Discussion of “Trade Fragmentation and Inflationary pressures”

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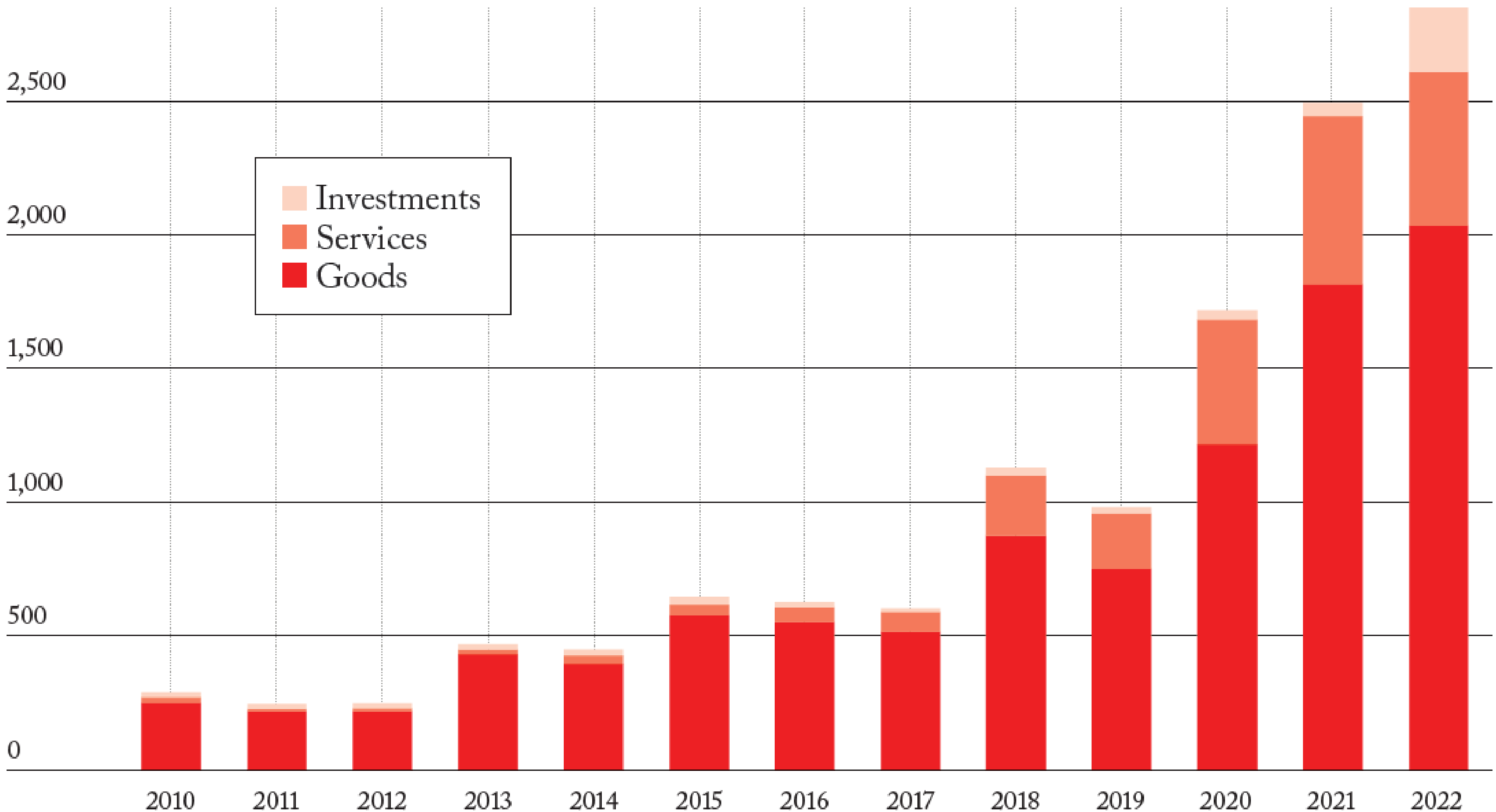
Fragmentation

