Discussion

Trade Fragmentation, Inflationary Pressures and Monetary Policy

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KEY MESSAGE OF THE PAPER

Reversal of trade integration may not be inflationary because:

- **Indirect demand effects:** Real income loss ⇨ less spending ⇨ *demand-pull disinflation* ***can dominate***
- **Direct supply effects:** Higher import prices or lower productivity in tradable sector ⇨ higher marginal costs ⇨ *cost-push inflation*
- Hence monetary policy should do more than "look through": **loosen** in the short term

→ Very important topic, very stimulating paper!

COMMENT 1: WHICH DEGLOBALIZATION?

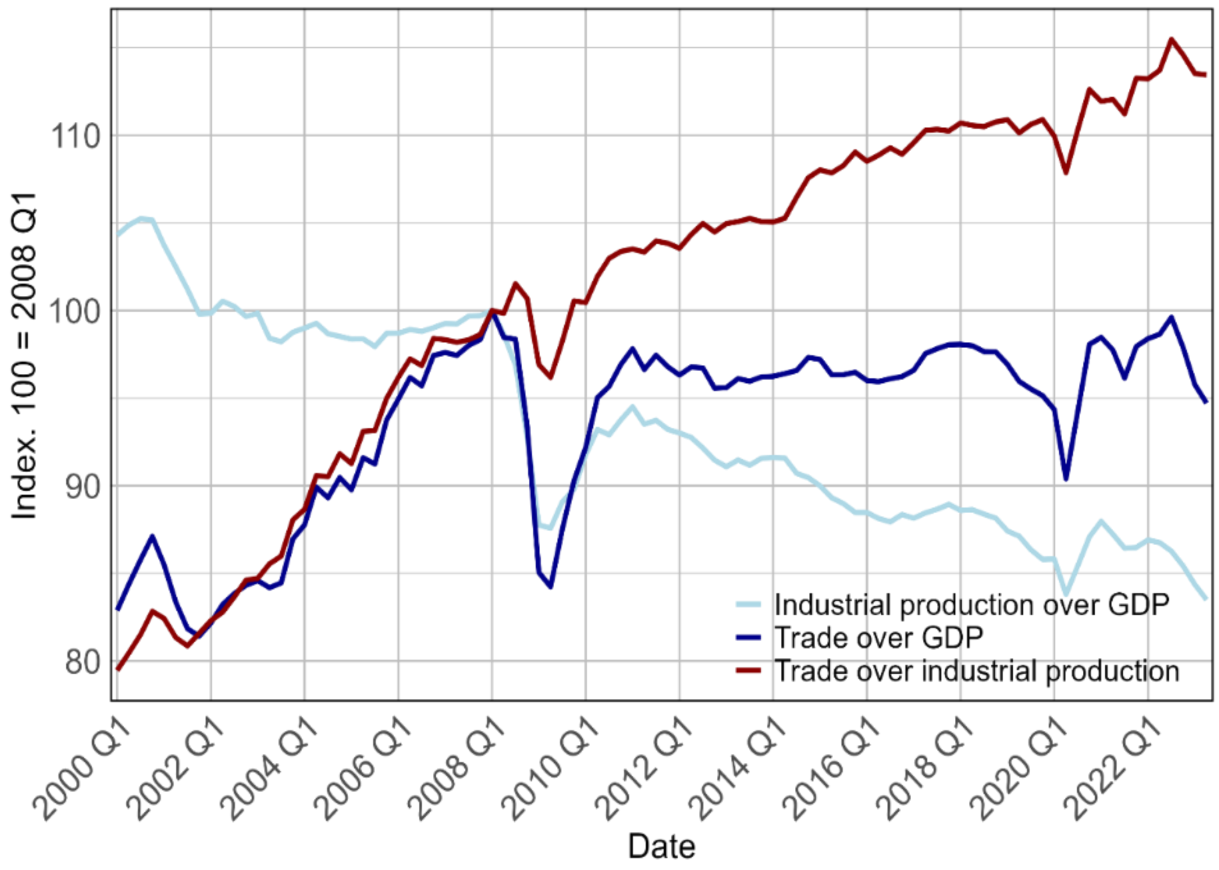
Goods: trade/industrial production not declining.

