Comments on: Entry Dynamics and the Decline in Exchange-Rate Pass-Through

Gust, Leduc and Vigfusson

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Summary

Question:

- What role did entry into export markets play in tempering the decline in exchange rate pass-through in the U.S. in the last decade?

Methodology:

- Extend DGE model in Gust, Leduc and Vigfusson (2010)
- Examine relationship between decreasing trade costs, productivity differentials and ERPT

Results/Conclusions:

- Firm entry into export markets did little to dampened the fall in exchange rate pass-through

Summary (details)

Two calibrations:

1. Baseline: Two countries with high trade costs and similar productivity levels
2. 2004 calibration: Lower trade costs and foreign country has higher productivity

Entry:

- Endogenous, and firms must pay a fixed and per-unit export cost
- Firms enter if their expected per-period profits are greater than the fixed cost of exporting

Proposed Mechanism

Decline in trade costs with a productivity differential

- Improves competitiveness of foreign exporters, resulting in an $\uparrow$ in markup
- As markup increases, foreign exporter's price becomes more sensitive to movements in competitor prices
- Firms vary markup more to changes in competition, and adjust prices less in response to movements in the exchange rate

$\Rightarrow$ Decline in pass-through

Entry into the export market

- Increases competition in foreign market leading to lower exporter markups
- Lower markups give exporting firms less room to adjust their prices in the face of exchange rate movements

$\Rightarrow$ Increase in pass-through

Issues

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  - The role of imported inputs and distribution margins (Campa & Goldberg, 2006)
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    - Industry-specific pricing strategies

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  - Industry-specific pricing strategies
- Emergence of China as a major exported to the U.S. (Marazzi & Sheets, 2006)

Imported Inputs and Currency Choice

Imported inputs:

$$q_t \frac{P^*_{mt}}{P^*_t} = \mu^*_{mt} MC(D_t, w_t, Z_t, P_{int,t})$$

- How do firms adjust to movements in intermediate inputs prices?
- How do intermediate input prices react to movements in exchange rates? Imported v. domestic inputs?

Currency choice:

- How are the results related to evidence on local currency pricing?

Canadian Evidence on Currency Choice

Cao, Dong and Tomlin (2011):

- Examine sensitivity of Canadian producer prices to movements in the Canada-U.S. exchange rate (using product-level data)
- Focus on goods sold in domestic and U.S. markets
- Evidence that exports priced in U.S. dollars are not sensitive to movements in the exchange rate (zero pass-through), while those priced in CAD are not sensitive either (near complete pass-through)
- Pooled estimates of 0.51 for exported products masks heterogeneous pricing behaviours

How Should We Think About Entry?

- In model, firms are homogeneous and have the same marginal costs within a country
- Who are the entrants? Are they populating previously (relatively) non-existent import markets or are they low productivity entrants into already well established import markets?
- Low productivity entrants (with small markups) would likely increase estimated pass-through, but it's not clear what would happen in new import markets
- Heterogeneous entrant model beyond the scope of the paper, but some discussion would be helpful

Industry Details and New Trade Partners

- Data includes automotive products — could unique aspects of industries explain some of the decline in pass-through?
  - Trade among affiliates in the production process may have increased with reduction in tariffs and it may be easier to trade in a single currency, leading to an observed decline in pass-through (not having to do with competition)
  - This is also related to use of intermediate inputs
- Zero pass-through to imports from China not enough to explain drop in pass-through (Marazzi & Sheets, 2007)
  - Model could help explain indirect effects on pass-through from import competition from China

Conclusions

- More industry-specific evidence would be helpful
  - Is this decline in pass-through driven by price changes in certain sectors/industries?
  - If so, is there something about these industries that could be driving these results?
  - How does the proposed model fit with this?
- Currency choice and local currency pricing is something worth exploring — could extend model to include two types of firms
- Some discussion on literature of distribution costs would be helpful — disconnect between data (import prices) and model (consumer prices)
- Interesting work!