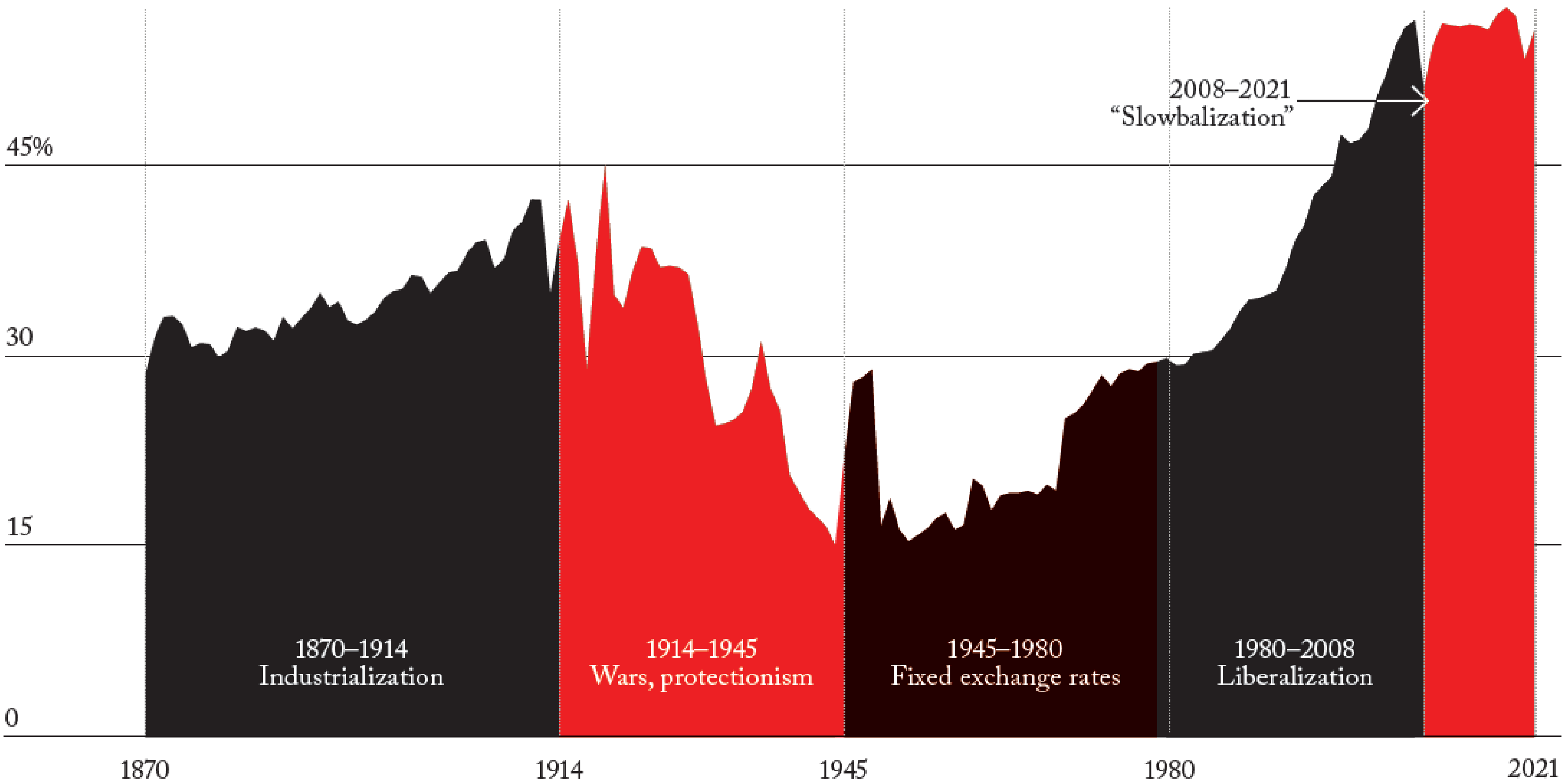
- Protectionism in industrial countries
  - Left behind groups
- Real risks
  - Resilience
- Geo-political risks
  - Ukraine, Taiwan

