

Exchange Rate Shocks and Sellers' Inflation in Developing Countries

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Developing countries often experience high and volatile exchange rate shocks, which significantly contribute to persistent inflationary pressures. Numerous studies highlight this connection, attributing a substantial share of inflation volatility in these countries to exchange rate instability. Additionally, supply chain constraints and firm pricing power exacerbate inflationary dynamics.

This paper argues that frequent and large exchange-rate shocks increase developing countries' susceptibility to sellers' inflation by creating fertile ground for sellers to justify price hikes. In response to high and frequent exchange rate shocks, firms attempt to protect or marginally increase their mark-ups to maintain or enhance profitability amid rising costs. In a world where exchange rate shocks create high uncertainty for both producers and buyers, and where buyers face asymmetric information, these price adjustments are seen as legitimate and thus sustained.

Using firm-level data from emerging markets, we test this hypothesis by analyzing markup adjustments during pronounced exchange-rate shocks relative to more stable periods. Specifically, we examine two types of nonlinearities in the relationship between exchange rates and mark-ups: a) whether firms in the real sector can sustain or increase their mark-ups during volatile periods relative to stable exchange rate environments, and b) whether the magnitude of exchange rate shocks triggers asymmetric mark-up responses, leading to asymmetric pass-through effects.

Our findings align with recent literature on sellers' inflation, which argues that post-pandemic inflation surges are primarily driven by the exploitation of supply-side disruptions. To the best of our knowledge, this is the first study to examine the relationship between markups and exchange rates, with a particular focus on nonlinearities, using a comprehensive firm-level dataset from emerging markets. We contribute to this literature by showing that, in developing countries, frequent exchange rate shocks act as persistent supply-side shocks, reinforcing sellers' inflation dynamics. Importantly, our study highlights how structural vulnerabilities in these economies make them especially susceptible to prolonged seller's inflation, addressing a key gap in understanding inflation persistence in developing markets.