

# Mind the data gap: an accounting approach to estimate the elasticity of the household consumption expenditure deflator to the exchange rate \*

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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). In line with the existing literature, we find a modest elasticity of around 0.1. The elasticity is stable over time but heterogeneous across countries, reflecting different degrees of openness to trade and differences in foreign product content in domestic consumption. Direct effects through imported consumption and intermediates entering domestic production explain most of the transmission of an exchange rate appreciation to domestic prices. By contrast, global value chains participation plays a limited role. As WIOT

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are not available for the latest years, we compute a precise estimate the HCE deflator elasticity from 2016 onwards using trade data and GDP statistics. By doing so, we compute a precise estimate of the elasticity without resorting to WIOT.

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

## Introduction

This paper focuses 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 2015. For the sake of robustness, we use several datasets (WIOD and two distinct releases of the OECD TiVA database). We perform an accounting exercise based on information contained in the WIOT with large matrices inversion. We make two additional assumptions to simplify our computations. First, we assume a full exchange rate pass-through to import prices. Hence, 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. As a result, our estimates provide an upper bound of the HCE deflator elasticity. Using alternative pricing assumptions would entail lower values. For instance, 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. We also assume that all pricing occur using the currency of the producing country, despite the well-documented role of dominant-currency pricing (Gopinath et al. [2020]). Despite these simplifying assumptions, our estimates provide an accounting-based gauge of how large the exchange rate pass-through could be, considering direct and indirect import content in consumption. It 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 and differences accross countries. We document 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 exchange rate appreciation. 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 to shed light on the cross-country heterogeneity in the elasticity estimates. Third, we analyse the determinants of the HCE elasticity and the role of global value chains in the transmission of an exchange rate appreciation to the HCE deflator. We identify four channels through which the exchange rate 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 pass through to the price of inputs for domestic and foreign goods and cause further production costs variations through input-output linkages.

We find that 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 cross-countries heterogeneity. Hence, only one-fourth of the HCE elasticity 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 without resorting to WIOT.

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. The latest dataset dates back to 2015. To address this gap, we estimate the HCE elasticity from 2016 onwards using GDP statistics and trade data on consumption and intermediates.

The rest of the paper is organised as follows. Section 1 reviews the related literature. Section 2 presents the methodology and the data sources. In section 3, we estimate the elasticity of the HCE deflator to the exchange rate up to 2015 and analyse its determinants. In section 4, we use up-to-date GDP and trade data to estimate the elasticity of the HCE deflator from 2016 onwards, without resorting to WIOT.

# 1 Related literature

## 1.1 Exchange rate pass-through

A large body of literature documents the exchange rate pass-through (ERPT hereafter) to domestic prices. Campa and Goldberg [2008] have documented a declining ERPT to import and consumer prices since the 1980s, whereas Leigh et al. [2017] find that both the ERPT and the price elasticity of trade volumes are stable over time. 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] show that the ERPT to euro area import and consumer prices has been stable since the 1990s. The ERPT differ across countries, as it depends, among other things, on their respective trade openness, integration in international production chains, pricing strategies and the currency of invoicing for trade. The choice of currency of invoicing 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 exchange rate pass-through to export prices. De Soyres et al. [2018] find that the ERPT decreases as the foreign value added increases.

Although we do not estimate the ERPT (we rather assume a full exchange rate pass-through to simplify our computations), 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.

## 1.2 The Input-Output model applied to a shock on production costs

The Leontief's production model (or Input-Output model, I-O thereafter) studies 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, and thus allows to extend Leontief's analysis to an international context. A number of studies [Hummels et al., 2001, Daudin et al., 2006, 2011, De Backer and Yamano, 2012, Johnson and Noguera, 2012, Koopman et al., 2014, Amador et al., 2015, Los et al., 2016, Miroudot and Ye, 2020] analyse the value added content of world trade. Some authors focus on Asia [Sato and Shrestha, 2014] or on the euro area [Cappariello and Felettigh, 2015]. Leontief's production model has a dual: the cost-push price model. In France, the Insee [Bourgeois and Briand, 2019] has developed the AVIONIC model based on French symmetric input-output tables. It measures the impact of an exogenous variation in the price of inputs on the price of production. Leontief's price model is broadly used in multi-sector, single-country macroeconomic models, for example, to measure the effect of changes in energy prices [Bournay and Piriou, 2015, Sharify, 2013]. Implicitly, Bems and Johnson [2015] use it to focus on competitiveness. They compute real effective exchange rates weighted by the value-added trade structure to measure the impact of a demand change in value

added on value added prices and final expenditure levels. Cochard et al. [2016] rely on an accounting approach to analyse the effects of costs on prices ("cost-push inflation") and shows that they are all the higher as countries are open.

Supply-driven input-output models (such as the Gosh model) have come under numerous criticism in the literature (e.g. Oosterhaven [1988]). Supply-driven price models are more widely accepted (Dietzenbacher [1997]). Still, the limitations of this approach are well known [Folloni and Miglierina, 1994]. In particular, and although the division of global value chains largely takes place within multinational firms, it assumes a unique pricing system based on market prices and independent of firms' strategies. Still, this method provides a measure of the vulnerability of each sector to price or productivity shocks [Acemoglu et al., 2012, Carvalho, 2014]. Hence, though unrealistic, this partial equilibrium approach using input-output tables is useful for identifying which countries and sectors are under pressure to adjust their prices when subject to exogenous cost shocks. For instance, it can show which euro area countries benefit most from an appreciation of the euro or whether adopting the euro has increased interdependence between member states.

## 2 The PIWIM model

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

### 2.1 Defining a price shock in an I-O model

To identify which countries are most affected by a price shock 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 describes, 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, the country blocks with flows of domestic transactions of intermediate goods and services between 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 of Leontief production functions. That facilitates the study of 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. Hence, we can 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 coefficient of dimension  $(N, N)$ , and  $Y$  the gross output vector of dimension  $(1, N)$ .

In each sector of each (country,sector) there is a representative firm producing with domestic production factors ( $V$ ) and domestic and imported intermediary inputs  $m$  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 domestic production factors share,  $a_{n,n'}$  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  $x$  the unit income of domestic production factors and  $x_n$  a constant depending



only on parameters:

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

Taking 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 ,  $Z$  a vector of  $\log(x_n) + \gamma_n \cdot \log(w_n)$ , all 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 use the products subject to a change in input prices as intermediate consumptions. The higher their reliance on those inputs, the higher the variation in their 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 change in input prices is passed on to all country-specific industries that rely on those shocked inputs in their production processes. 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 well-known of Leontieff inverse matrix. If the change in the exchange rate is small enough, the elements of  $S$  can be understood as the elasticity of sectoral price to an input price shock. Using consumption shares to perform a weighted average of these elasticities, we compute the Household consumption expenditure (HCE) deflator elasticity to an input price shock <sup>1</sup>.

## 2.2 Data

WIOTs are an extension of the national input-output tables. 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 the 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

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<sup>1</sup> This HCE deflator has different sectoral weights than the headline Consumer price index (CPI) as it also encompasses, for example, the rental equivalent of real estate expenditures.

uses the exports of a given country. For example, WIOTs show how much international trade is embedded in the consumption of a particular final product.

Aggregating national input-output tables into world input-output tables is challenging for many 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 two multi-year WIOTs: the World Input Output Database (WIOD) and the Trade in Value Added Database (TiVA) from the OECD-ICIO.