Number of trade restrictions imposed annually worldwide

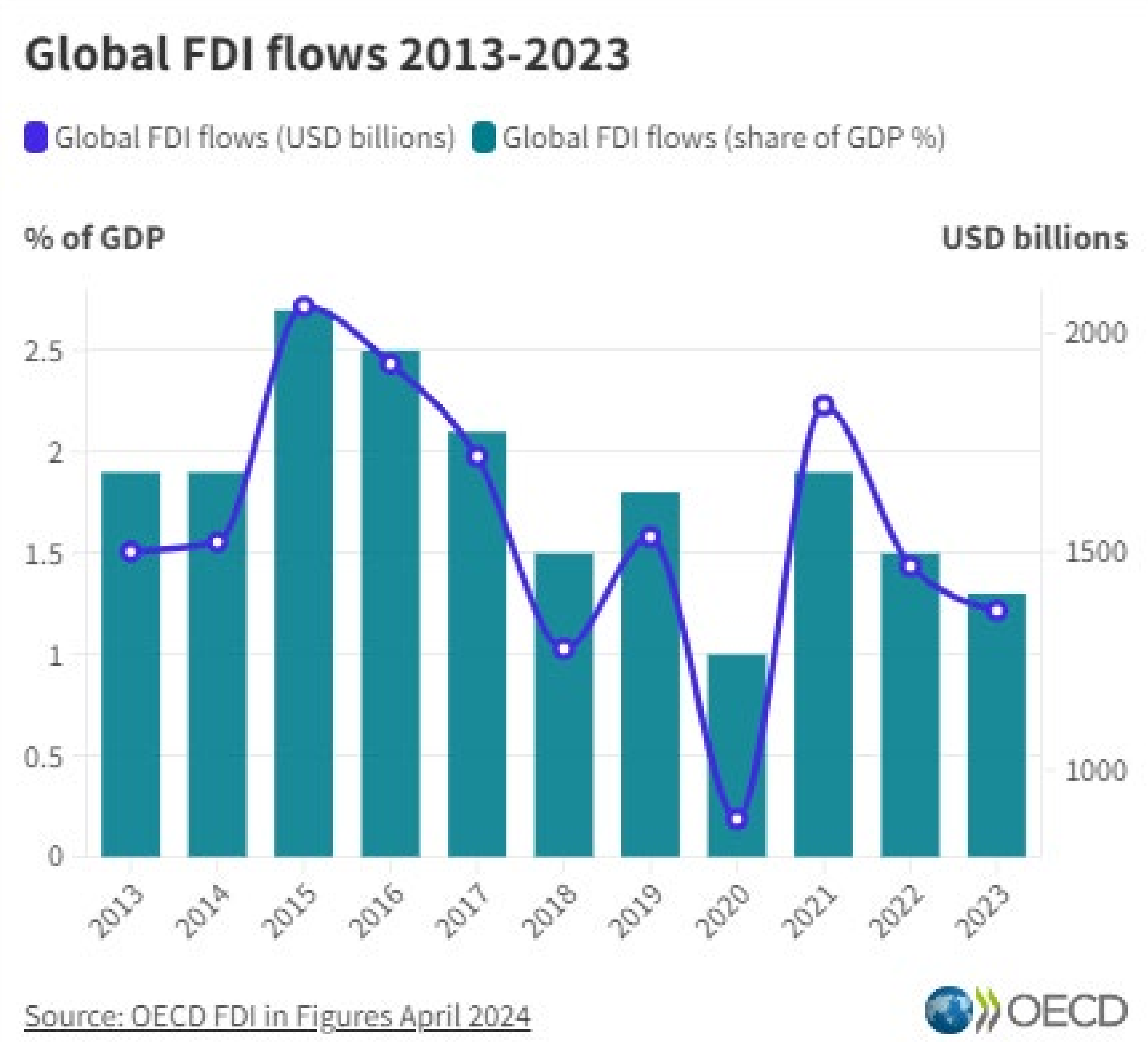


Sources: Global Trade Alert; IMF staff calculations.

Sum of exports and imports as a percentage of GDP



Note: Sample's composition changes over time. *Sources: Peterson Institute for International Economics; Jordà-Schularick-Taylor Macrohistory Database; Penn World Table (10.0);World Bank; IMF staff calculations.*



Global FDI flows 2013-2023
Global FDI flows (USD billions)
Global FDI flows (share of GDP %)
% of GDP
USD billions
2.5
2
1.5
1
0.5
0
2000
1500
1000
2013
2014
2015
2016
2017
2018
2019
2020
2021
2022
2023
Source: OECD FDI in Figures April 2024
OECD

Important question

- What does trade fragmentation do to inflation?
- Popular wisdom:
  - Makes imports costlier
  - Higher inflation
- Traditional monetary economics
  - Only implies relative price adjustments
  - No long run effect provided central bank committed
  - Need to guard against second round effects

This paper

- Could even be deflationary
  - Need to look at aggregate demand also
  - Fragmentation may lower or increase r*
- Assumptions
  - Takes as given central bank inflation commitment (Taylor rule).
- Examines 3 cases

1. Gradual import price increase

- Fragmentation restricts supply, leading to gradually higher import prices.
- Terms of trade shock, lower incomes
- Unconstrained households
  - lower spending because permanent income lower.
  - Can smooth through capital markets
- Hand to mouth households
  - real wages lower
  - lower spending and increase labor supply

