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Research Report

Uncertainty about exchange rates affects import prices in the Euro Area

RWI Impact Notes

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Uncertainty about Exchange Rates Affects Import Prices in the Euro Area

RWI research shows that monetary policy should take uncertainty about exchange rate fluctuations into account

When aiming at price stability, central banks closely monitor exchange rates. Their level is known to influence prices, since many product components are sourced internationally. An RWI study suggests that central bankers should also take the level of uncertainty about future exchange rates into account when aiming at price stability. The study finds that in the Euro Area, importers bear the main burden of the uncertainty. Mainly affected are countries like Germany, Italy, and the Netherlands, whose industries rely heavily on intermediate goods imports. When uncertainty increases, importers buy less goods to lower the risk. Consequently, prices for intermediate goods fall.

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MAIN FACTS

Uncertainty about exchange rates affects the behaviour of firms in international trade.

In the Euro Area, importers reduce their exposure to exchange rate fluctuations by importing less.

As importers' demand declines due to exchange rate uncertainty, prices of import goods fall.

How do exchange rates influence import prices?

Some cars assembled in Germany have their engine produced in Argentina and Mexico, their chassis in China, and their gearbox in Spain – their production price therefore depends on many different currencies. However, an RWI study finds that prices are not only affected by the level of exchange rates, but also by the degree of uncertainty surrounding future exchange rate developments. Uncertainty arises when individuals are unable to make good predictions about the future. When exchange rate fluctuations are low, individuals have greater confidence in their predictions. Even if the realized exchange rate differs from their expectations, this difference may be small and the consequences relatively minor. However, in volatile times, like during the recent Corona crisis, exchange rates fluctuate heavily, making them hard to predict. This creates high exchange rate uncertainty.

Why does exchange rate uncertainty matter?

The so called “Exchange Rate Pass-Through” indicates how fluctuations in the exchange rates are related to changes in the import prices. The pass-through has been shown to be rather low in most advanced economies but high in emerging markets.

Based on a monthly dataset of industrial import prices for the Euro area, the RWI study is the first to show that exchange rate uncertainty affects prices even if the exchange rate levels remain the same. That is, even with low pass through, exchange rate volatility affects import prices.

Who is affected by exchange rate uncertainty and how?

Exporting and importing firms are affected differently by uncertainty in exchange rates depending on the currency in which the transaction takes place. If the contract is written in the exporter's currency, the exporter does not need to worry about exchange rates and the importer bears the exchange rate risk. The contrary is true if the contract is stipulated in the importer's currency. Policy makers have to consider which effect dominates. For the Euro area, the RWI study shows that importers bear the main burden of exchange rate uncertainty. Hence, when exchange rate uncertainty increases, importers demand fewer goods and import prices fall even if the exchange rate level remains constant. Notably, this uncertainty effect is strongest in Germany, Italy, and the Netherlands, which are all heavily involved in international trade.

Sources: **Shaped by crises: Exchange rate uncertainty in the Euro Area**

Blagov, B. (2019): Exchange rate uncertainty and import prices in the euro area. *Review of International Economics* 27.5 (2019): 1537-1572. <https://onlinelibrary.wiley.com/doi/epdf/10.1111/roie.12434>



Sources: RWI illustration based on Blagov (2019).

Policy Recommendations

i Aiming at price stability, central banks should not only consider exchange rate levels, but also take exchange rate volatility into account.

i Importers from Germany, Italy, and the Netherlands, which trade heavily with non-Euro area countries, bear a significant exchange rate risk. The import price channel should be monitored more closely during turbulent times.

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