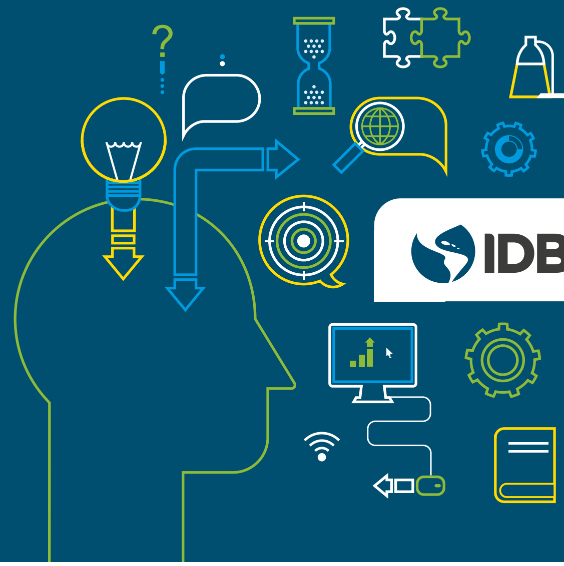
RESEARCH INSIGHTS

How Does Buyer Market Power Influence Exchange Rate Pass-through in International Trade?



N.° 140 | December 2024

Author: Leticia Juarez.

- **In developing countries, such as most Latin American nations, a small number of large foreign buyers dominate exports, exerting significant market power.**
- **Due to their market power, different buyers for identical products can end up with varying prices, influenced by the buyer's power. Larger buyers often receive prices with markdowns (discounts).**
- **In concentrated markets, buyers act as a buffer against exchange rate shocks. Markets dominated by powerful buyers exhibit lower sensitivity of local currency prices to exchange rate fluctuations.**

CONTEXT

In recent decades, large firms have increasingly come to dominate key sectors of the global economy, significantly shaping international trade dynamics. In many export markets, a vast number of small firms sell to a handful of large, multinational buyers. In fact, a small group of top importers accounts for the majority of global trade, underscoring the concentration of buyer power. This raises the question of how large buyers influence pricing and price dynamics in export markets. Specifically, during exchange rate shocks, how do these powerful buyers affect the pricing strategies and economic stability of the smaller firms connected to them?

Key Concept

MARKDOWN

A price paid that is below the standard or listed price.

PROJECT

Using detailed transaction-level data from Colombian exporters, this project explores the dynamics of international pricing and the influence of buyer market power on exchange rate pass-through. The study utilizes an innovative open economy model of oligopsony to theoretically and empirically examine how large buyers affect price determination in international markets. Additionally, the study quantifies the effect of large foreign buyers on Colombian sellers, analyzing how buyer power influences pricing strategies and seller responses to exchange rate fluctuations. This research aims to shed light on the broader implications of buyer-seller relationships for pricing dynamics and market outcomes.

RESULTS

Buyer market power plays a substantial role in moderating the exchange rate pass-through in Colombian export markets. This effect is shown in Figure 1, which illustrates the negative relationship between market concentration (HHI) and exchange rate pass-through. Also, when faced with an exchange rate shock, larger buyers strategically adjust their price markdowns, leading to more stable prices in the seller's currency. Specifically, markets with fewer, larger buyers exhibit significantly lower exchange rate pass-through, with the pass-through rate ranging from as low as 1 percent for the largest buyers to as high as 15 percent for smaller buyers. This finding supports the idea that large buyers act as a buffer, shielding sellers from the full impact of currency depreciation.

Additionally, the study highlights that price discrimination across buyers is common, even for identical products sold in the same market. This suggests that larger buyers can negotiate lower prices, not only through sheer market power but also by leveraging more flexible markdowns. These markdowns play a critical role in how prices adjust in response to exchange rate fluctuations. The strategic use of markdowns by larger buyers effectively reduces the exposure of connected sellers to price volatility in international markets, offering a form of "insurance" for small sellers against currency shocks.

Key Concept

OLIGOPSONY

A market structure characterized by many sellers and a few dominant buyers, where the buyers exert substantial influence over prices.

Further robustness tests validate these findings. The results remain consistent even when accounting for currency of invoicing, price stickiness, and alternative definitions of buyer market share. The study also quantifies the size of markdowns for large buyers, finding that markdowns for the average firm are around 26 percent. A counterfactual simulation reveals that in the absence of buyer market power, sellers' revenues would be higher, but their exposure to international shocks would also increase, leading to greater revenue volatility in response to exchange rate fluctuations. These findings underscore the complex trade-offs faced by sellers in markets dominated by large buyers.