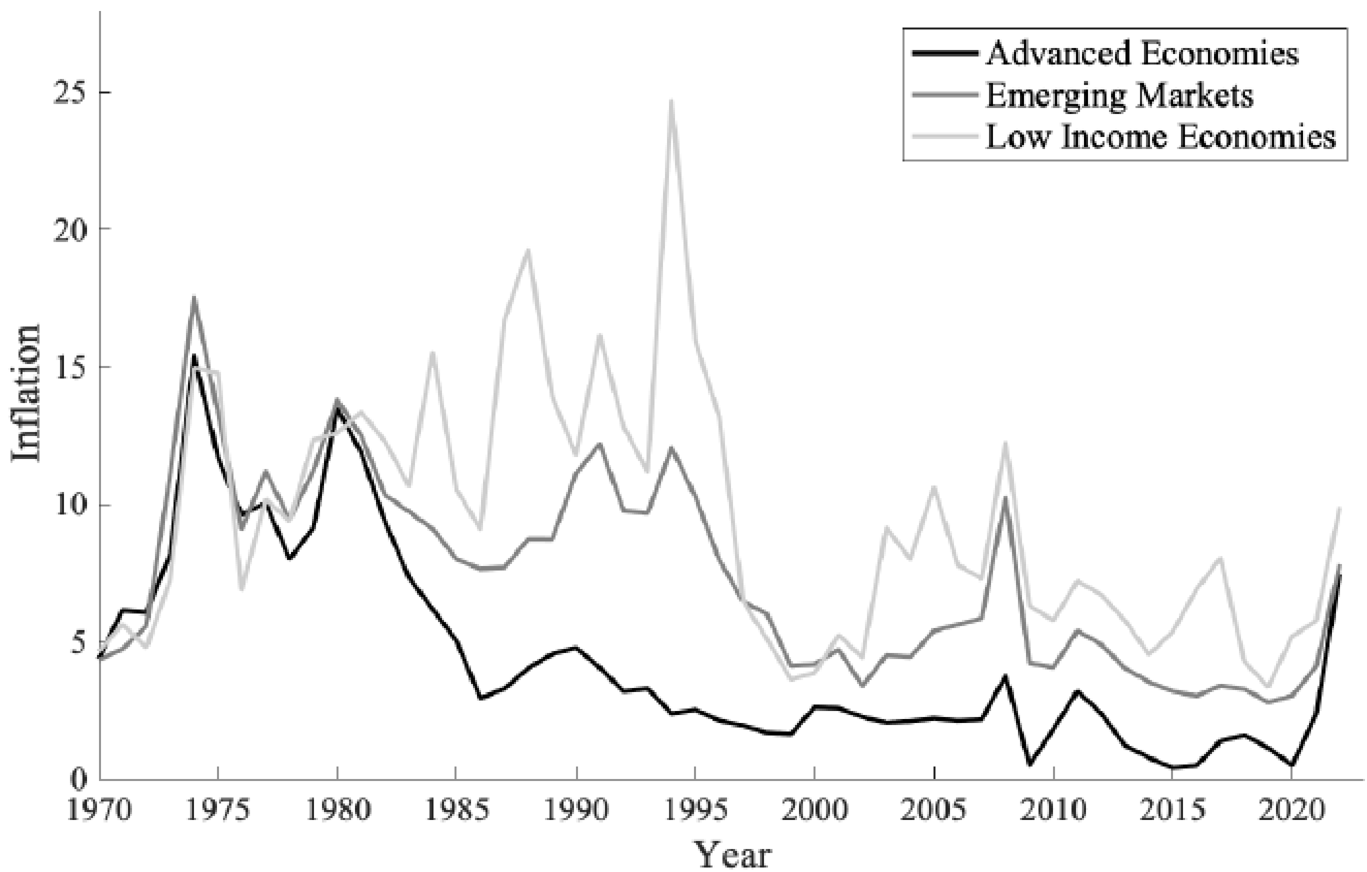
Gradual Contd.

- CPI – average of lower domestic and higher foreign, with more weight on former
  - Inflation falls
  - r* falls because demand decline stronger
  - Monetary policy needs to loosen

Assessment

- Very interesting results from a tour de force exercise in modeling
- Challenges received wisdom
- Received wisdom comes partly from experience of increasing globalization

What else might happen?



Source: Ha, Kose, and Ohnsorge (2021).

Central bank incentives

- Not just central bank efforts/frameworks (Rogoff (2003))
  - Disinflation even in countries that did not adopt inflation targeting
- De-globalization changes competition and thus monopoly profits
  - Greater temptation for central bank to inflate to increase output (Rogoff (2003)).
  - Greater incentive for central bank to tolerate higher inflation so as to keep labor share constant (Afrouzi et al. (2024))
    - Focus on long run demand

Persistent transitional effects

- Can the relative price adjustment needed alter inflationary expectations and make inflation more persistent?
  - Adjustment to oil shocks in the 1970s.
  - Adjustment in EMs with lower credibility.

Investment effects

- Lower FDI can affect productivity not just in traded sector but also in non-traded sector.
- What does lower productivity in non-traded sector do?

Changed world alters central bank

- Fiscal pressures
  - Ageing, defense, green transition
  - Higher incentives from fiscal to inflate
    - Devalue stock of debt
    - Reduce real rate and stimulate economy
- Green transition
  - Forced investment pushes up higher real rates
- Away from zero lower bound (less contractionary)
  - Long term real rates back up to long term trend (Rogoff, Rossi, and Schmelzing (2022)
- Are higher nominal and real rates harder for a central bank to maintain?

Conclusion

- Thought-provoking, carefully done paper.
- Will rightly provoke a lot of discussion.