currency to:

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<sup>4</sup> We could have used the log point approximation earlier and write that  $c^i = -c_{\$}^i$  with nearly the same results for small exchange rate variations.

$$\Delta^1 \log(p_{ij}) = \sum_{l=1}^{l=J} c^i \cdot a_{ij,1l} + \dots + \sum_{l=1}^{l=J} c^i \cdot a_{ij,kl} + \sum_{l=1}^{l=J} c^i \cdot a_{ij,Il} = \left( -\frac{c_{\$}^i}{1 + c_{\$}^i} \right) \cdot \sum_{\substack{k=1 \\ k \neq i}}^{k=I} \left[ \sum_{l=1}^{l=J} a_{ij,kl} \right]$$

This change can be converted into dollars:

$$\Delta^1 \log(p_{\$ij}) = (1 + c_{\$}^i) \cdot \left( -\frac{c_{\$}^i}{1 + c_{\$}^i} \right) \sum_{\substack{k=1 \\ k \neq i}}^{k=I} \left[ \sum_{l=1}^{l=J} a_{ij,kl} \right] \quad (4)$$

This yields the first step impact of the exchange rate variation on all input prices of all countries. To express this in matrix notation, we define two matrices that build on the world input-output matrix  $\mathcal{A}$  defined in 3.1 :  $\mathcal{B}^i$  and  $\tilde{\mathcal{B}}^i$ . These two matrices retain only the first-step effects of the exchange rate variation on the price of goods and services imported by the shocked country  $i$  and the first-step effects of the exchange rate variation on the price of goods and services imported by the rest of the world from country  $i$ . Compared to  $\mathcal{A}$ , we "close off" the links between a change in domestic input prices and the price of goods as well as the link between non-shocked input prices and the price of goods in a non-shocked country (see the notation table and infra) Let us first consider the impact of the exchange rate variation from the perspective of countries that import inputs from country  $i$ .

Let  $C_{\$}^i$  be the vector of log points changes in dollar prices following the appreciation of the currency of country  $i$  against all other currencies. Hence,

$$C_{\$}^i = (0 \dots 0 \dots c_{\$ij} \dots c_{\$ik} \dots 0 \dots 0)$$

with  $c_{\$ij} = c_{\$ik} = c_{\$}^i$  for all sectors  $j$  and  $k$  in the shocked country  $i$ .

Building on Equation 3, the direct impact of the exchange rate variation on the other countries corresponds to the product of the shock vector  $C_{\$}^i$  and a matrix  $\mathcal{B}^i$ .  $\mathcal{B}^i$  builds on the large matrix  $\mathcal{A}$  of technical coefficients, but only keeps the coefficients of each country's sectoral inputs imported from the shocked country  $i$ . The other coefficients are replaced by 0, including those

of the block of country  $i$  concerning the domestic inputs of country  $i$ . The first-step impact of the appreciation of a currency against the dollar on the price of inputs in countries that are not impacted by the appreciation is equal to  $C_{\$}^i \mathcal{B}^i$  with

$$C_{\$}^i \mathcal{B}^i = (0 \dots c_{\$}^i \dots 0) \begin{pmatrix} 0 & \dots & 0 \\ a_{11,ij} & 0 & a_{IJ,ij} \\ 0 & \dots & 0 \end{pmatrix} \quad (5)$$

where each  $a_{kl,ij}$  element of the line block represents the technical coefficient related to imports of inputs by sector  $l$  in country  $k$  (with  $k \neq i$ ) from sector  $j$  of country  $i$ .

Let us now consider the impact of the exchange rate fluctuation from the perspective of the shocked country  $i$ .

Define  $C^i$  the vector of change in prices everywhere expressed in country  $i$ 's currency.

$$C^i = \left( -\frac{c_{\$}^i}{1 + c_{\$}^i}, \dots, 0, \dots, -\frac{c_{\$}^i}{1 + c_{\$}^i} \right)$$

From Equation 4, we write the first-step impact for country  $i$  of the fall in input prices from the rest of the world. The first-step impact is the product of the shock vector  $C^i$  and a matrix  $\tilde{\mathcal{B}}^i$ .  $\tilde{\mathcal{B}}^i$  builds on the large matrix  $\mathcal{A}$  of which only the country blocks of those inputs imported by country  $i$  from other countries have been retained. The other coefficients are replaced by 0, including those of the block of country  $i$  concerning the domestic inputs of country  $i$ .

**Notation table**

- $a_{kl,ij}$ : the share of inputs from country  $i$ 's sector  $j$  in the production of country's  $k$  sector  $l$ .
- $\mathcal{A}$ : Matrix of world input-output coefficients.
- $\mathcal{B}^i$ :  $\mathcal{A}$  including only the country blocks of each country's sectoral inputs imported from country  $i$  (excluding domestic inputs in  $i$ ).
- $\tilde{\mathcal{B}}^i$ :  $\mathcal{A}$  including only the country blocks of the inputs imported by country  $i$  from other countries (excluding domestic inputs in  $i$ ).
- $c_{\$}^i$ : change in the exchange rate of the currency of country  $i$  in dollar. If it appreciates by 10%,  $c_{\$}^i = 0.1$ .
- $c^i$ : impact of the exchange rate variation on the price of non- $i$  goods expressed in the currency of  $i$ .  $c^i = -\frac{c_{\$}^i}{1+c_{\$}^i}$ . If  $c_{\$}^i = 0.1$ ,  $c^i = -0.0909...$
- $C^i$ : vector of log point changes in prices everywhere expressed in country  $i$ 's currency:  
 $C^i = \left(-\frac{c_{\$}^i}{1+c_{\$}^i}, \dots, 0, \dots, -\frac{c_{\$}^i}{1+c_{\$}^i}\right) = (c_i, \dots, 0, \dots, c_i)$
- $C_{\$}^i$ : vector of log points changes in dollar prices following the appreciation of the currency of country  $i$  against all other currencies.  $C_{\$}^i = (0 \dots 0 \dots c_{\$ij} \dots c_{\$ik} \dots 0 \dots 0)$  with  $c_{\$ij} = c_{\$ik} = c_{\$}^i$
- $\hat{C}_{\$}^i$ : vector of the log point changes in dollar prices of goods and services from country  $i$  used as inputs in all other countries.  $\hat{C}_{\$}^i = \left(0 \dots \frac{c_{\$}^i}{1+c_{\$}^i}, \dots, 0\right)$
- $p_{\$ij}$ : price of goods produced by the sector  $j$  in country  $i$  in dollars (or any international reference currency)

The first-step impact of the appreciation of the country  $i$ 's currency on the price of its inputs



corresponds, in national currency, to  $C^i \tilde{\mathcal{B}}^i$  with:

$$C^i \tilde{\mathcal{B}}^i = \left( -\frac{c_{\$}^i}{1 + c_{\$}^i}, \dots, 0, \dots, -\frac{c_{\$}^i}{1 + c_{\$}^i} \right) \begin{pmatrix} 0 & \dots & a_{ij,11} & \dots & 0 \\ 0 & & 0 & & 0 \\ 0 & \dots & a_{ij,IJ} & \dots & 0 \end{pmatrix} \quad (6)$$

where each  $a_{ij,kl}$  element in the column block represents imports of inputs by sector  $j$  in country  $i$  from sector  $l$  of country  $k$ . We then convert the direct impact into dollars, by multiplying it by the new value of the national currency in dollars,  $(1 + c_{\$}^i)$ . The direct impact of the appreciation of country  $i$ 's currency on the price of its inputs corresponds, in dollars, to  $\tilde{C}_{\$}^i \tilde{\mathcal{B}}^i$  with:

$$\tilde{C}_{\$}^i \tilde{\mathcal{B}}^i = (1 + c_{\$}^i) \cdot C^i \tilde{\mathcal{B}}^i = (-c_{\$}^i \dots 0 \dots -c_{\$}^i) \begin{pmatrix} 0 & \dots & a_{ij,11} & \dots & 0 \\ 0 & & 0 & & 0 \\ 0 & \dots & a_{ij,IJ} & \dots & 0 \end{pmatrix} \quad (7)$$

The first-step effect on the world is therefore the sum of the vectors from equations 5 and 7, i.e.  $C_{\$}^i \mathcal{B}^i + \tilde{C}_{\$}^i \tilde{\mathcal{B}}^i$ .