**The World Input Output Database (WIOD)** WIOD is hosted and updated by the University of Groningen (Netherlands) and benefits from the financial support of the European Commission. It 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. WIOD covers 43 countries (of which 28 members of the European Union) accounting for 85% of global GDP (see Table 1). WIOD contains annual information for 56 industries. Therefore, for each year a full country-sector input-output matrix traces the importance of a supplying industry in one country for an industry in another country. The values in WIOTs are 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: **Economies included in the World Input-Output Database**

**The Trade in Value Added (TiVA) database** The 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 [Decembre 2018] on the differences between the two datasets.). The third revision, released in 2016, includes 64 economies (i.e. 35 OECD countries, 28 non-OECD economies and the Rest of the world) and 34 industries. The third TiVA revision covers the period 1995-2011. It 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 (just like WIOD) 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: **Economies included in TiVA revisions 3 (2016) and 4 (2018)**

**Comparison of the WIOD and TiVA databases** WIOD and TiVA databases are constructed using similar assumptions (OECD and WTO [2011], Timmer et al. [2015], OECD [Decembre 2018]). For example, both start with the construction of harmonised country-specific supply-use tables (SUTs) that are then transformed into world input-output tables. Both 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 may

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. WIOD and TiVA 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 assumes that the input mix is independent from the destination market. TiVA databases do not rely on this assumption for two countries (Mexico and China). Instead, 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 between TiVA and WIOD, we obtain similar results with TiVA and WIOD, which probably reflects the fact that our study does not focus on Mexico and China.

Another difference relates to the method for harmonising national data and trade statistics. WIOD relies 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).

### **2.3 Accounting impact of a change in the nominal exchange rate on domestic prices**

Implementing an exchange rate variation is more complex than implementing a production cost shock. 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 increase. We are mainly interested in the impact of the exchange rate appreciation on the consumer prices in country  $A$ . We also estimate the inflationary impact on countries that directly and indirectly, through third countries linkages, consume inputs from country  $A$ .

Suppose a world with two countries  $A$  and  $B$ , each having its own national currency, and

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

For the sake of simplicity, we assume that the exchange rate pass-through is full. Hence, producers are assumed to completely pass the exchange rate appreciation on their production prices. 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 shock spread over multiple simultaneous production cycles. The overall impact of the shock in dollar terms is equal, for the shocked country  $A$ , to the rise in prices due to the exchange rate shock, minus 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 shock, 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, the appreciation of a country's currency  $i$  against all other currencies translates into a rise in country  $i$ 's prices in dollars. The price of each sector will vary in percentage (approximated as log point assuming the shock is small enough) by:  $c_{\$}^i$  for sectors in the shock-stricken country  $i$  and 0 in other countries.

Hence, for each sector  $j$  in country  $i$ :

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

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 the producer price depends directly on the quantity of inputs imported from the shock-stricken country  $i$ , weighed by the variation in level of the price of inputs in dollars (i. e. the exchange rate shock). 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  $-\frac{10}{11}\%$  with  $c_{\$}^i = 10\%$ .

We approximate these shocks by their log point equivalent<sup>2</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>2</sup> We could have used the log point approximation earlier and write that  $c^i = -c_{\$}^i$  with nearly the same results for small shocks.

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

This shock 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 shock 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 2.1. These two matrices retain only the first-step effects of the exchange rate shock on the price of goods and services imported by the shocked country  $i$  and the first-step effects of the exchange rate shock 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 domestic input price shock and the price of goods as well as on the link between non-shocked input prices and the price of goods in a non-shocked country.

Let us first look at the shock 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 shock 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 shocked 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 shock 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 can write the first-step impact for country  $i$  of the fall in input prices from the rest of the world. The first-step impact corresponds to 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 the 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 the 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 coefficients 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  $i$ ).
- $c_{\$}^i$ : exchange rate shock on the currency of country  $i$  in dollar. If it appreciates by 10%,  $c_{\$}^i = 0.1$ .
- $c^i$ : exchange rate shock 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 change in prices everywhere expressed in country  $i$ 's currency:  $C^i = \left(-\frac{c_{\$}^i}{1+c_{\$}^i}, \dots, 0, \dots, -\frac{c_{\$}^i}{1+c_{\$}^i}\right) = (c_i, \dots, 0, \dots, c_i)$
- $C_{\$}^i$ : 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 change 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 shocked country  $i$  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 this direct impact in dollars, by multiplying it by the new value of the national currency in dollars,  $(1 + c_{\$}^i)$ . The direct impact of the appreciation of the shocked country  $i$  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 these vectors from equations 5 and 7, i. e.  $C_{\$}^i \cdot \mathcal{B}^i + \tilde{C}_{\$}^i \tilde{\mathcal{B}}^i$ .

The input price shock 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 are completely exhausted. In the end, the total price effect of the exchange rate shock 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 the non-shocked countries), and by all changes in prices during the production processes, i. e.:

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

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

With  $S_{\$}^i$  the total impact vector composed of the elements  $s_{\$kj}^i$  showing the total impact of a shock on country  $i$ 's exchange rate on the price of the country  $k$ 's sector  $j$  in international currency 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, this paper focuses on the effect of an exchange rate shock on the 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 shock in international currency, multiply the balance by the scalar of conversion equal to  $\frac{1}{1+c_{\$}^i}$  and add the initial exchange rate shock in national currency.

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

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 a exchange rate shock on prices in each sector of each country expressed in the currency of country  $i$ . It is expressed in log points. If the shock is small enough, its elements are the elasticities to an exchange rate shock of the prices consumers in country  $i$  are paying for each good. We return to this equation and its interpretation in section 4.

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

$HC^i$  be the vector of sectoral shares in country  $i$ 's household consumption<sup>3</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  $i$ .

$\bar{s}_i^{i,HC}$  provides the HCE deflator of country  $i$  elasticity to an exchange rate shock.

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

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

### 3 Accounting impact of an exchange rates variation on consumer prices

We use the model presented in 2.3 to analyse the impact of an exchange rate variation on the household consumption expenditure (HCE) deflator. We assume that the variation in the exchange rate is small enough to assimilate log and percentage points and hence consider  $\bar{s}_i^{i,HC}$  as the HCE deflator elasticity to an exchange rate shock. 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.

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<sup>3</sup> Consumption is at market prices, whereas the WIOTs are all at basic prices. This is not an issue as long as we assume that all taxes and subsidies on products are proportional, as is the main one, the value-added tax.

### 3.1 Heterogeneity across country

We find that the HCE deflator elasticity is heterogeneous across countries. Using the WIOD database, which covers a sample of 43 countries, we find that the elasticity ranges from 0.05 to 0.35 (see Figure 2). 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 instance, we find an elasticity of 0.06 in 2011 for the US. Accross the euro area, the elasticity of the HCE deflator differs substantially, ranging from 0.07 in Italy to 0.18 in Ireland. 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. It is twice higher in small open countries like Luxembourg, Malta, Slovakia and Ireland.

Figure 1 shows that we obtain similar country results with the three databases (WIOD and two distinct releases of TiVA), both in 2011 and 2014.

