This thesis analyzes the incomplete exchange rate pass-through effect on Mongolian economy and its implication on monetary policy under foreign and domestic shocks. The analysis is carried out in a small open economy New Keynesian DSGE model proposed by Monacelli (2005), where incomplete exchange rate pass-through is introduced via nominal rigidities on import prices. In order to accomplish the goal, we firstly derive the solutions of the model, calibrate the parameters, and finally simulate the impulse responses. Moreover, SVAR estimation is achieved to estimate the pass-through. Four main results are obtained. First, the exchange rate pass-through into import price and inflation is 0.69% and 0.49% respectively in short run, implying incomplete pass-through in Mongolia. Second, the exchange rate acts as a shock absorber for domestic productivity and foreign demand shock, but as a shock amplifier for domestic demand shock. Third, in case of incomplete pass-through the central bank of Mongolia is required to adjust the nominal interest rate more under the productivity shock, but less for the domestic and foreign demand shock. Finally, deviations from the law of one price contributes considerably to the variability of the output gap under the low pass-through. Therefore, considering incomplete pass-through in the conduct of monetary policy is significant to improve the effectiveness of the monetary policy for the central Bank of Mongolia.