The change in input prices then spreads to all sectors in all countries via the global intersectoral exchanges transcribed by the matrix of technical coefficients of the large matrix  $\mathcal{A}$ . This process will be simultaneously repeated several times, until the effects completely wear off. In the end, the total price effect of the exchange rate variation is equal to the sectoral shock itself, incremented by changes in input prices due to changes in imported input prices (both in the shocked country and in non-shocked countries), and by all changes in prices during the production processes:

$$\begin{aligned} S_{\$}^i = \Delta P_{\$}^i = C_{\$}^i &+ \left( C_{\$}^i \mathcal{B}^i + \tilde{C}_{\$}^i \tilde{\mathcal{B}}^i \right) + \left( C_{\$}^i \mathcal{B}^i + \tilde{C}_{\$}^i \tilde{\mathcal{B}}^i \right) \mathcal{A} + \left( C_{\$}^i \mathcal{B}^i + \tilde{C}_{\$}^i \tilde{\mathcal{B}}^i \right) \mathcal{A}^2 \\ &+ \dots + \left( C_{\$}^i \mathcal{B}^i + \tilde{C}_{\$}^i \tilde{\mathcal{B}}^i \right) \mathcal{A}^k + \dots \end{aligned}$$

$$S_{\$}^i = C_{\$}^i + \left( C_{\$}^i \mathcal{B}^i + \tilde{C}_{\$}^i \tilde{\mathcal{B}}^i \right) * (I - \mathcal{A})^{-1} \quad (8)$$

With  $S_{\$}^i$  the total impact vector composed of the elements  $s_{\$kj}^i$  showing the total impact of a

change in the exchange rate of country  $i$  on the price of the country  $k$ 's sector  $j$  in international currency expressed in log points. Equation 8 gives the evolution of sectoral prices in international currency. Analysing this vector is the main objet of Cochard et al. (2016), which focuses on the evolution of price-competitiveness.

By contrast, we focus on the effect of an exchange rate variation on consumer prices. Hence, we are interested in the same impact expressed in national currency. To obtain the evolution of the sectoral prices of the shocked country in national currency, we remove the exchange rate variation in international currency, multiply the balance by the scalar of conversion equal to  $\frac{1}{1+c_{\$}^i}$  and add the initial exchange rate variation in national currency.

$$\begin{aligned}
 S^i &= C^i + \left( \frac{1}{1+c_{\$}^i} \right) * (S_{\$}^i - C_{\$}^i) \\
 &= C^i + \left( \frac{1}{1+c_{\$}^i} \right) * \left( C_{\$}^i \cdot \mathcal{B}^i + \tilde{C}_{\$}^i \tilde{\mathcal{B}}^i \right) * (I - \mathcal{A})^{-1} \\
 &= C^i + \left( \hat{C}_{\$}^i \cdot \mathcal{B}^i + C^i \tilde{\mathcal{B}}^i \right) * (I - \mathcal{A})^{-1}
 \end{aligned} \tag{9}$$

Where  $\hat{C}_{\$}^i = \left( 0 \dots \frac{c_{\$}^i}{1+c_{\$}^i}, \dots 0 \right)$  is the increase in dollar prices of goods and services from country  $i$  used as inputs in all other countries.

$S^i$  represents the overall impact of an exchange rate variation on prices in each sector of each country expressed in the currency of country  $i$ .  $S^i$  is expressed in log points. If the variation is small enough, the elements of  $S^i$  correspond to the elasticities to the exchange rate of consumer prices in country  $i$ . We return to this equation and its interpretation in section 5 (see equation 14).

To convert this vector into the HCE deflator elasticity in country  $i$ ,  $\bar{s}^i$ , we use the household consumption shares to compute a weighted average of the elements of  $S^i$ . Let  $HC^i$  be the vector

of sectoral shares in country  $i$ 's household consumption<sup>5</sup>:

$$HC^i = \begin{pmatrix} \frac{hc_{11}^i}{hc^i} \\ \dots \\ \frac{hc_{kj}^i}{hc^i} \\ \dots \\ \frac{hc_{IJ}^i}{hc^i} \end{pmatrix}$$

Where  $hc_{kj}^i$  corresponds to household consumption in country  $i$  of goods and services produced by sector  $j$  from country  $k$  and  $hc^i$  represents the total household consumption of country  $i$ .

$\overline{s}_i^{i,HC}$  provides the elasticity of the HCE deflator of country  $i$  to its own exchange rate.

$$\overline{s}_i^{i,HC} = S^i \cdot HC^i = \sum_{\substack{j=1 \dots J \\ k=1 \dots I}} s_{kj}^i \cdot \frac{hc_{kj}^i}{hc^i} \quad (10)$$

where  $s_{kj}^i$  is a coefficient of  $S^i$  for country  $i$ .

## 4 Accounting impact of an exchange rate variation on consumer prices

We use the model presented in 3.2 to analyse the impact of an exchange rate variation on the household consumption expenditure (HCE) deflator. We assume that the variation in the nominal exchange rate is small enough to assimilate log and percentage points and hence consider  $\overline{s}_i^{i,HC}$  as the HCE deflator elasticity to its own exchange rate. Following an appreciation of the national currency versus all other currencies, imported inputs and imported consumer goods become cheaper and domestic prices expressed in national currency decrease.

### 4.1 Heterogeneity across countries

Using the WIOD database, which covers a sample of 43 countries, we find that the HCE deflator elasticity ranges from 0.05 to 0.22 depending on the country (see Figure 1). This heterogeneity reflects different degrees of openness to trade and differences in foreign product content in domestic consumption. The elasticity is lower for large advanced and developing countries. For

<sup>5</sup> Consumption is at market prices, whereas all WIOTs are at basic prices. To move from one to the other, we make the simplifying assumption that all taxes and subsidies on products are proportional, as is the value-added tax.

instance, we find an elasticity of 0.06 in 2014 for the US. Within the euro area, the elasticity of the HCE deflator differs substantially, ranging from 0.07 in Italy to 0.18 in Ireland, a small open economy with a large traded sector and a large share of trade outside the euro area. For larger countries (France, Germany, Italy and Spain) and countries whose trade is concentrated with euro area partners (such as Portugal and Greece), the elasticity is close to 0.10, reflecting a lower degree of openness to trade. The elasticity is twice higher for small open economies like Luxembourg, Malta, Slovakia and Ireland.

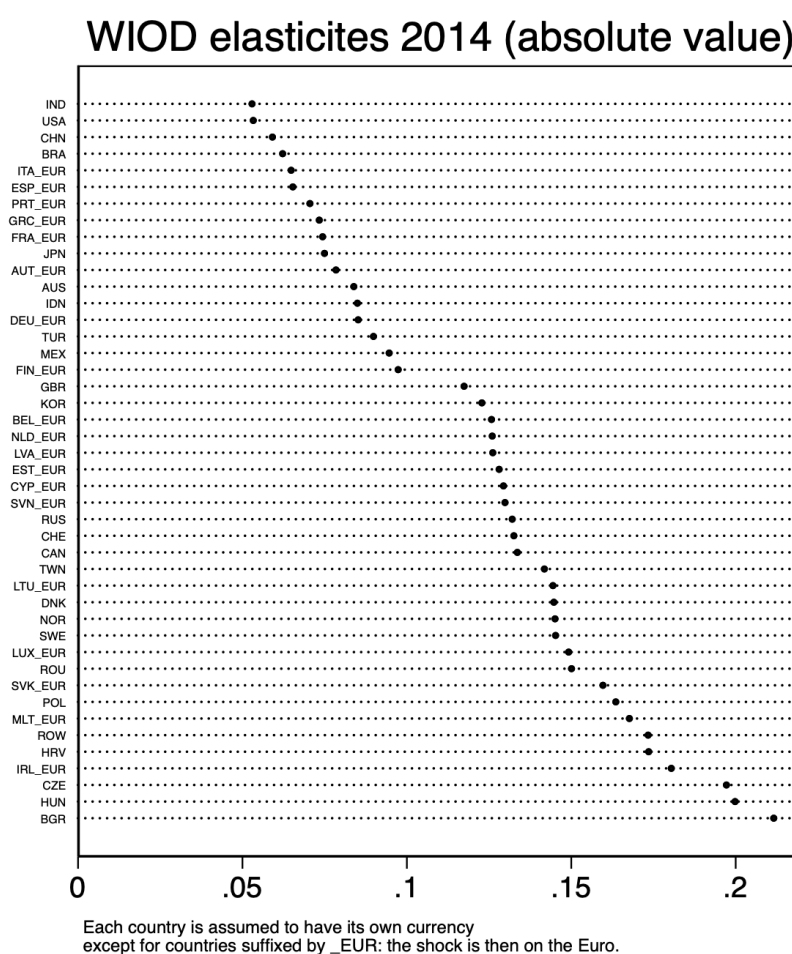


Fig. 1: Elasticity of the HCE deflator to the domestic currency (WIOD), 2014.

