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# *Exchange Rate Pass- through to Domestic Prices in Japan*

Thesis submitted For the Degree of Master in Economics

by

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# Abstract

The study investigates the exchange rate pass-through effect (ERPTE) to the Japanese consumer price index (CPI) using monthly data over the period extending from April 2013 (the adoption of Abenomics) to June 2019. The theoretical basis for this relationship is the Purchasing Power Parity (PPP). PPP assumes that any increment in exchange rates is translated into proportional movements in domestic prices. There are two channels through which exchange rate movements affect domestic prices. The direct channel is through the prices of both traded final goods and imported intermediate commodities. The indirect channel is through the competitiveness of traded commodities in the international markets and inflation expectations. Both channels are increasingly becoming more important due to the increase in the degree of openness of almost all economies. Since 1990s, Japan has suffered chronic CPI deflation, very low interest rate, a lack of effective demand, the asset price deflation, …etc. To overcome these challenges, the Prime Minster Abe introduced, in December 2012, the package of policies known as Abenomics which encompasses three arrows: aggressive monetary easing; flexible fiscal policy; and a growth strategy. Thus, a relevant question might be to what extent the Abenomics contributes to stimulate the Japanese economy (e.g. aggregate demand and inflation)? Moreover, the current thesis empirically examines the ERPTE to the CPI in Japan using the Autoregressive Distributed Lag (ARDL) model cointegration technique (or bounds testing). The Japanese CPI is regressed against the nominal effective exchange rate (NEER) and CPI of major trading partners (i.e. China and the USA), the industrial production index (IPI), and the Nikkei225 stock index. The analysis shows that unconventional monetary easing policies have succeeded in the yen's depreciation, achieving higher stock prices, and higher corporate profits. Nevertheless, their impact on stimulating aggregate demand and inflation was not strong as expected. Moreover, they have adversely affected financial institutions and financial markets. With regard to the fiscal objectives, Abenomics did not succeed in achieving the primary surplus target with a rapid rise in the debt-to-GDP ratio. According to the ARDL results, there exists a long-run equilibrium relationship between the Japanese CPI and the explanatory variables with incomplete ERPTE. In the long run, a 10% depreciation of the NEER increase the Japanese CPI by 0.2% whereas a rise of the Chinese CPI by 10% increases the Japanese CPI by 2%. Moreover, a 10% in the IPI and Nikkei225 results in an increase of the Japanese CPI by 1.37% and 0.08%, respectively, in the long run. It is worth mentioning that the short-run elasticities are lower than their long-run counterparts. The short-run coefficient of the IPI has a negative sign which does not agree with prior theoretical expectations. It seems that Japanese firms find it difficult to raise their sales prices, and, thus they adopt the discount-based marketing strategies.