POLICY IMPLICATIONS

This study underscores the need for policies that address the implications of buyer concentration in export markets, particularly in developing countries. First, promoting the diversification of export markets can reduce dependency on a small number of powerful buyers, thereby mitigating their ability to dictate terms and suppress prices. Expanding trade partnerships across different regions could provide exporters with more bargaining power and reduce their exposure to the negative effects of buyer concentration.

Key Concept

EXCHANGE RATE PASS-THROUGH

The degree to which changes in the exchange rate influence the domestic prices of imported and exported goods.

Additionally, policies that encourage transparency in pricing practices could help smaller exporters negotiate more favorable terms with large international buyers. Greater clarity in how prices and markdowns are determined might reduce the asymmetry in buyer-seller negotiations and empower smaller firms to secure better deals. This could be particularly effective when integrated with competition laws or regulations that monitor and limit excessive buyer dominance in concentrated sectors.

Moreover, the findings have broader implications for international trade negotiations and mergers and acquisitions (M&A) policy. As larger firms often grow through M&A activities, regulators should consider how these consolidations could further entrench buyer power, potentially leading to even greater market concentration. Ensuring that merger reviews incorporate the impact on international pricing and market dynamics for smaller exporters is essential. Trade agreements should also consider the role of buyer market power to ensure that developing economies are protected from exploitative practices by large multinationals. **By addressing these issues, policymakers can help create a more equitable international trading environment that benefits a broader range of firms.**

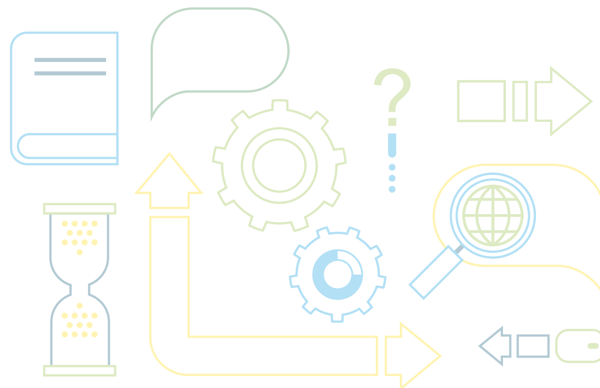
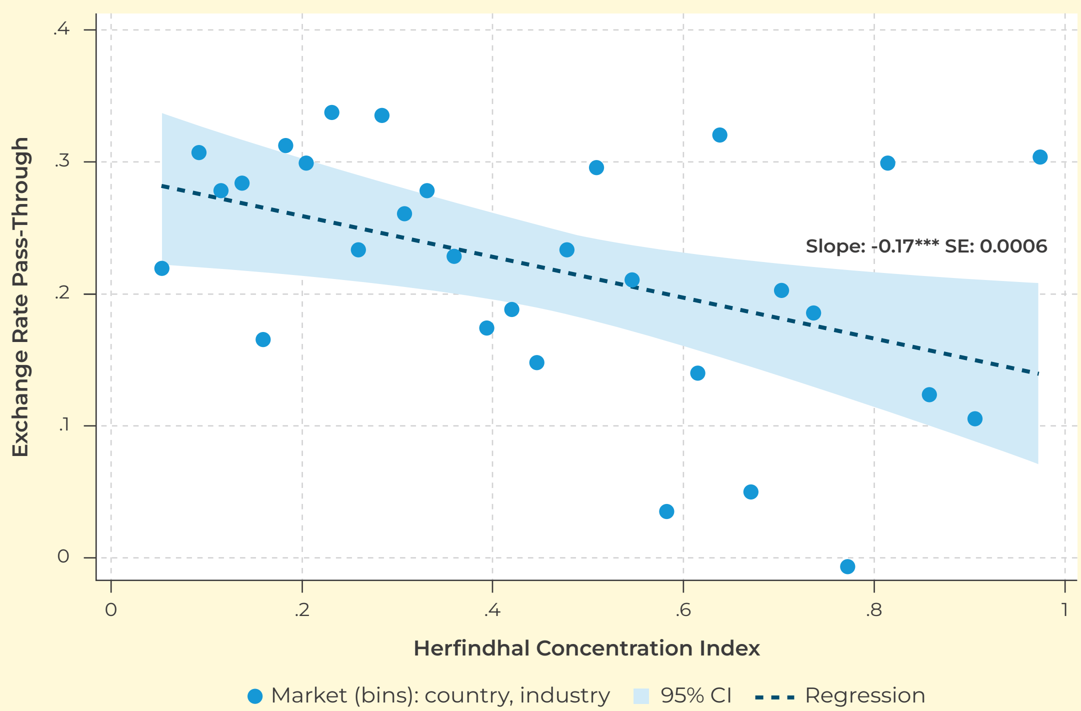