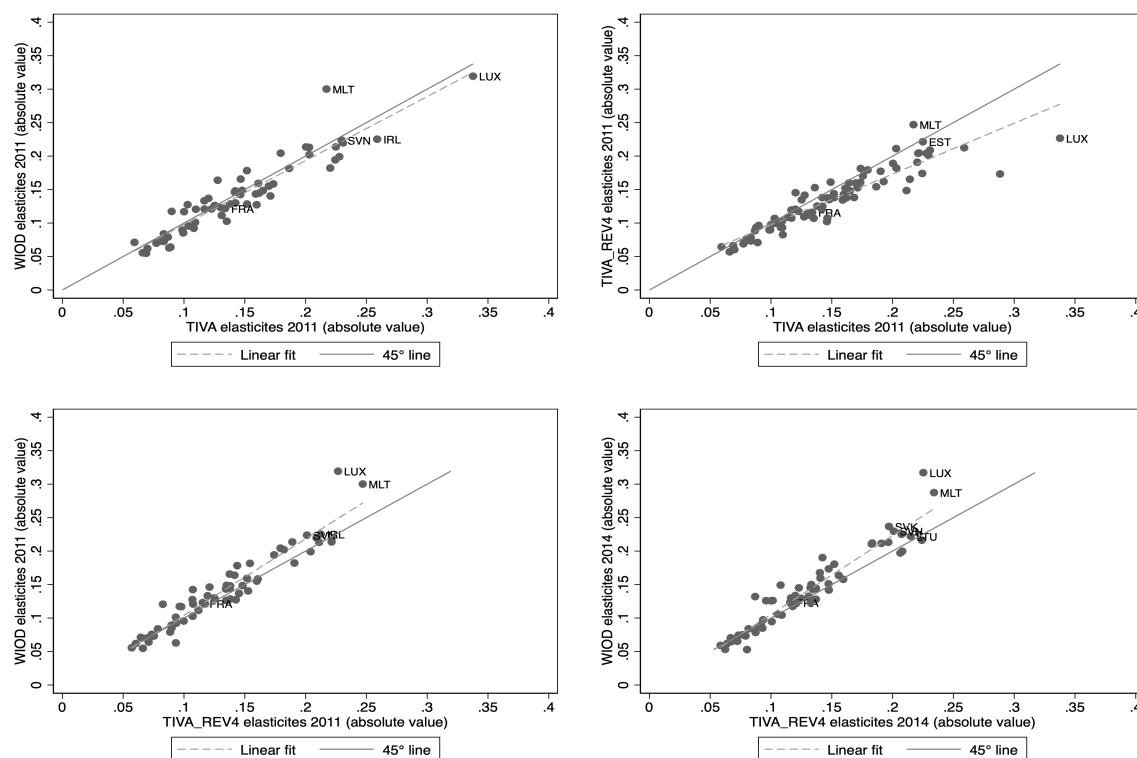


Fig. 1: Comparison of the HCE deflator elasticity to an exchange rate shock for WIOD, TIVA and TIVA rev. 4, 2011 and 2014

Sources: WIOD, TIVA rev3 and TIVA rev4, authors' calculations

Heterogeneity in the elasticity is related to differences in foreign product content in domestic consumption. Figure 4 shows that the value of the elasticity is closely related to the share of imported goods and services in household consumption. The higher the country's import share in consumption, the higher the elasticity of the HCE deflator to the exchange rate. Small open economies in the euro area post higher import content of consumption. Our findings concur with the literature. For instance, Ortega and Osbat [2020] find that the direct and indirect import content in consumption ranges from 12% in Italy to 33% in Ireland and Malta according to calculations based on input-output tables from WIOD.

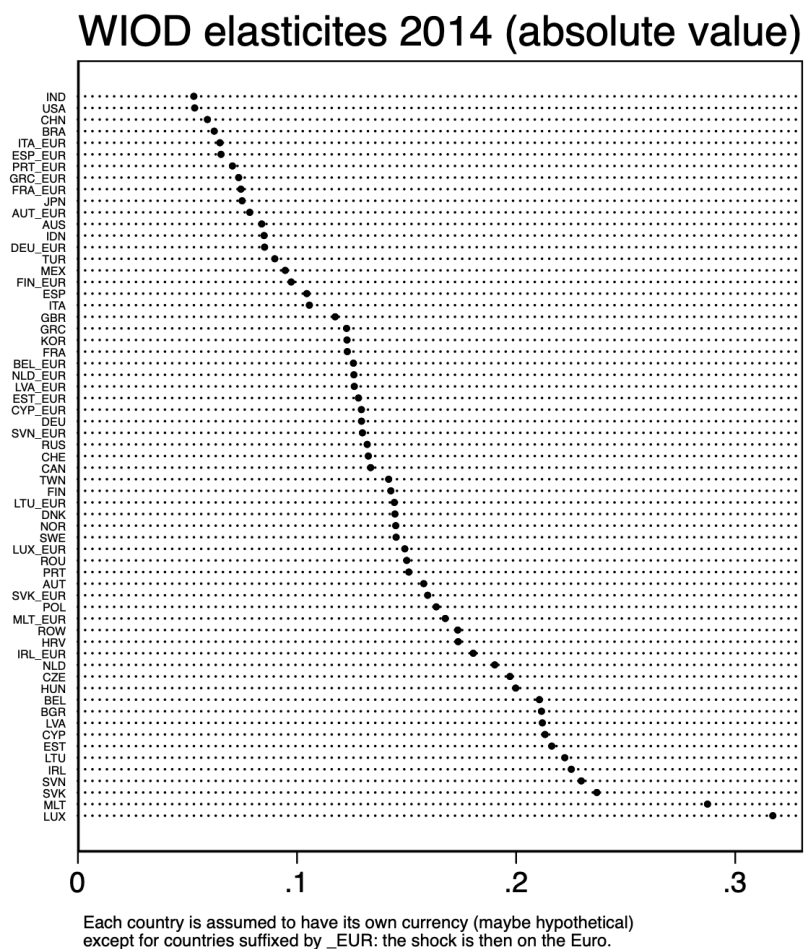


Fig. 2: Distribution of the HCE deflator elasticity to an exchange rate shock (WIOD) - 2014.

Sources: WIOD and authors' calculations

### 3.2 Evolution over time

We find that the elasticity of the HCE deflator to the exchange rate has remained broadly stable over the past two decades. Using the WIOD database, we find that the mean output-weighted elasticity of the HCE deflator increased from 0.08 in 2000 to 0.09 in 2008. After peaking in 2008, the elasticity slightly declined between 2009 and 2015. 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 since the 2008-2009 Great Recession. We obtain similar results with WIOD and TIVA



(see Figure 3). Using data from TIVA rev. 3, which covers a sample of 64 countries, yields a higher elasticity. This result 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 small differences observed between WIOD and TIVA rev. 4 likely reflects different ways of reconciling national accounts and international trade statistics. Output-weighted results provide a lower elasticity, reflecting the fact that large countries are relatively closed compared to small economies. Using the third revision of the TiVA database, we find that the output-weighted elasticity has increased by 25% between 1995 and 2008, reaching 0.1 in 2008. The elasticity has slightly declined afterwards.

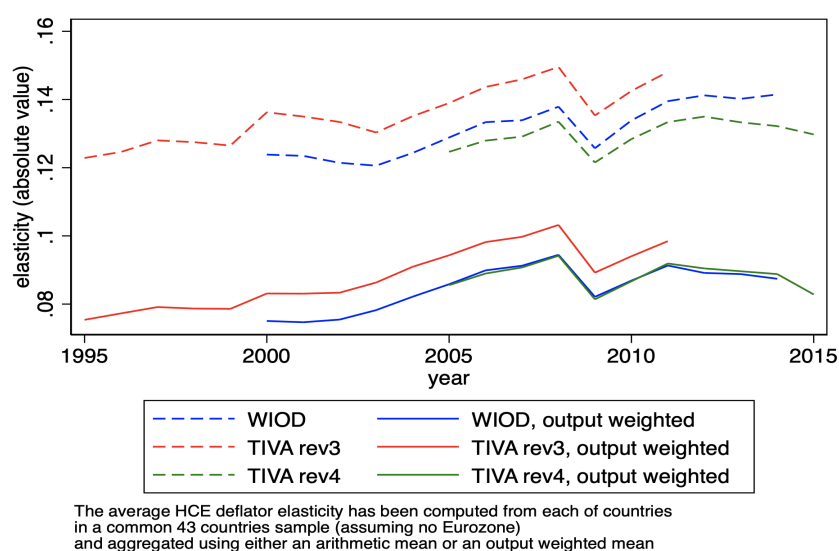


Fig. 3: Evolution of the output-weighted elasticity of the HCE deflator, 1995-2015

