

Liability Dollarization and Exchange Rate Pass-Through to Domestic Prices

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Abstract

We explore the negative balance sheet effect of foreign currency borrowing on the exchange rate pass-through to domestic prices. Exploiting a large unexpected devaluation episode in Korea in 1997, we show that firms with higher foreign currency debt have indeed experienced balance sheet deterioration and faced lower growth rates of sales, net worths, and price-cost markups. We then empirically document that a sector populated by firms with higher foreign currency debt exposure prior to the crisis experienced a larger price increase. Building a heterogeneous firm model with financial constraints, we quantify the role of foreign currency liabilities in explaining the exchange rate pass-through to prices and find that 20% to 80% of the sectoral price changes during the crisis can be explained by the balance sheet effect of foreign currency debt alone. We emphasize the role of strategic complementarity in amplifying the sectoral price increase.

JEL classification: D22, E31, E44, F31, F34

Keywords: Exchange rate pass-through, Financial constraints, Strategic complementarity, Balance sheet effects, Price setting, Asian Financial Crisis

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