FIGURE 1. Exchange Rate Pass-through and the Concentration Index



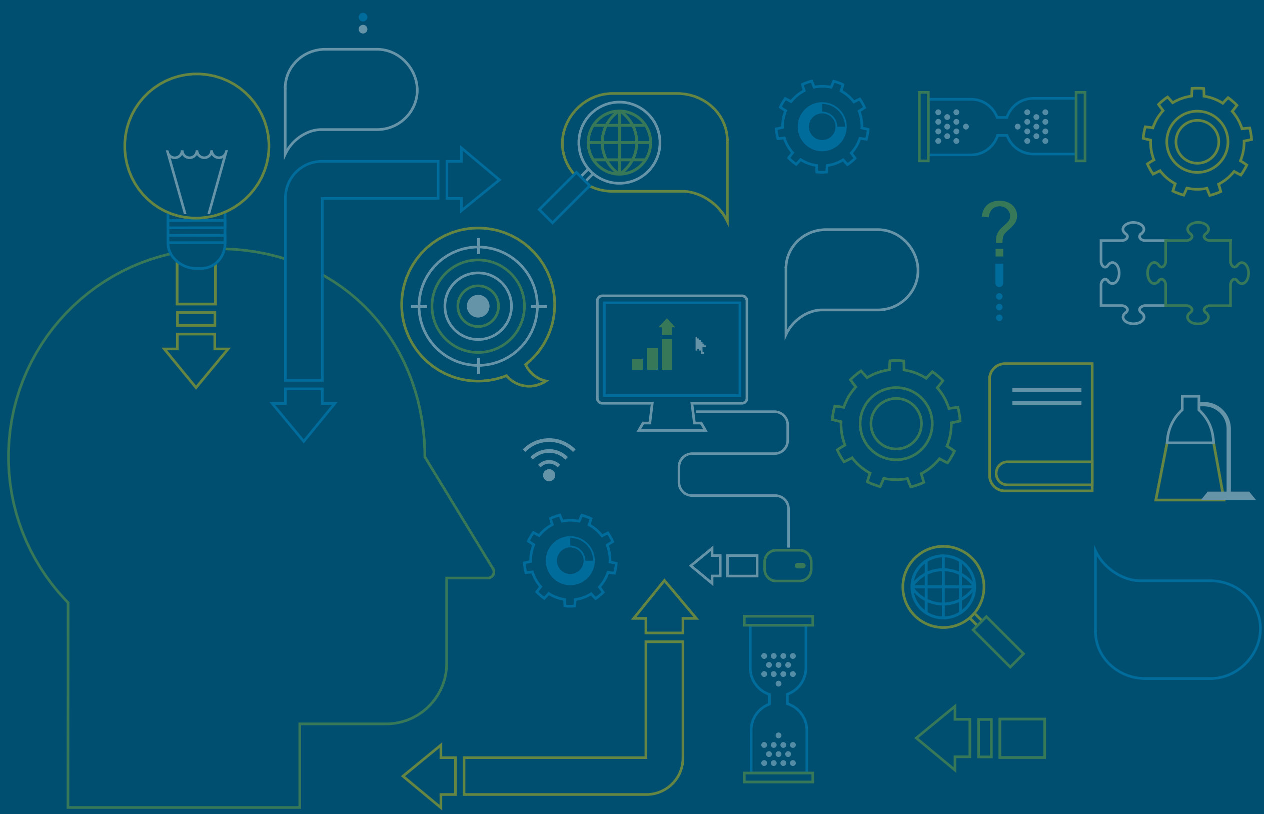
Source: Colombian Customs Data.
Notes: This figure shows regression correlations between the exchange rate pass-through coefficient for a given market and market concentration (HHI).

FULL STUDY

Juárez, Leticia. 2023. "Buyer Market Power and Exchange Rate Pass-Through." IDB Discussion Paper No. 1026. Washington, DC: Inter-American Development Bank. https://doi.org/10.18235/0005083.

Department of Research and Chief Economist

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.



www.iadb.org/res