Sources: WIOD, TIVA rev3, TIVA rev4 and authors' calculations

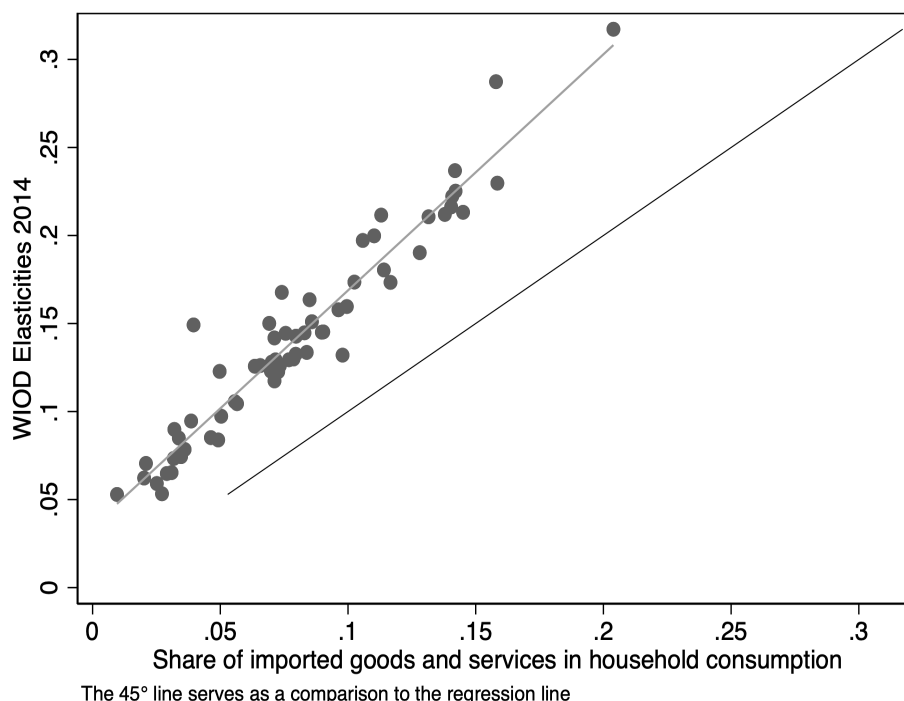


Fig. 4: HCE deflator elasticity and share of imported consumption in total consumption (WIOD)

Sources: WIOD and authors' calculations

### 3.3 Determinants of the HCE elasticity and the role of global value chains in the transmission of an exchange rate appreciation to domestic prices

We analyse the determinants of the HCE elasticity and the role of global value chains in the transmission of an exchange rate appreciation to the HCE deflator. To do so, 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 pass through to the price of inputs for domestic and foreign goods and cause further production costs variations through input-output linkages.

Figure 5 shows the contribution of domestic versus imported goods to the HCE deflator elasticity. 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,

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

Figure 5 shows that changes in the prices of imported final consumer goods contribute more to the total effect than changes in the prices of domestic goods. Although imported final consumer goods account for a smaller share of total consumption than domestic goods, they are the most impacted by changes in the exchange rate. Imported final consumer goods also explain the differences in price elasticities observed between open and relatively closed economies.

Overall, we find that 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. Hence, only one-fourth of the HCE elasticity to the exchange rate is attributable to participation in global value chains.

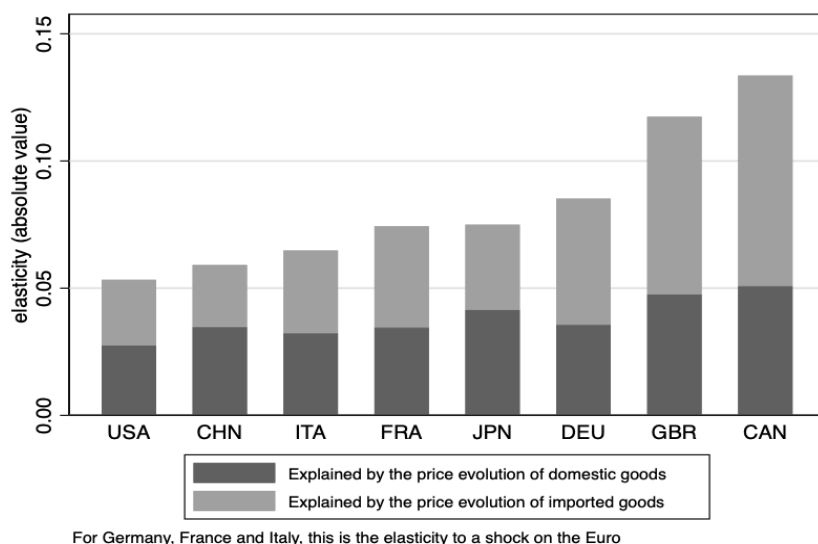


Fig. 5: Contribution of imported and domestic final goods and services to the HCE deflator elasticity

Sources: WIOD and authors' calculations

### 3.4 Contribution of the main components of the HCE deflator

Building on sectoral data, we examine which sectors experience higher spillovers from an exchange rate appreciation. 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 to shed light on the observed heterogeneity in the elasticity estimates. Figure 6 shows the impact of a variation 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, services represent a substantial share of total consumption. Similarly, domestic core inflation (all products except food and energy) accounts for a significant share of the total impact (Figure 7), reflecting the weight of domestic services and non-energy industrial goods in total consumption.

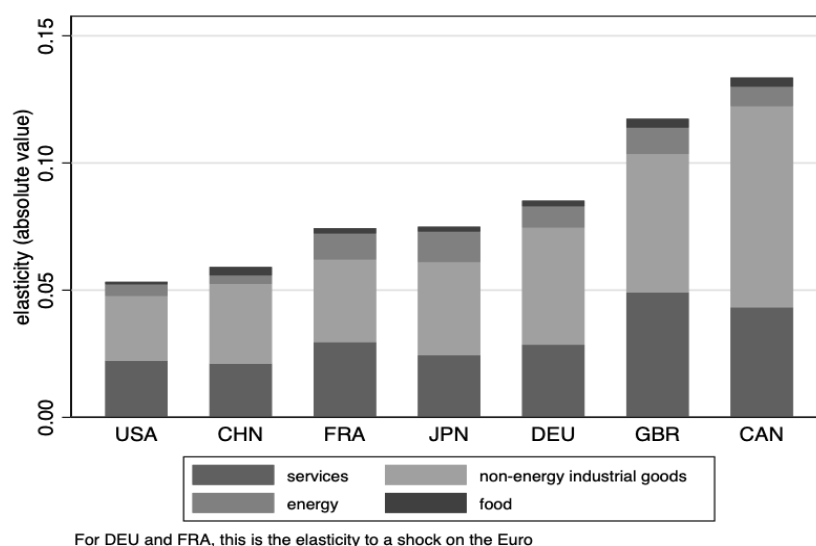


Fig. 6: Contribution of different products to the HCE deflator elasticity to an exchange rate shock

