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Trade Openness and Inflation: the Role of Real and Nominal Price Rigidities

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Highlights:

- I model the impact of trade openness and competition on price flexibility
- Trade openness increases real price rigidities
- Trade openness reduces nominal price rigidities
- The impact of trade openness on the inflation-output trade-off is ambiguous

Abstract

The paper revisits the long-standing question of the impact of trade openness on the inflation-output trade-off by accounting for the effects of product market competition on price flexibility. The study develops a New-Keynesian open-economy dynamic stochastic general equilibrium model with non-constant price elasticity of demand and Calvo price setting in which the frequency of price adjustment is endogenously determined. It demonstrates that trade openness has two opposing effects on the sensitivity of inflation to output fluctuations. On the one hand, it raises strategic complementarity in firms' pricing decisions and the degree of real price rigidities, which makes inflation less responsive to changes in real marginal cost. On the other hand, it strengthens firms' incentives to adjust their prices, thereby reducing the degree of nominal price rigidities and increasing the sensitivity of inflation to changes in marginal cost. The study explains the positive relationship between competition and the frequency of price adjustment observed in the data. It also provides new insights into the effects of global economic integration on the Phillips Curve.

JEL classification: F41; E31; E32

Keywords: Trade Openness; Inflation; Nominal Rigidities; Real Rigidities; Phillips Curve

1 Introduction

The substantial increase in global economic integration during recent decades initiated a heated debate on the impact of trade openness on inflation and the short-run inflation-output trade-off. As understanding this impact is of crucial importance for the optimal design and conduct of monetary policy, the topic has attracted significant interest not only among academics but also policy makers.[1] One of the key determinants of the sensitivity of inflation to changes in domestic economic activity is the degree of nominal price rigidities, which depends on the

[1] See speeches by Kohn (2006), Bean (2006), Bernanke (2007), Fukui (2007) and Trichet (2008).