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Abstract

The incomplete pass-through of exchange rates to prices is a well-documented phenomenon. Firms respond optimally to exchange rate shocks by adjusting margins and buying inputs from regions with more advantageous terms of trade. Consumers, in turn, substitute goods that become more expensive for relatively cheaper goods after an exchange rate shock. We use data from the market for new cars in Colombia to empirically analyze the determinants of incomplete passthrough after a large depreciation of the local currency. We estimate a structural oligopoly model that nests the optimal reactions of firms and consumers to assess their relative importance in explaining the lack of response of retail prices to the exchange rate shock. We find that, in relative terms, the most important factor explaining incomplete pass-through is consumer substitution, followed by strategic interaction between sellers.