Sources: WIOD and authors' calculations

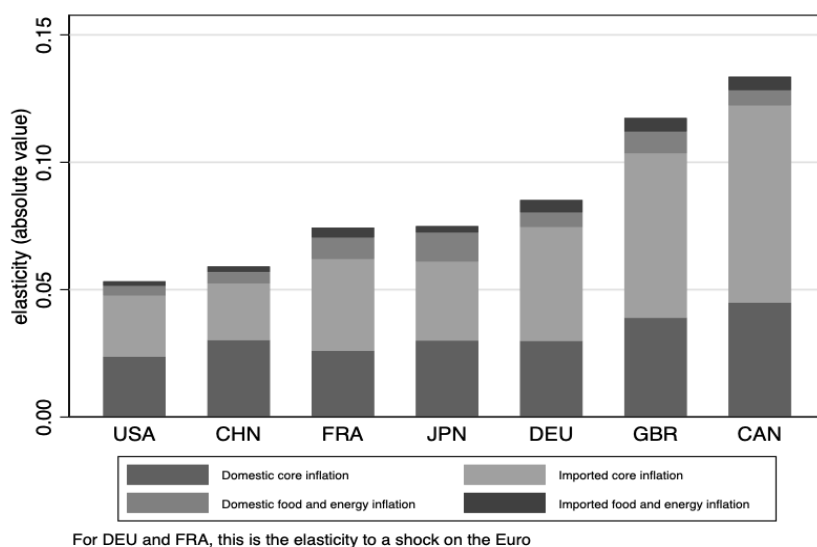


Fig. 7: Contribution of domestic and imported components to the HCE deflator elasticity

Sources: WIOD and authors's calculations

## 4 Estimating the HCE deflator elasticity without resorting to WIOT

### 4.1 Doing without the world input-output matrices

In this section, we show that a precise assessment of the HCE deflator elasticity to the exchange rate can be estimated without resorting to WIOT. The construction of World Input-Output 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 rev4 are, respectively, 2014 and 2015. In addition, using WIOTs 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 elasticity from 2016 onwards using GDP statistics and trade data on consumption and intermediates.

First, we break down  $\bar{s}_i^{i,HC}$  into different elements classified by ease of use and computation. Let us start from equation 9. We have:

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

$C^i$  and  $\hat{C}_{\$}^i$  have a large number of zeros. So, we can write, 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  $E3$ .

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

When the domestic currency appreciates,  $E1.HC^{i,imp}$  (for short  $E1.HC$ ),  $E2.HC^{i,dom}$  (for short  $E2.HC$ ) reduce the consumer prices of the country  $i$  whereas  $E3.HC^{i,imp}$  (for short  $E3.HC$ ) 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 an exchange rate shock. By contrast, equation 15 highlights the transmission channels of the shock.

Figure 8 plots the shares of  $E1.HC$ ,  $E2.HC$ ,  $E3.HC$  and  $E4.HC$  (shortening  $E4.HC^i$ ) in  $\bar{s}_i^{i,HC}$ .  $E1.HC$  dominates. While  $E3.HC$  is negligible,  $E4.HC$  accounts for 10% to 30% of  $\bar{s}_i^{i,HC}$  for most countries except China. On the whole, as shown by Figure 9, input-output mechanisms (i.e. all shares except  $E1.HC$ ) explain a large share of the elasticity, especially for large countries or countries of the Eurozone subject to a shock on the Euro. This share has increased until 2013-2014, implying an increasing need of data from WIOTs to perform our computations (see Figure 10).

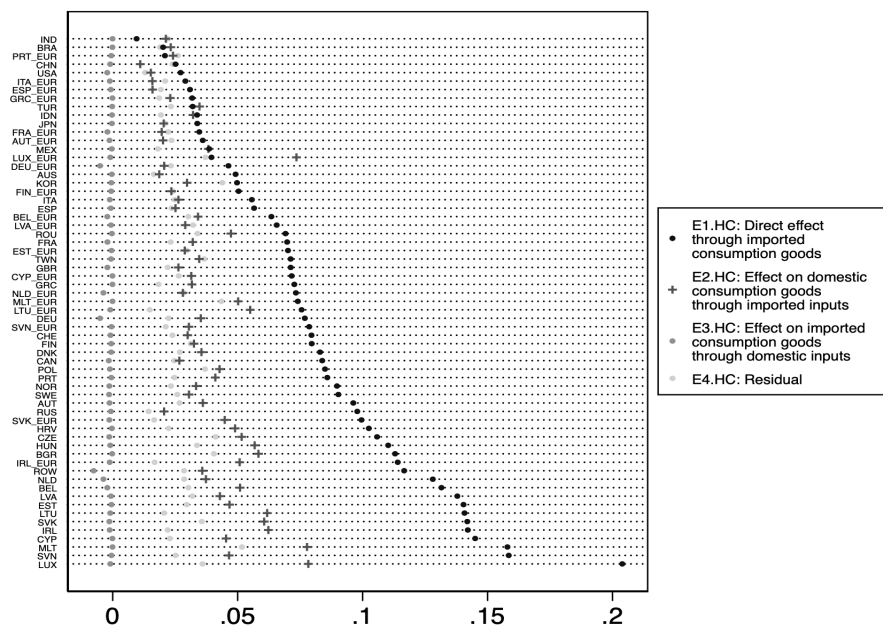
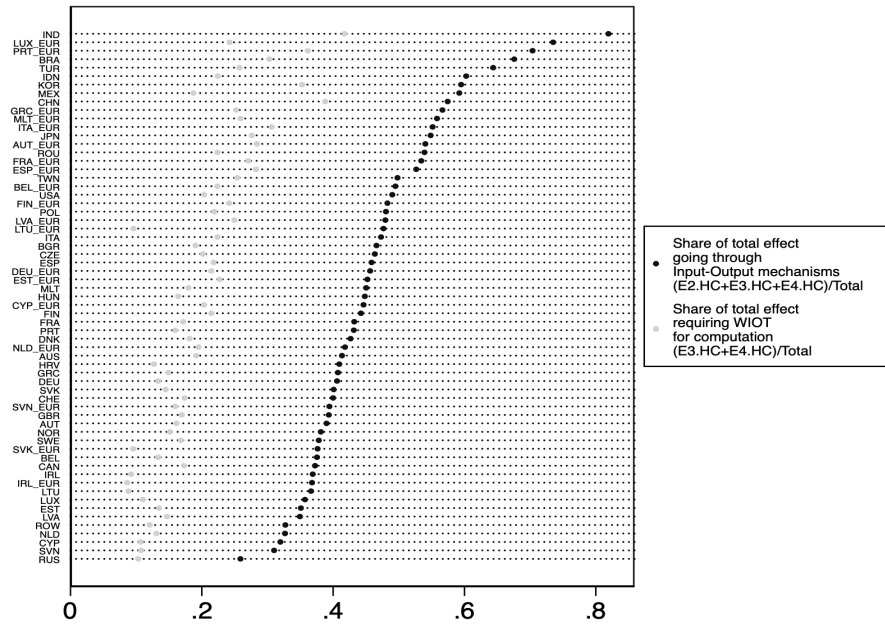
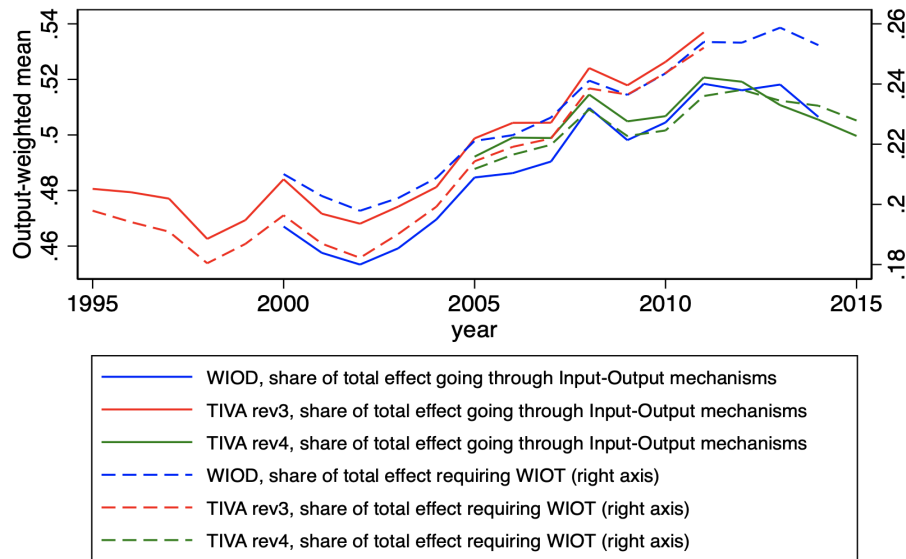