Sources: WIOD and authors' calculations.

Figure 2 compares the results obtained with WIOD and two distinct releases of TiVA for

years 2011 and 2014.

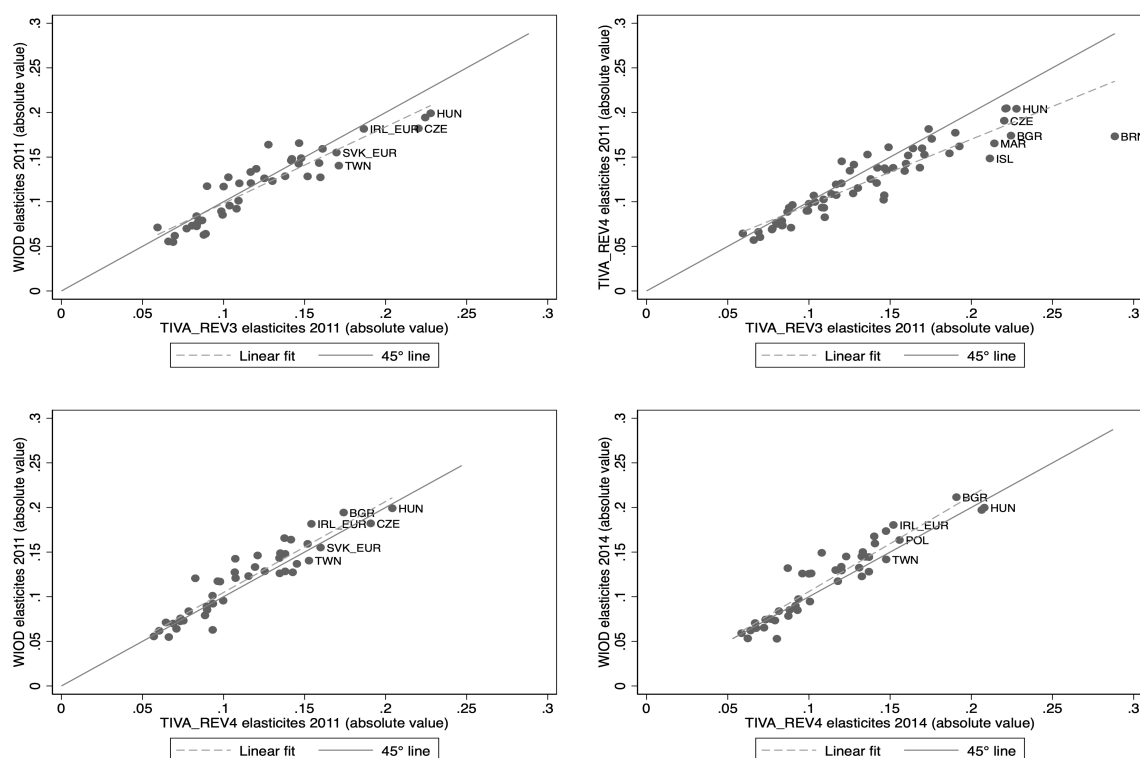


Fig. 2: Comparison of the HCE deflator elasticity to the exchange rate for WIOD, TIVA rev. 3 and TIVA rev. 4 (2011 and 2014)

Sources: WIOD, TIVA rev. 3 and TIVA rev. 4, authors' calculations

Figure 3 shows that the value of the elasticity is closely, but not perfectly, related to the share of imported goods and services (from outside the euro area for euro area countries) in household consumption. The higher the country's import share in consumption, the higher the elasticity of the HCE deflator to the exchange rate. We come back to the relations between the HCE deflator and various openness measures in section 5.

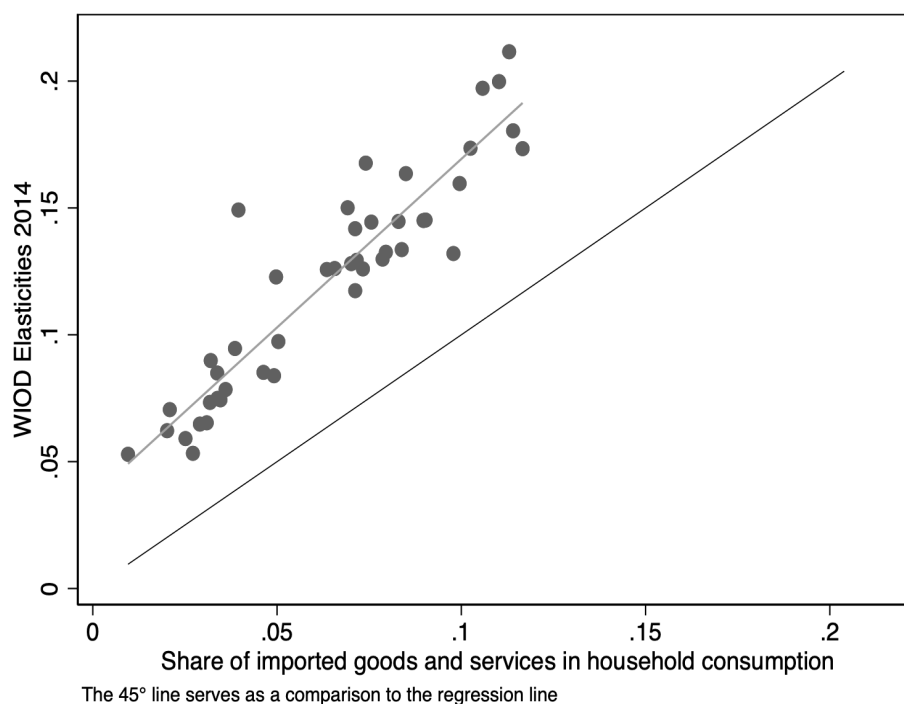


Fig. 3: HCE deflator elasticity and share of imported consumption in total consumption (WIOD, 2014)

Sources: WIOD and authors' calculations

## 4.2 Impact of an appreciation of the US dollar

The model can also track the effect on the domestic economy of variations in the currency of foreign countries. As an example, we estimate the impact of an appreciation of the US dollar (USD) using WIOD. This exercise assumes that exports are always invoiced in the exporter's currency. We do not take into account the large role of the dollar in international trade invoicing. The US example illustrates that countries are affected in proportion to their trading links with the country whose currency appreciates. We obtain the highest elasticities for the major trading partners of the US. The elasticity of the HCE deflator to the USD amounts to 0.12 for Canada and 0.09 for Mexico (see Figure 4). The elasticity is below 0.06 for most euro area countries. Ireland stands out, with an elasticity of 0.09, i.e. close to that of Canada and Mexico. The U.S. is Ireland's major trading partner outside of the EU, even if a large portion of Irish imports from the US (pharmaceuticals and aircraft) are later exported by Irish-based firms without being purchased by Irish consumers (Reddan and Rice, 2017), and therefore have a negligible

contribution to domestic consumer goods inflation.