Globalization in services, c.f. Baldwin “Globotics” (3rd unbundling).

Possible impact on inflation through:

- Higher marginal productivity
- Flatter Phillips curve
- Higher rents (bigtechs)

Different measures of globalization, World



Indices for trade over GDP, trade over industrial production and industrial production over GDP in advanced economies. Sources: CPB for trade and industrial production, OECD (Advanced Economies only) for GDP.

FROM TRADE INTEGRATION TO TRADE FRAGMENTATION

- **Supply-side effects of integration:** (slightly) deflationary through access to cheaper goods
  - **US:** in the 2000's, **Chinese import competition** led to an annual **fall in manufacturing prices** of between 0.19pp and 1.1pp (Amiti, Feenstra, and Romalis 2019; Bai and Stumpner 2019; Jaravel and Sager 2019)
  - **France:** over 1994-2014, **imports from low-wage countries reduced CPI inflation** by 0.02pp per year on average (Carluccio et al. 2023)

- Is **trade fragmentation** the reverse of trade integration?
  - **Trade integration:** productivity shocks in low-wage countries, multilateral
  - **Trade fragmentation:** targeted policies (industrial policy, bilateral trade policy), uncertainty shocks, supply constraints, trade diversion (e.g. US-China)

- **Supply-side effects of fragmentation**
  - **Evidence-based:** limited impact of **Trump tariffs** on US retail prices, fall in ToT, compression of US margins (Cavallo et al. 2021); the **Brexit** depreciation **increased consumer prices** by 2.9% (Breinlich et al. 2022)
  - **Model-based:** Substantial impact of geopolitical fragmentation on producer prices, from 1.8 to 8.4% at world level (Attinasi, Boeckelmann and Meunier, 2023)