Fig. 8: Decomposition of  $\bar{s}_i^{i,HC}$  into  $E1.HC$ ,  $E2.HC$ ,  $E3.HC$  and  $E4.HC$

Sources: WIOD and authors' calculatons

Fig. 9: Decomposition of  $\bar{s}_i^{i,HC}$ 

Sources: WIOD and authors' calculations



The average share has been computed from each of countries in a common 43 countries sample (assuming no Eurozone) and aggregated using an output weighted mean

Fig. 10: Decomposition of  $\bar{s}_i^{i,HC}$  through time

Sources: WIOD, TIVA rev3, TIVA rev4 and authors' calculations

$E1.HC$  and  $E2.HC$  can be computed with national input-output matrices, whereas



world input-output matrices are needed for computing  $E3.HC$  and  $E4.HC$ . Although world input-output matrices are not available for the most recent years,  $E4.HC$  can be inferred from easier-to-compute elements of  $\bar{s}_i^{i,HC}$ .

We try to infer  $\bar{s}_i^{i,HC}$  from  $E1.HC$  and  $E2.HC$ . Figure 11 depicts the relationship between  $\bar{s}_i^{i,HC}$  and  $E1.HC + E2.HC$  according to equation 16. The high  $R^2$  (0.98) suggests that  $E1.HC + E2.HC$  is a good predictor of  $\bar{s}_i^{i,HC}$ .

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

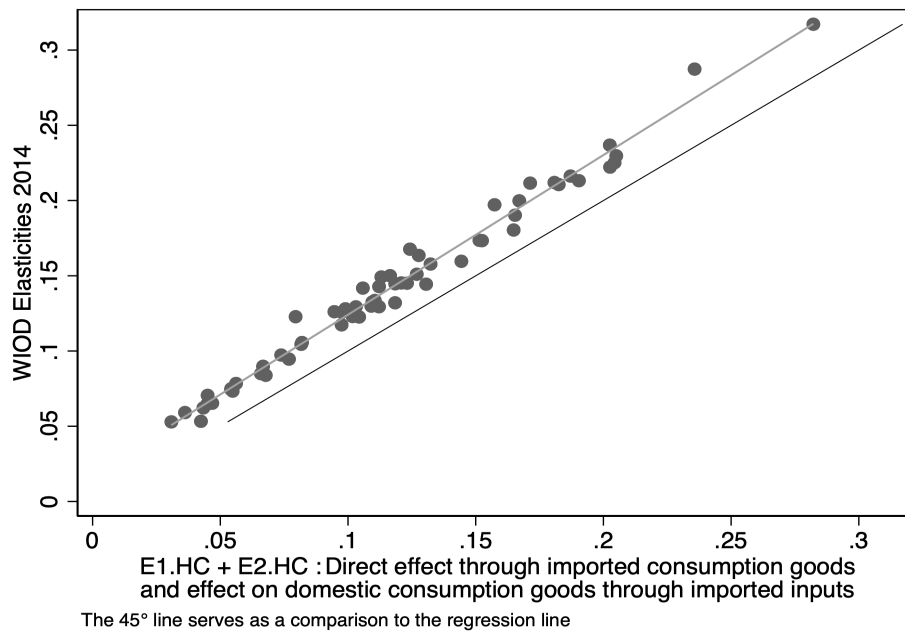


Fig. 11: Comparison of  $\bar{s}_i^{i,HC}$  and  $E1.HC^{i,imp} + E2.HC^{i,dom}$

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 12 and 13).

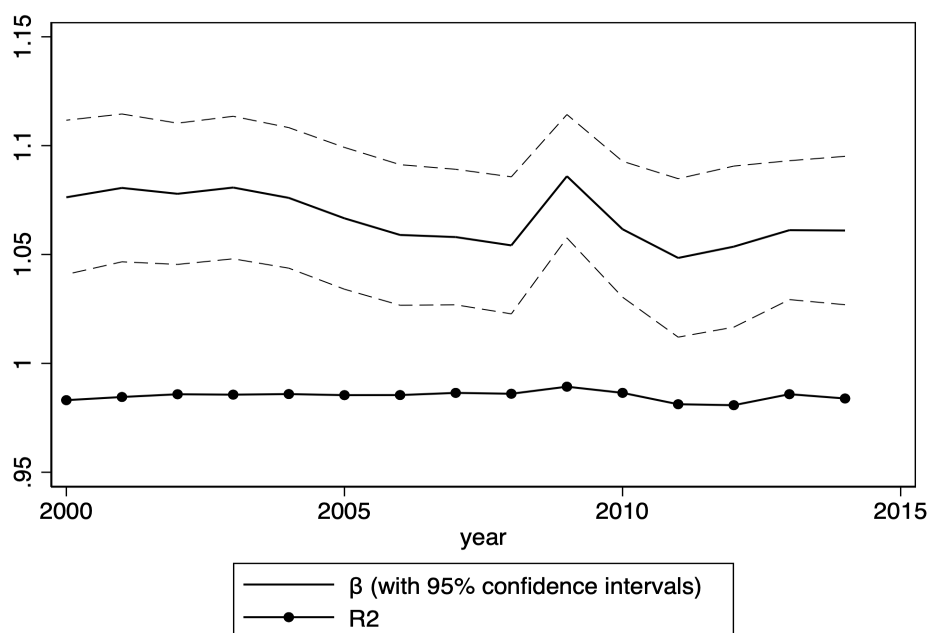


Fig. 12: Evolution of  $\beta$  (the coefficient of  $E1.HC+E2.HC$ ) and  $R^2$  over time (WIOD)

Sources: WIOD and authors' calculations

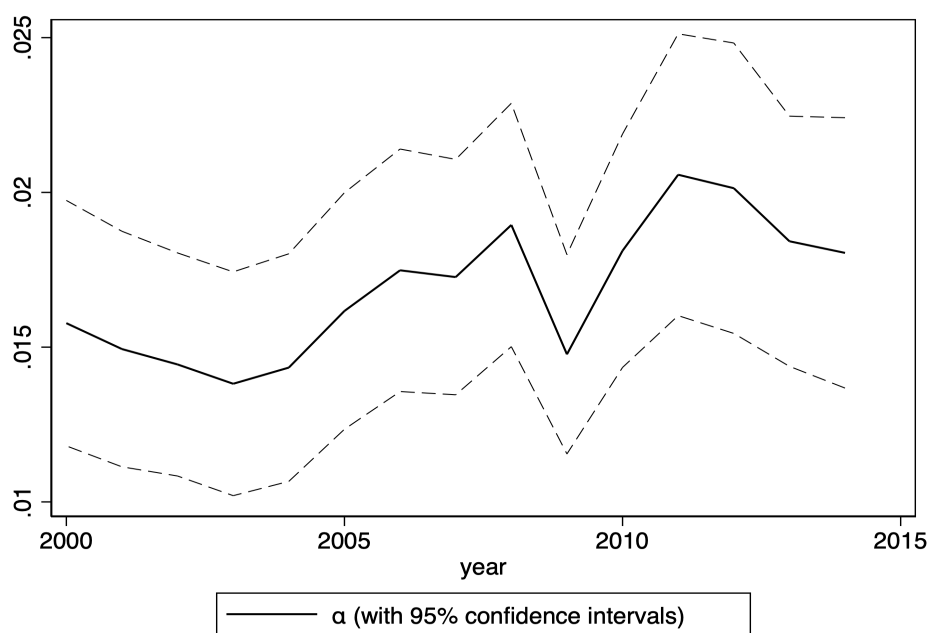


Fig. 13: Evolution of  $\alpha$  (the constant) over time (WIOD)