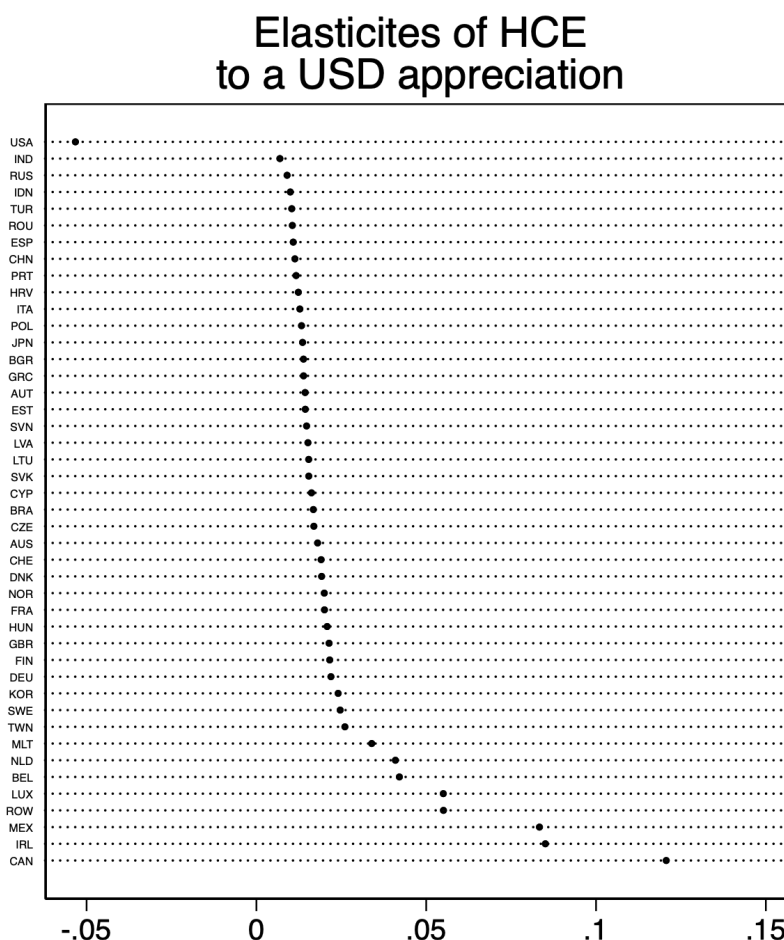


Fig. 4: Elasticity of the HCE deflator to the USD (WIOD) - 2014.

Sources: WIOD and authors' calculations.

### 4.3 Evolution over time of the HCE deflator elasticity

The output-weighted elasticity of the HCE deflator to the exchange rate has remained broadly stable over the past two decades. Output-weighted elasticities are lower than arithmetic means, reflecting the fact that large countries are relatively closed compared to small economies. Using WIOD, we find that the mean output-weighted elasticity of the HCE deflator increased from 0.06 in 2000 to 0.08 in 2008 (see Figure 5). After peaking in 2008, the elasticity sharply declined in 2009. It has hovered around 0.08 in subsequent years. Our results concur with the literature.

Using comprehensive measures of global value chain integration, Timmer et al. (2016) find that the expansion of global value chain has slowed down since the Great Recession.

While the latest dataset available for WIOD dates back to 2014, MRIO covers the most recent years, up to 2019. Results from the MRIO database suggest that the elasticity has bounced back from 2016 onwards, reaching 0.09 in 2019. However, the version of MRIO we use (March 2021) suffers from data quality issues for 2018 and 2019 (see Online Appendix C). Between 2017 and 2018, the HCE deflator elasticity sharply increased in a number of countries (e.g. China and India). Hence, we assume that the elasticity estimated using MRIO is not reliable for 2018 and 2019 (see Section 5.3 for further details).

Overall, our estimates are robust to using different databases. WIOD and MRIO provide similar elasticities. The main difference between the two databases relates to the broader geographic coverage of MRIO, which includes nineteen additional emerging Asian economies. Given these economies' relative small size, using MRIO provides aggregate results similar to those of WIOD. By contrast, using data from TiVA rev. 3, which covers a sample of 64 countries up to 2011, yields a higher elasticity. TiVA rev. 3 suggests that the output-weighted elasticity has increased by 25% between 1995 and 2008, reaching 0.10 in 2008.

The higher estimates obtained with TiVA rev. 3 likely reflects the different treatment of contract manufacturing in the 2008 system of national accounts compared to the 1993 system, which reduces imported inputs. The slight differences observed between WIOD and TiVA rev. 4 likely reflect different ways of reconciling national accounts and international trade statistics.



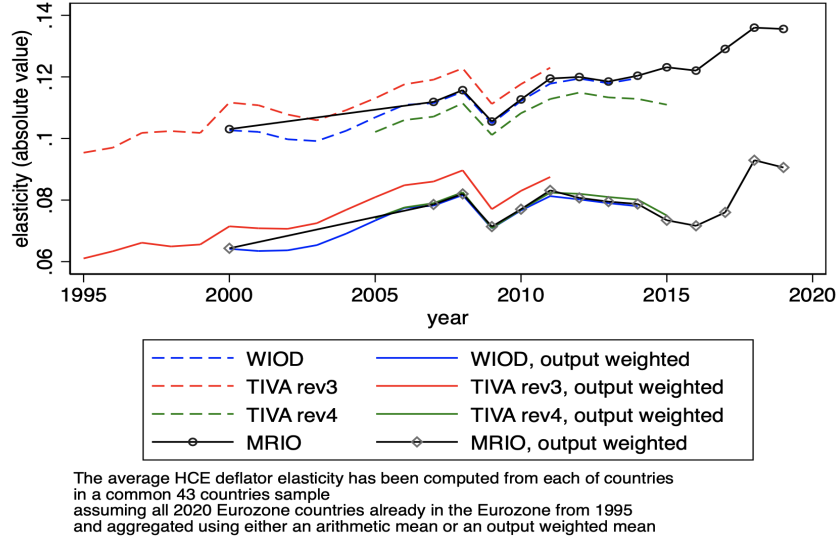


Fig. 5: Evolution of the HCE deflator elasticity, 1995-2019

Sources: WIOD, MRIO, TIVA rev. 3, TIVA rev. 4 and authors' calculations

#### 4.4 Contributors to the HCE deflator elasticity

In this section, we analyse the contributions of each part of the consumption basket to the pass-through of exchange rate variations to consumer prices. We start with the contributions of domestic versus imported goods. We define

$$\bar{s}_i^{i,HC} = \bar{s}_{i,imp}^{i,HC} + \bar{s}_{i,dom}^{i,HC} = S^i . HC^{i,dom} + S^i . HC^{i,imp} \quad (11)$$

Where:

$$\begin{aligned} HC^i &= HC^{i,dom} + HC^{i,imp} \\ &= \begin{pmatrix} 0 \\ \dots \\ \frac{hc_{ij}^i}{hc^i} \\ \dots \\ 0 \end{pmatrix} + \begin{pmatrix} \frac{hc_{11}^i}{hc^i} \\ \dots \\ 0 \\ \dots \\ \frac{hc_{IJ}^i}{hc^i} \end{pmatrix} \end{aligned} \quad (12)$$

For example,

$$\bar{s}_{i,imp}^{i,HC} = \sum_{\substack{j=1\dots J \\ k=1\dots I \\ k \neq i}} s_{kj}^i \frac{hc_{kj}^i}{hc^i} \quad (13)$$

Figure 6 shows that changes in the prices of imported final consumer goods and services contribute more to the total effect than changes in the prices of domestic final goods and services. Furthermore, imported final consumer goods also explain the differences in price elasticities observed between open and relatively closed economies. Although imported final consumer goods account for a smaller share of total consumption than domestic goods, they are the most impacted by exchange rate fluctuations.

