Abstract

This study examines the pass through of exchange rate shocks to Ethiopian domestic inflation. The baseline analysis carried out with the VAR/SVAR model, using four endogenous and three exogenous variables, employing quarterly data for the period 1993Q1 to 2011Q4. The pass through effect is quantified by means of impulse response. The finding of the full sample estimate shows that, although statistically insignificant, the ERPT to consumer prices is fairly large, but incomplete. Moreover, a sub sample analysis reveals that although the pass through for the two periods has been substantially large and complete, it is higher for the relatively low inflation periods (1993Q1-2002Q4) than for the high inflation period (2003Q1-2011Q4); which contradicts with other empirical studies. On the other hand, the variance decomposition function results show that the external factors such as world oil price fluctuations and foreign prices have a greater role in explaining the domestic inflation for the period 2003Q1-2011Q4 than for the period 1993Q1-2002Q4. The high share of imported goods to the total CPI, the market structure of the economy and the openness of the economy to the international market are the determining factors of the pass through. The supply side shocks, the money supply growth, shocks of world oil price and the foreign prices have a significant contribution to the domestic inflation of Ethiopia.