Sources: WIOD and authors' calculations

We obtain similar results with TiVA (see Online Appendix C). Our results suggest that we can approximate the HCE deflator elasticity for the most recent years, 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. Yet, 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. It might be that the small economy counterbalances its small size with its large openness rate and vice versa.<sup>4</sup>

## 4.2 Doing without TiVA and WIOD, but keeping Eurostat

However, even these data ( $E1.HC$  and  $E2.HC$ ) are not up-to-date for a large number of countries. The share of imports in household final consumption and in intermediate consumption for the production of domestic household final consumption are not routinely computed by national statistical institutes. We thus rely on a proxy by identifying consumption and intermediary goods imports using UN Comtrade data and the BEC classification. While the World Bank provides regular estimates for household consumption, estimates for intermediate consumptions are lacking. However, Eurostat provides estimates for intermediate consumptions for European countries. Combining these three data sources, we compute the share of imported consumption goods in household consumption and the share of imported inputs in all inputs.

We mimick equation 16 by equation 17. We estimate successive cross-sections of equation 17 to check whether the proxy is satisfactory.

$$\begin{aligned} \bar{s}_i^{i,HC} = \alpha &+ \beta_1 \frac{\text{imported consumption goods}_i}{\text{household consumption}_i} \\ &+ \beta_2 \left[ \frac{\text{imported intermediate goods}_i}{\text{intermediate consumption}_i} * \frac{\text{domestic consumption goods}_i}{\text{household consumption}_i} \right] + \varepsilon_i \end{aligned} \quad (17)$$

In the same way, Figure 14 mimicks Figure 12. The results are less encouraging: the  $R^2$  is smaller and declining over time, and the estimated coefficient is not constant.

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<sup>4</sup> Although this functional form might seem counterintuitive (one might expect that the elasticity is 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 D).

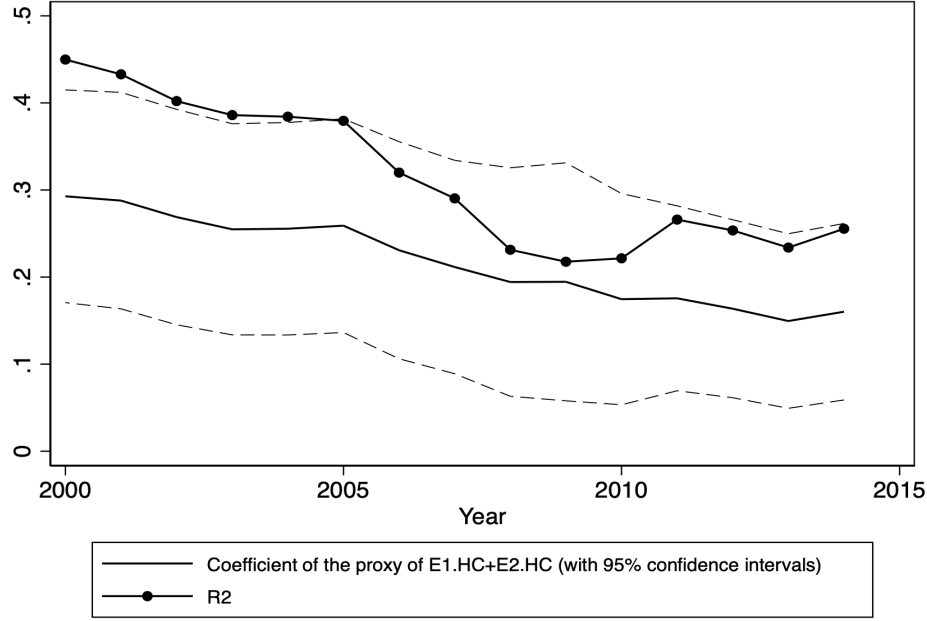


Fig. 14: Evolution of  $\beta$  and  $R^2$  (WIOD) using Eurostat data to approximate E1.HC + E2.HC (limited number of countries)

Sources: WIOD and authors' calculations

Yet, estimating successive cross-sections of equation 17 is a demanding test to establish a link between the elasticity computed by PIWIM based on WIOD data and more up-to-date data assembled from various sources. It does not allow to exploit country-specific information on the determinant of the elasticity. A less demanding test consists in running a panel regression with country fixed-effects, assuming that  $\beta$  is constant over time but that it explains only within-country variations. To take into account year-specific shocks, we add two year-specific variables : the GDP-weighted mean of each variable of interest (see equation 18).

$$\begin{aligned}
 \bar{s}_{i,t}^{i,t,HC} = \alpha & + \beta_1 \frac{\text{imported consumption goods}_{i,t}}{\text{household consumption}_{i,t}} \\
 & + \beta_2 \left[ \frac{\text{imported intermediate goods}_{i,t}}{\text{intermediate consumption}_{i,t}} * \frac{\text{domestic consumption goods}_{i,t}}{\text{household consumption}_{i,t}} \right] \\
 & + \beta_3 \frac{\text{Total imported consumption goods}_t}{\text{Total household consumption}_t} \\
 & + \beta_4 \left[ \frac{\text{Total imported intermediate goods}_t}{\text{Total intermediate consumption}_t} * \frac{\text{Total domestic consumption goods}_t}{\text{Total household consumption}_t} \right] \\
 & + f e_i + \varepsilon_{i,t}
 \end{aligned} \tag{18}$$

We run the panel regressions for the period 2000 to 2008. We then estimate the out-of-sample elasticity for each country  $i$  for 2014. The outcome is close to the elasticity computed with WIOD for 2014 despite a small downward bias (see Figure 15). Hence, we could use this approach to estimate the HCE deflator elasticity to the exchange rate from 2015 onwards.

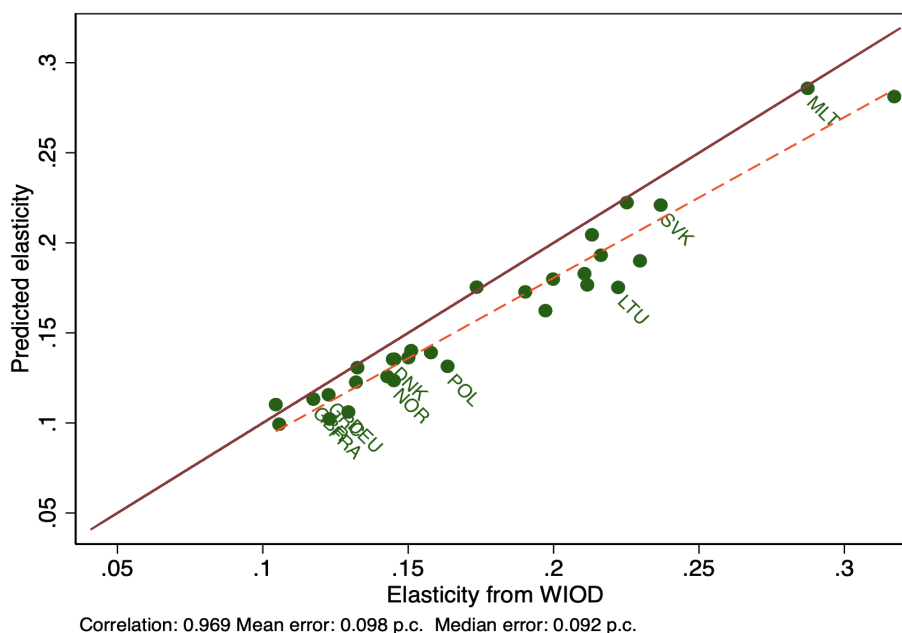


Fig. 15: Comparing the HCE deflator elasticity in 2014 (WIOD) and the prediction from a panel regression on the 2000-2008 period with fixed effects using Eurostat data.