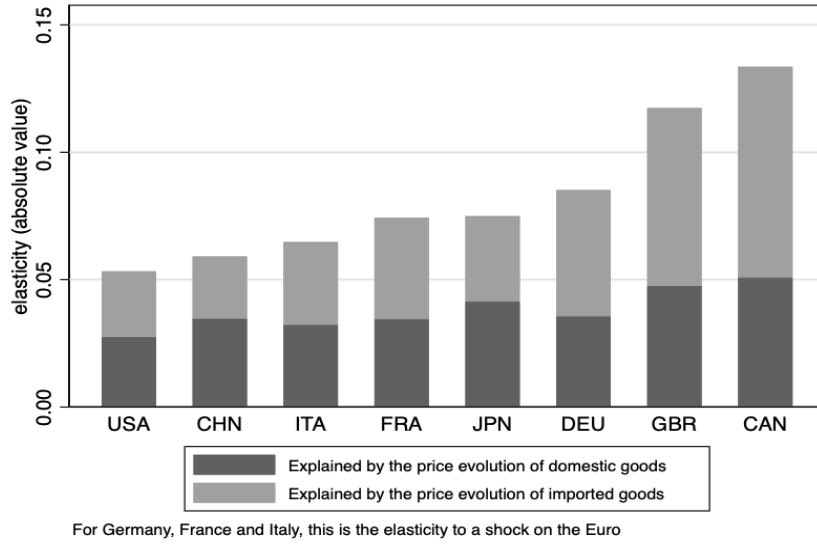


Fig. 6: Contribution of imported and domestic final goods and services to the HCE deflator elasticity (WIOD, 2014)

Sources: WIOD and authors' calculations

We also examine the contributions of each sectors to the HCE deflator elasticity. We regroup industries into four categories: manufacturing goods, services, food and energy. Figure 7 shows the impact of a change in the exchange rate on the main components of the HCE deflator. Non-energy industrial goods explain the bulk of the total impact. However, services also play a significant role, especially in advanced economies. Although services are mainly produced domestically and do not rely much on imported inputs, they represent a substantial share of

total consumption: even small price changes have large impacts on the HCE deflator.

Finally, mixing both the industrial and origin analysis shows that domestic core inflation (i.e. all domestic products except food and energy) accounts for a significant share of the total impact (Figure 8), reflecting the weight of domestic services and non-energy industrial goods in total consumption.

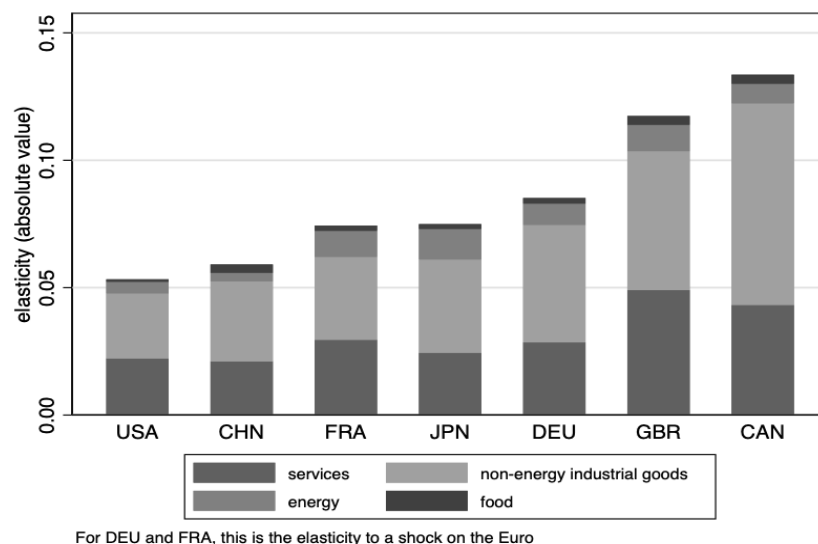


Fig. 7: Contribution of different products to the HCE deflator elasticity (WIOD, 2014)

Sources: WIOD and authors' calculations

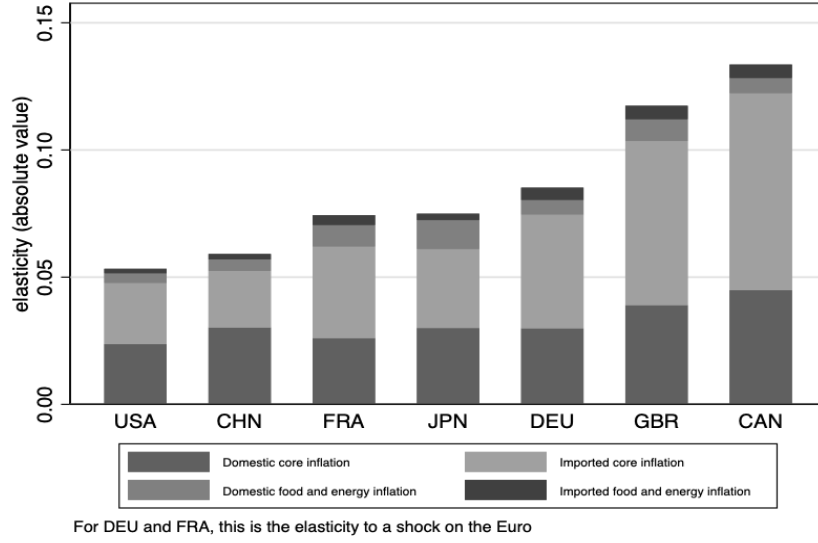


Fig. 8: Contribution of domestic and imported components to the HCE deflator elasticity (WIOD, 2014)

Sources: WIOD and authors's calculations

## 5 Filling the data gap: estimating the HCE deflator elasticity without resorting to WIOTs

### 5.1 Assessing the role of global value chains in the transmission of exchange rate variations to domestic prices

In this section, we analyse the determinants of the HCE deflator elasticity. In particular, we assess the role of global value chains in the transmission of an exchange rate appreciation to the HCE deflator. We identify four channels through which an exchange rate appreciation impacts the HCE deflator when production processes are global: *i*) the prices of imported final goods sold directly to domestic consumers; *ii*) the prices of imported inputs entering domestic production; *iii*) the price of exported inputs feeding through imported foreign production; *iv*), changes in domestic and foreign production costs in turn passing through to the price of inputs for domestic and foreign goods and causing further changes in production costs through input-output linkages. Mathematically, we break down  $\bar{s}_i^{i,HC}$  into these different elements. Starting from equation 9,

we have:

$$\begin{aligned}
 S^i &= C^i + \left( \hat{C}_{\$}^i \cdot \mathcal{B}^i + C^i \tilde{\mathcal{B}}^i \right) * (I - \mathcal{A})^{-1} \\
 S^i &= \underbrace{C^i}_{\text{(E1) direct effect through imported consumption goods}} + \underbrace{C^i \tilde{\mathcal{B}}^i}_{\text{(E2) effect on domestic consumption goods through imported inputs}} + \underbrace{\hat{C}_{\$}^i \cdot \mathcal{B}^i}_{\text{(E3) effect on imported consumption goods through domestic inputs}} \\
 &\quad + \underbrace{\left( \hat{C}_{\$}^i \cdot \mathcal{B}^i + C^i \tilde{\mathcal{B}}^i \right) * (I - \mathcal{A})^{-1} * \mathcal{A}}_{\text{(E4) residual}}
 \end{aligned} \tag{14}$$

Defining  $HC^{i,dom}$  and  $HC^{i,imp}$  as the domestic and imported shares of  $HC^i$  and adjusting the dimension of  $E1$ ,  $E2$  and  $E3$ , we have:

$$\begin{aligned}
 \bar{s}_i^{i,HC} &= S^i \cdot HC^i = E1 \cdot HC^i + E2 \cdot HC^i + E3 \cdot HC^i + E4 \cdot HC^i \\
 &= E1 \cdot HC^{i,imp} + E2 \cdot HC^{i,dom} + E3 \cdot HC^{i,imp} + E4 \cdot HC^i
 \end{aligned} \tag{15}$$

When the domestic currency appreciates,  $E1 \cdot HC^{i,imp}$  ( $E1 \cdot HC$  hereafter) and  $E2 \cdot HC^{i,dom}$  ( $E2 \cdot HC$  hereafter) reduce consumer prices in country  $i$ , whereas  $E3 \cdot HC^{i,imp}$  ( $E3 \cdot HC$ ) increases them. This decomposition differs from equation 11. Equation 11 focuses on the contribution of domestic versus imported goods to the HCE deflator elasticity to the exchange rate. By contrast, equation 15 highlights the transmission channels of the exchange rate fluctuation. Figure 9 plots the shares of  $E1 \cdot HC$ ,  $E2 \cdot HC$ ,  $E3 \cdot HC$  and  $E4 \cdot HC^i$  ( $E4 \cdot HC$ ) in  $\bar{s}_i^{i,HC}$ . Direct effects through imported consumer goods ( $E1 \cdot HC$ ) dominate. The effect on domestic consumer goods through imported inputs ( $E2 \cdot HC$ ) is also important. While the effect on imported consumer goods through domestic inputs ( $E3 \cdot HC$ ) is negligible (except for Germany and the Netherlands),  $E4 \cdot HC$  accounts for 10% to 30% of  $\bar{s}_i^{i,HC}$  for most countries (and close to 50% for India, Brazil, Portugal and Luxembourg). With the exception of Luxembourg, the less open to trade is a country, the larger the share of  $E4 \cdot HC$ .

