Referee report on MS769: “Asymmetric exchange rate pass-through in the Euro Area"

This paper analyzes the extent to which exchange rate pass through (ERPT) into CPI inflation is a nonlinear function of exchange rate changes for 12 Euro Area countries. The authors analyze and justify two sources of nonlinearity: asymmetric response to appreciations and depreciations and nonlinear response to large vs small exchange rate changes. The authors find more supportive evidence of the second type of non-linearity.

My assessment of the paper is that it makes a nice contribution towards this area with an interesting set of results. These results do have a policy relevance dimension: monetary policy during turbulent exchange rate periods should factor in the change in ERPT and how it affects inflation dynamics.

The paper is competently executed and, technically, I have no concerns. The interpretation of the results in light of theory arguments is interesting and gives a layer of robustness to the empirical analysis beyond a standard econometric application.

Regarding the paper's weaknesses, I'd highlight the following points:

1. The model used to justify the specification of the estimated equation appears to be more appropriate for the analysis of import price rather than CPI inflation (and it follows closely Bailliu and Fujii, 2004). CPI inflation will depend also on the extent to which the country is open (which can be time-varying itself) and the degree of imperfect competition in the distribution sector (from imports to the final consumer). This is an aspect that should perhaps be given more thought, especially in terms of interpreting the final results in terms of the theory mechanisms.

2. It is not clear at all which exchange rate measure is being used. Is it a nominal effective exchange rate (NEER)? Is it a bi-lateral exchange rate? If it is a NEER measure, given that most of the trade of these countries is intra-EA, how would the volatility of the NEER be affected by the creation of the single currency? Could this have implied a change in volatility regimes that drives the main results of the paper? A more thorough description of the data including a few plots and descriptive statistics would go a long way to clarify these aspects. As it stands, this becomes a significant weakness, which also impairs the interpretability of the results.

3. Related to the above, I wonder how the results would change in the pre- and post-Euro periods. Surely, PCP and LCP within a single currency are undistinguishable, and here is a natural way of understanding if switching from LCP to PCP is one of the driving forces behind the results.