### 4.3 Doing with only World Bank and Comtrade data

Data on intermediate consumption and household consumption are not available for all countries. As a result, our regressions only include a limited number of observations. To expand our panel, we use an even simpler proxy for  $E1.HC + E2.HC$ . This proxy only requires trade data from Comtrade and GDP data from the World Bank. This data is available until 2018. As a result, we can include more countries in the new panel (see

equation 19).

$$\begin{aligned}
 \bar{s}_{i,t}^{i,t,HC} = & \alpha + \beta_1 \frac{\text{imported consumption goods}_{i,t}}{\text{GDP}_{i,t}} \\
 & + \beta_2 \frac{\text{imported intermediate goods}_{i,t}}{\text{GDP}_{i,t}} \\
 & + \beta_3 \frac{\text{Total imported consumption goods}_t}{\text{Total GDP}_t} \\
 & + \beta_4 \frac{\text{Total imported intermediate goods}_t}{\text{Total GDP}_t} \\
 & + f e_i + \varepsilon_{i,t}
 \end{aligned} \tag{19}$$

The out-of-sample prediction remains satisfactory, although the mean and median errors are larger (see Figure 16). Our findings are robust to using other databases (revision 3 and revision 4 of TIVA).<sup>5</sup>

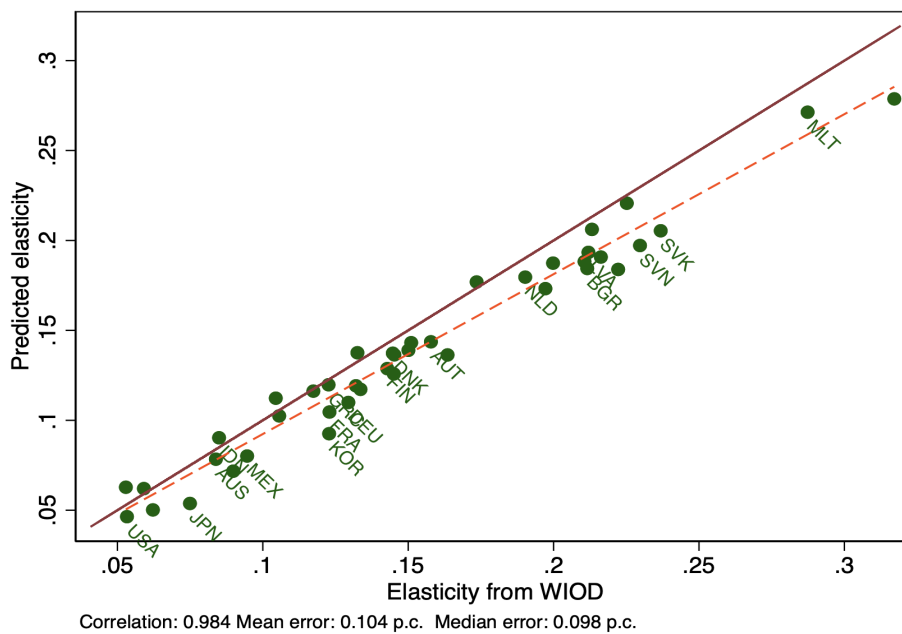


Fig. 16: Comparing the HCE deflator elasticity in 2014 (WIOD) and the prediction from a panel regression on the 2000-2008 period with fixed effects using only World Bank and Comtrade data.

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

Using these equations, we can predict the HCE deflator elasticity from 2016 onwards to make up for the lack of WIOTs. Figure 17 shows the predictions. The in-sample predictions seem rather robust, giving confidence in the quality of the out-of-sample predictions.

<sup>5</sup> Results are available upon request

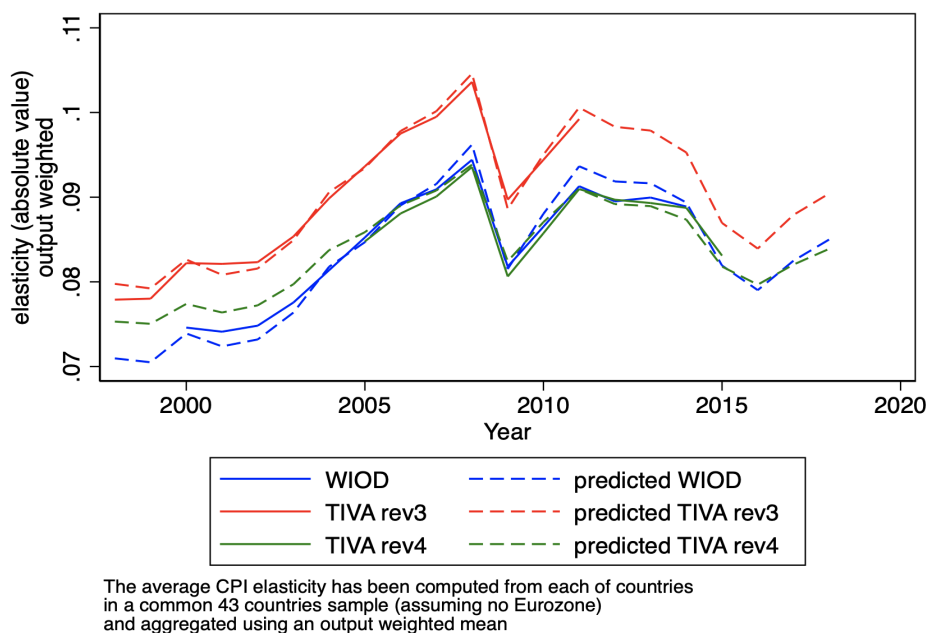


Fig. 17: Comparing the output-weighted HCE deflator elasticity to its prediction using only World Bank and Comtrade data.

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

## 5 Conclusion

This paper focuses on the elasticity of the household consumption expenditure (HCE hereafter) 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 years of data, from 1995 to 2015. We use several datasets to ensure the robustness of our results. In line with the existing literature, we find a rather modest elasticity of the HCE deflator to the exchange rate of around 0.1. The elasticity of the HCE deflator to the exchange rate has remained broadly stable over the past two decades. The aggregate figure masks 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 sectors experience higher spillovers from an exchange rate appreciation. To do so, we focus on the main components of the HCE deflator. Non-energy

industrial goods explain the bulk of the total HCE deflator elasticity to the exchange rate. Services also play a significant role, especially in advanced economies, where services represent a substantial share of total consumption.

Third, we analyse the determinants of the HCE elasticity and the role of global value chains in the transmission of an exchange rate appreciation to the HCE deflator. We find that 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, with marked across-countries heterogeneity.

Fourth, we show that a precise assessment of the HCE deflator elasticity to the exchange rate can be estimated without resorting to WIOT, which are not available for the most recent years. To address this gap, we estimate the HCE deflator elasticity from 2016 onwards using GDP statistics and trade data on consumption and intermediates.



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