COMMENT 2: TERMS OF TRADE

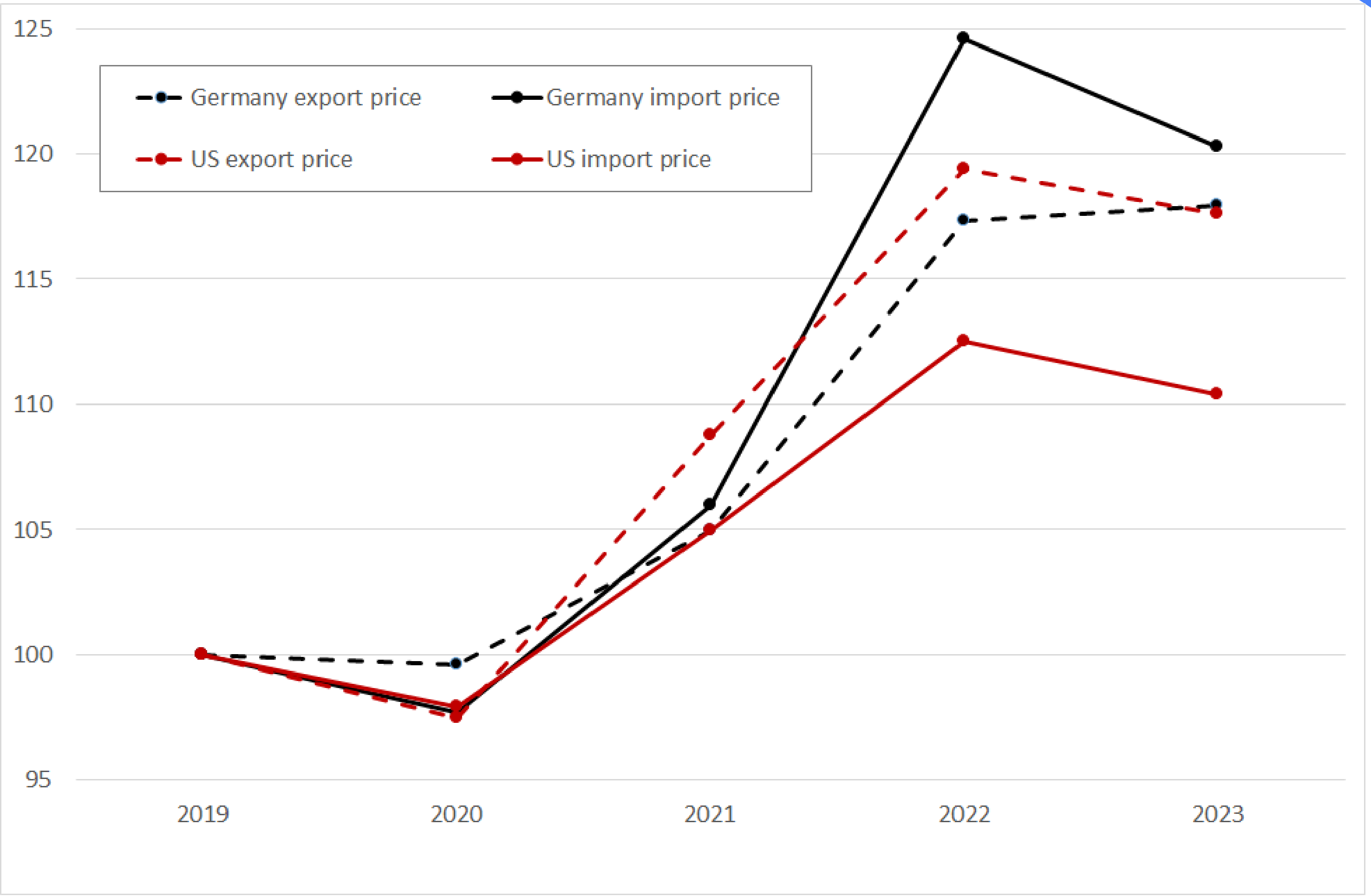
Shock: a rise in **import prices**

What about **export prices**?

- Model: both import and export prices are exogenous in foreign currency, hence ToT shock is persistent.
  - Law of one price for traded goods. Lower TFP → nom. depreciation, T-inflation.
  - Higher (frontloaded) import price → nom. appreciation and T-deflation.

- What if export prices increase following the rise in import prices? (no imported input in the tradable sector)