Figure 10 shows that input-output mechanisms (i.e. all channels except  $E1 \cdot HC$ ) explain a large share of the elasticity, especially for large countries or euro area countries. The share explained by input-output mechanisms has increased until 2013-2014 (see Figure 11), implying an increasing need of data from WIOTs to perform our computations.

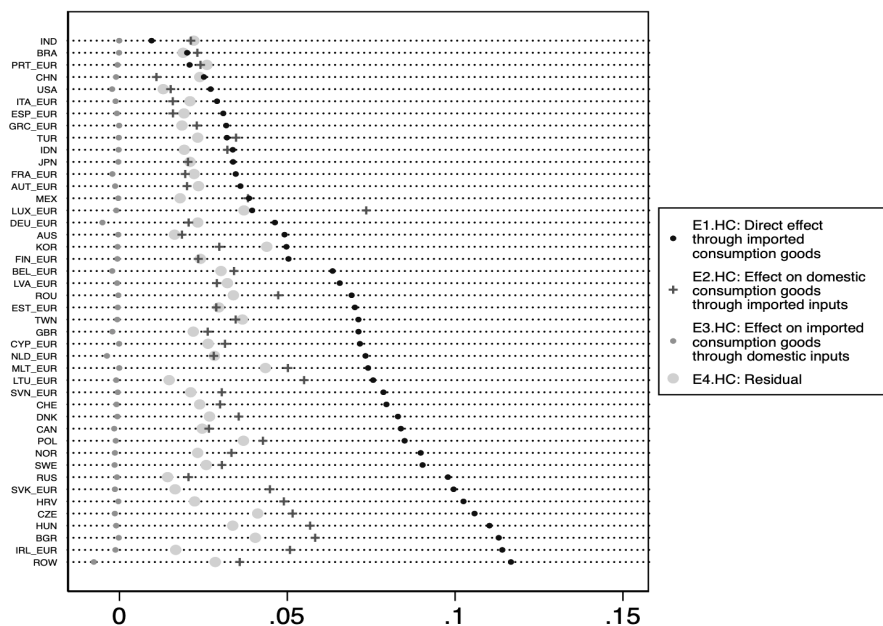


Fig. 9: Decomposition of  $\bar{s}_i^{i,HC}$  into  $E1.HC$ ,  $E2.HC$ ,  $E3.HC$  and  $E4.HC$  (WIOD, 2014)

Sources: WIOD and authors' calculations

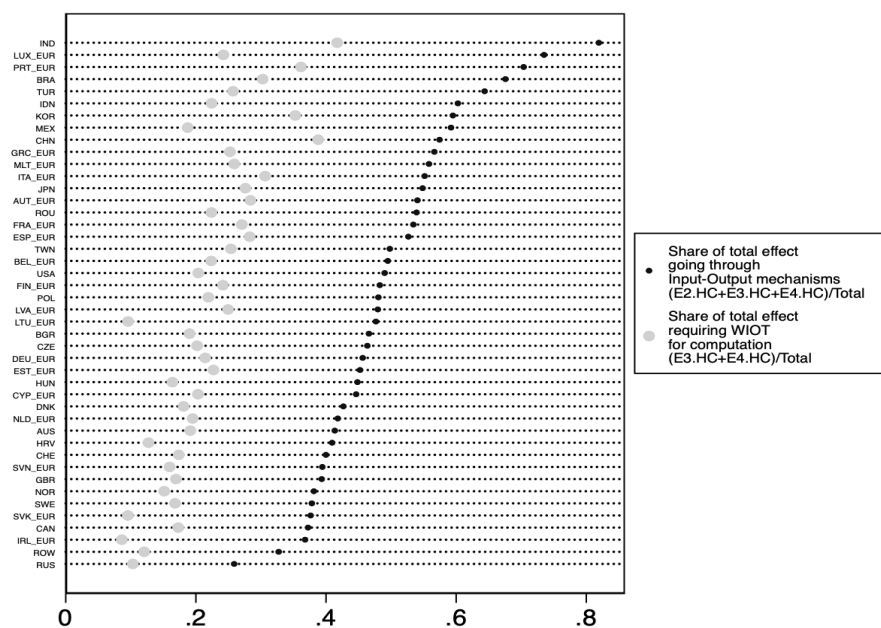


Fig. 10: Decomposition of  $\bar{s}_i^{i,HC}$  (WIOD, 2014)

Sources: WIOD and authors' calculations

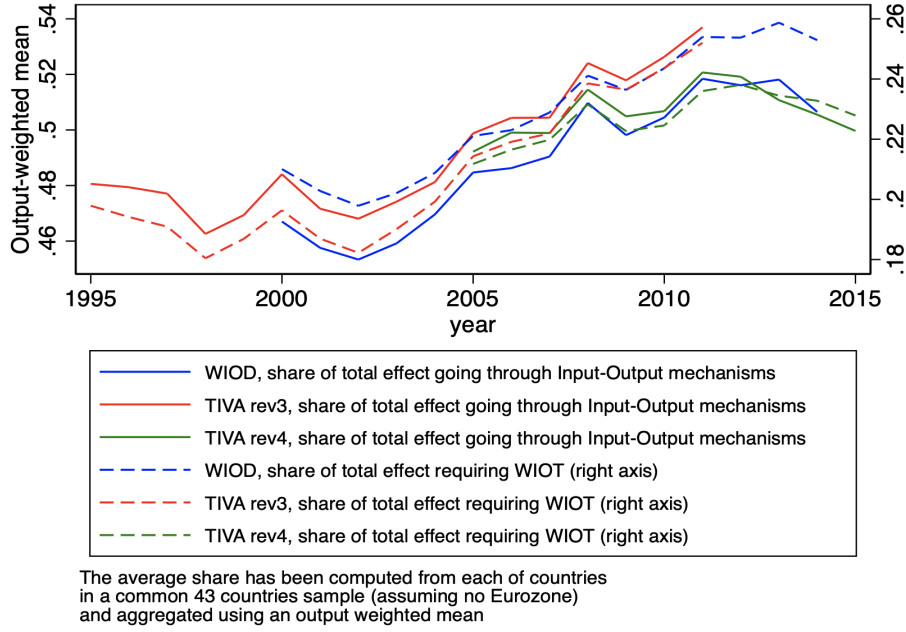


Fig. 11: Decomposition of  $\bar{s}_i^{i,HC}$  through time

Sources: WIOD, TIVA rev. 3, TIVA rev. 4 and authors' calculations

Overall, the first two channels explain three-quarters of the transmission of an exchange rate appreciation to domestic prices. By contrast, the last two channels, which reflect the impact of global value chains, play a more limited role, with marked across-countries heterogeneity. Approximately one-fourth of the HCE deflator elasticity to the exchange rate is attributable to participation in global value chains.

Still,  $E1.HC$  and  $E2.HC$  are relatively important (especially for small countries). Although the model as it stands cannot easily accommodate simultaneous exchange rate changes in different currencies (which would require increasing the number of  $\mathcal{B}$  matrices and  $C$  vectors), we expect the effect of simultaneous variations of different currencies to be correctly approximated by an own-currency exchange rate change of the trade-weighted average of the country-specific exchange rate changes.



