Monetary Policy and Trade Globalization

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Summary

The connection between deepening economic integration and the fall of world-wide inflation has generated considerable debate. I develop a two-country dynamic stochastic general equilibrium model which combines two key features: heterogeneous price-setting firms and inflation targeting central banks. In doing so, I provide a model-based appraisal of the "globalization-inflation hypothesis".

I show that a contractionary domestic monetary policy shock generates a ‘cleansing out’ effect in the domestic economy. Specifically, the shock induces lower domestic inflation and higher foreign inflation. Changes in inflation alter the costs associated with exporting in such a way that fewer but more productive domestic firms export whilst a greater number of less productive foreign firms export. Overall, fewer varieties of the two goods are traded globally. These results hold when governments target either consumer price inflation or domestic price inflation.

A rise in labor productivity generates only modest positive changes in average productivity for both sets of exporting firms when consumer price inflation is targeted. When domestic price inflation is targeted, as each government is only concerned with domestically produced varieties, and as labor productivity has a direct impact on all domestic firm's pricing decisions, the shock results in a shift of resources away from exports and towards domestic production. This causes a fall in the average productivity of domestic firms. However, it also generates a far larger rise in the productivity of foreign firms.