Import and export prices in domestic currency, 2019=100

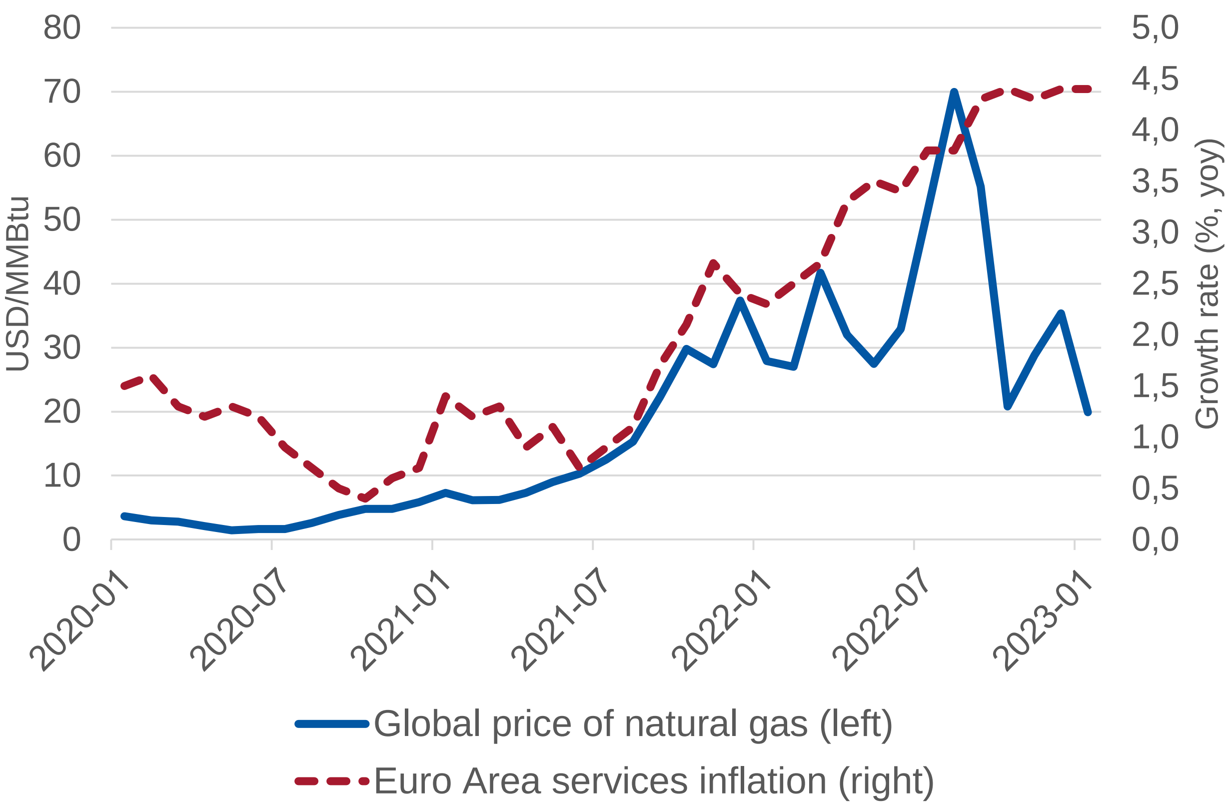


Source: OECD.

COMMENT 3: DOMESTIC INFLATION

- No doubt about the existence of an aggregate demand channel

- **How much**? Delayed *increase* in services inflation in the euro area.
  - To what extent are unconstrained households **forward-looking**? (what if all households are HtM?)
  - To what extent can HtM households increase their **labor supply** in the short term? How flexible are real wages? (orders of magnitude could be more discussed)
  - To what extent does **output** increase following a negative ToT shock?



Sources: IMF, OECD

→ **Are the deflationary forces that strong and that persistent?**

FORWARD-LOOKING BEHAVIOUR

- **Unconstrained households:**
  - perfectly foresee the full path of the input price shock (out to 10 years); and
  - are fully rational in anticipating the economic effects

- What if agents have a **limited degree of forward-lookingness**?
  - Finite planning horizon reduces immediate downward pressure on aggregate demand in case of a ToT shock (Dupraz et al. 2022)
  - Direct effect via aggregate supply could then dominate, implying a net **inflationary effect**

- What if the **central bank becomes forward-looking**?
  - Model: households are forward-looking but the central bank reacts myopically and with inertia.
  - What if the central bank also reacts to (future) output?

LESSONS FOR MONETARY POLICY

- **With only one objective, the central bank can counteract any shock**
  - TFP (temporary) shock: inflation stays constant, but (i) fall in real wages, (ii) fall in consumption only for constrained households, (iii) fall in government transfers, (iv) reallocation of employment towards tradables. Political economy?
  - Possibly: reaction of fiscal policy.

- **Well-anchored expectations**
  - To what extent can temporary inflationary pressures be tolerated by central banks? (Dupraz and Marx, 2024)
  - Departure from «looking-through» policy for certain types of shocks? Credibility as an asset.

- **Trade fragmentation could increase price uncertainty rather than inflation**
  - A succession of front-loaded shocks rather than a well-anticipated path?

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