## 5.2 Estimating the HCE deflator elasticity using the shares of imported goods and imported inputs in household consumption

The importance of  $E1.HC$  and  $E2.HC$  suggests that the HCE deflator elasticity to the exchange rates could be estimated using national accounts data and input-output matrices. National accounts data provide  $E1.HC$  and  $E2.HC$ , whereas world input-output matrices are needed for computing  $E3.HC$  and  $E4.HC$ . We investigate whether  $E3.HC$  and  $E4.HC$  can be inferred from easier-to-compute elements of  $\bar{s}_i^{i,HC}$ .

We infer  $\bar{s}_i^{i,HC}$  from  $E1.HC$  and  $E2.HC$  using equation 16. Figure 12 depicts the relationship between  $\bar{s}_i^{i,HC}$  and  $E1.HC + E2.HC$ . The high  $R^2$  (0.98) suggests that  $E1.HC + E2.HC$  is a good predictor of  $\bar{s}_i^{i,HC}$ .

$$\bar{s}_i^{i,HC} = \alpha + \beta \left( E1.HC^{i,imp} + E2.HC^{i,dom} \right) + \varepsilon_i \quad (16)$$

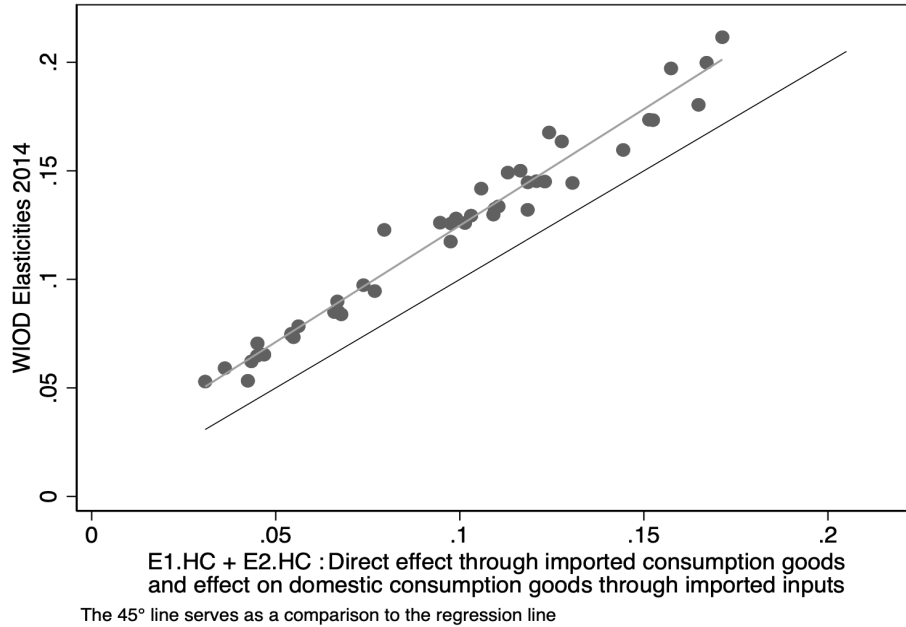


Fig. 12: Comparison of  $\bar{s}_i^{i,HC}$  and  $E1.HC^{i,imp} + E2.HC^{i,dom}$  (WIOD, 2014)

Sources: WIOD and authors' calculations

We check whether the relationship is constant over time by estimating yearly cross-sections of equation 16. With the exception of 2009, the relationship is broadly stable (see Figures 13).

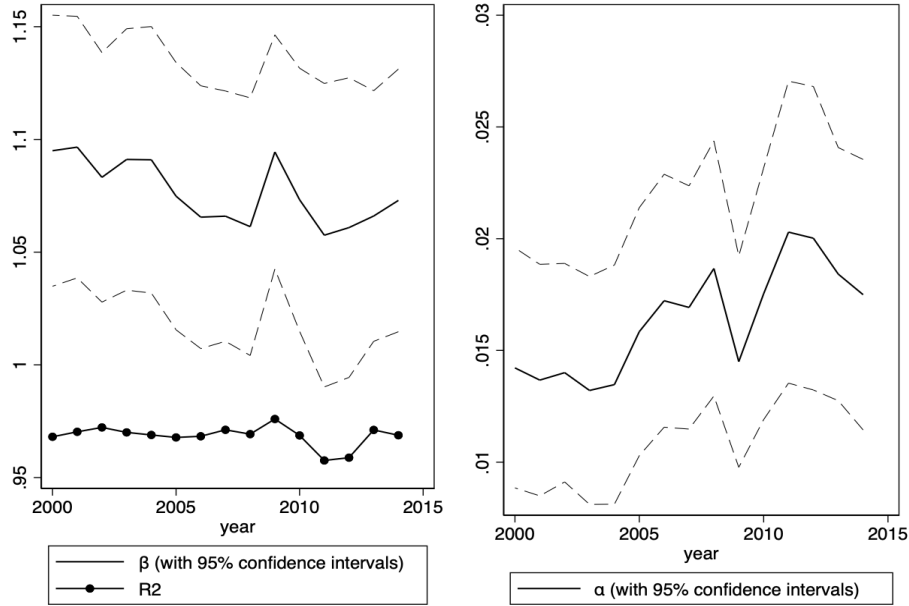


Fig. 13: Evolution of  $\alpha$  (the constant),  $\beta$  (the coefficient of  $E1.HC + E2.HC$ ) and  $R^2$  over time (WIOD)

Sources: WIOD and authors' calculations

We obtain similar results with TiVA (see Online Appendix D). Our results suggest that we can approximate the HCE deflator elasticity using the share of imported goods in household consumption and the share of imported inputs in household consumption of domestic goods.  $E1.HC + E2.HC$  is a good predictor of the total effects. Interestingly, they cannot be extrapolated in a multiplicative way, as the other effects ( $E3.HC + E4.HC$ ) add to them rather than amplifying them. They are of similar size for small open economies and large closed ones. This likely reflects the fact that a small economy compensates for its small size (and small influence on global value chains) by being more open (and hence more sensitive to changes in global value chains).<sup>6</sup>

### 5.3 Extrapolating the HCE deflator elasticity using GDP and trade statistics

In this section, we show that a precise assessment of the HCE deflator elasticity to the exchange rate can be estimated without resorting to WIOTs. The construction of World Input-Output

<sup>6</sup> Although this functional form might seem counterintuitive (we expected the elasticity to be an affine function of openness as summarized by  $E1.HC$ ), the analytical examination of the two-country, one-sector case shows that it is plausible (see Online Appendix E).

tables is data-demanding and WIOTs are typically released with a lag of several years. As a result, world input-output matrices are not available for the most recent years. The latest years covered by WIOD and TiVA rev. 4 are, respectively, 2014 and 2015. While the MRIO database covers more recent years, it is fraught with data quality issues for 2018 (see Section 4.3 and Online Appendix C). Using WIOTs also involves cumbersome computations. Given these difficulties, we look for a simpler way to compute the elasticity of the HCE deflator to the exchange rate. We estimate the HCE deflator elasticity from 2015 onwards using GDP statistics and trade data on consumption and intermediates.

As discussed in 5.2, the sum of the share of imported goods in household consumption and the share of imported inputs in household consumption of domestic goods ( $E1.HC + E2.HC$ ) is a good predictor of the impact of exchange rate fluctuations on household consumption prices. However, these data ( $E1.HC$  and  $E2.HC$ ) are not up-to-date for a large number of countries, as they are not routinely computed by national statistical institutes. We cannot use them to easily extrapolate HCE deflators.

Online Appendix F explores the using consumption and intermediate goods imports from the CEPII BACI database and the BEC classification (Gaulier and Zignago, 2010)<sup>7</sup> to extrapolate HCE deflators. Still, household consumption and intermediate products are more difficult to collect systematically for many countries and many years. In Online Appendix F, we use data from the World Bank and Eurostat, which are only available for a limited number of countries. This limits the number of countries to 29.

Here, to expand our panel to 42, we use an even simpler proxy for  $E1.HC + E2.HC$ , using only trade data from BACI and GDP data from the World Bank (see equation 17). These data are available until 2019.

$$\begin{aligned} \bar{s}_{i,t}^{i,t,HC} = & \beta_1 \frac{\text{imported consumption goods}_{i,t}}{\text{GDP}_{i,t}} \\ & + \beta_2 \frac{\text{imported intermediate goods}_{i,t}}{\text{GDP}_{i,t}} \\ & + \beta_3 \frac{\text{Total sample imported consumption goods}_t}{\text{Total sample GDP}_t} \\ & + \beta_4 \frac{\text{Total sample imported intermediate goods}_t}{\text{Total sample GDP}_t} \\ & + f e_i + \varepsilon_{i,t} \end{aligned} \tag{17}$$

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<sup>7</sup> BACI provides disaggregated data on bilateral trade flows for more than 5000 products and 200 countries. The database is built from data directly reported by each country to the United Nations Statistical Division (Comtrade). Products are defined as items from the Harmonized System nomenclature, at the 6-digit level.

	(1) WIOD	(2) TIVA	(3) TIVA REV4
$\beta_1$	0.49*** (0.17)	0.19 (0.17)	0.09 (0.16)
$\beta_2$	0.10*** (0.03)	0.09** (0.04)	0.11*** (0.04)
$\beta_3$	0.25 (0.43)	-0.23 (0.59)	1.25** (0.60)
$\beta_4$	0.27*** (0.05)	0.35*** (0.10)	0.20*** (0.04)
Observations	630	629	506
Country fixed effects	Yes	Yes	Yes
Number of countries	42	45	46
Number of years	15	14	11
Adj. R-square	0.98	0.96	0.97
p-value joint significance test (excluding fixed effects)	0	0	0

Note: Country-clustered standard errors in parentheses, \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

Tab. 3: Regression 17 for WIOD, TIVA and TIVA rev4

We then perform an out-of-sample prediction for WIOD, 2014, using data for years 2000 to 2008. The results are satisfactory, although the mean and median errors are larger than in Online Appendix F (see Figure 14). Our findings are robust to using other databases (results obtained with TiVA revisions 3 and 4 are available upon request).

Using these equations, we can predict the HCE deflator elasticity from 2015 onwards. Figure 15 shows that the in-sample predictions are robust, giving confidence in the quality of the out-of-sample predictions. We also compare our predictions with the elasticity estimated using MRIO, which provides WIOTs up to 2019. Our predictions are in line with results from MRIO up to 2017. For the most recent years, there seem to be data issues in MRIO (see Online Appendix C), which the comparison helps to identify. We thus provide a simple accounting tool to estimate the percentage change in prices in response to exchange rate variations for the most recent years.

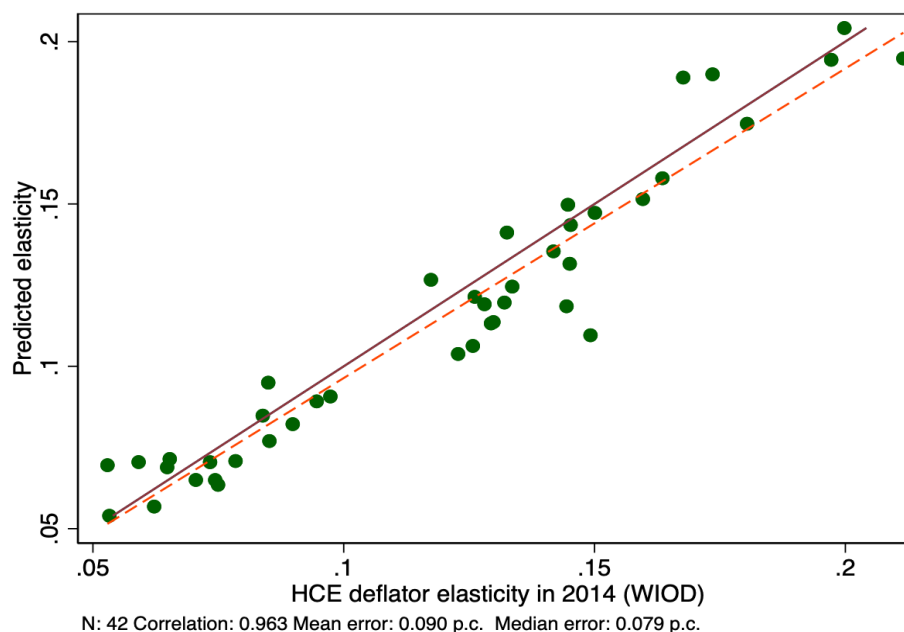


Fig. 14: Comparing the HCE deflator elasticity in 2014 (WIOD) and the prediction from a panel regression on the 2000-2008 period with fixed effects using only World Bank and Comtrade data.

Sources: WIOD, World Bank, BACI and authors' calculations

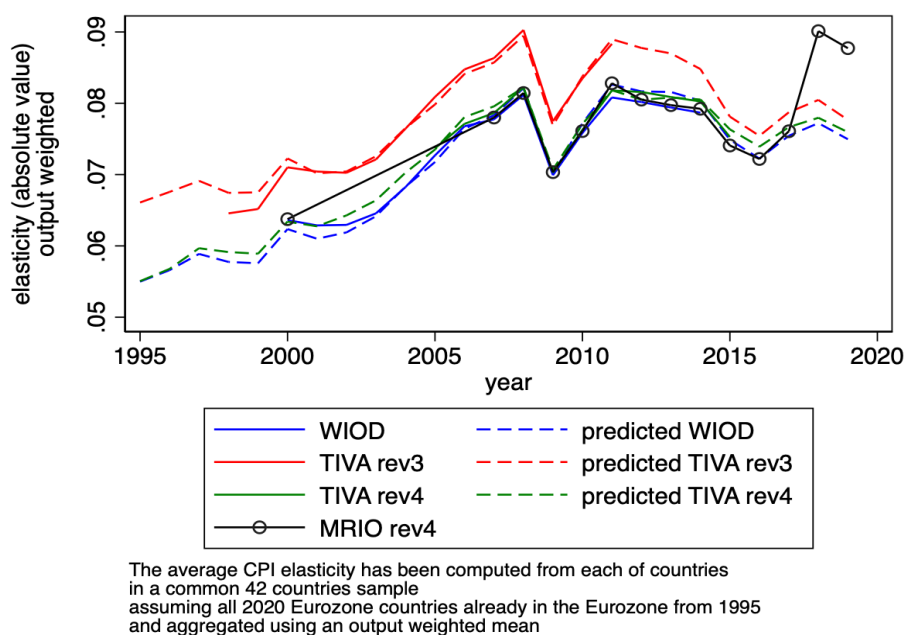


Fig. 15: Comparing the output-weighted HCE deflator elasticity to predictions based on World Bank and BACI data.

Sources: WIOD, TIVA, MRIO, World Bank, BACI and authors' calculations

## 6 Conclusion

This paper studies the elasticity of the household consumption expenditure (HCE) deflator to the exchange rate. Our contribution to the literature is fourfold.

First, we analyse the composition and determinants of the HCE deflator elasticity using world input-output tables covering twenty-four years of data, from 1995 to 2019. We use several datasets to ensure the robustness of our results. In line with the existing literature, we find a rather modest output-weighted elasticity of the HCE deflator to the exchange rate of around 0.1 at the world level. The output-weighted elasticity has remained broadly stable over the past two decades. Aggregate figures mask substantial cross-country heterogeneity, reflecting different degrees of openness to trade and differences in foreign product content in domestic consumption. The elasticity is larger for small open economies with higher import content of consumption.

Second, we examine which parts of the consumption basket contribute most to the elasticity of the HCE deflator to the exchange rate. Non-energy industrial goods explain the bulk of the total HCE deflator elasticity. Services also play a significant role, as they represent a substantial share of total consumption.

Third, we analyse the determinants of the HCE deflator elasticity and the role of global value chains in the transmission of an exchange rate appreciation to domestic prices. There is a marked cross-countries heterogeneity. On the whole, direct effects through imported consumption and intermediates entering domestic production explain three-quarters of the transmission of an exchange rate appreciation to domestic prices. By contrast, global value chains participation plays a limited role.

Fourth, we show that a precise assessment of the HCE deflator elasticity to the exchange rate can be extrapolated for recent years, for which good-quality WIOTs are missing. We estimate the HCE deflator elasticity using GDP statistics and trade data on consumption and intermediates and obtain reliable out-of-sample predictions.

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