

Discussion of “Trade Fragmentation, Inflationary Pressures and Monetary Policy”

- Models shocks to a small open economy that are designed to mimic the impact of trade fragmentation.
- The key insight is simple and important. Trade fragmentation is an adverse shock not only to supply, but to real income.
- While the aggregate supply curve may be shifting upwards/leftwards, the aggregate demand curve will be shifting downwards/leftwards.
- The inflationary impulse from the supply shock will be at least partly tempered by the equilibrium demand response.
- The overall impact might even be disinflationary. How?

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- Let's trace through the gradual fragmentation shock modelled as higher import prices.
- While seemingly reasonable, the implementation is essentially a terms of trade shock as there is no corresponding increase in export prices.
- It should not be too surprising that such a terms of trade decrease can be disinflationary; the terms of trade increase experienced in Australia during the mining boom proved to be inflationary despite falling AUD import prices.
- But the mechanics of this shock may not be a good guide for policymakers.

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- The economy is not a conventional open economy model; it is essentially helpless in the face of this shock due to key elasticity assumptions.
- Foreign goods have two key roles in the model economy:
 1. As final consumption goods in the tradable sector;
 2. As the only intermediate inputs used in the domestic production of non-tradable goods.
- The following elasticities of substitution are all 1:
 1. Between home and foreign goods;
 2. Between tradeable and non-tradeable goods;
 3. Between labour and intermediate inputs used in production

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- The “trade fragmentation” shock creates a critical balance of payments problem that will be very unlike how Australia experiences the actual trade fragmentation problem.
- With key elasticities set at one (at home and abroad), the economy can’t generate more export revenue, nor can it easily substitute domestic output for imports, as the import share of nominal domestic spending is absolutely fixed.
- The MU of consumption rises due to the collapse in the quantity of imports both of final goods and intermediate goods used to produce domestic non-tradeables. This leads to greater labour supply.

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- The marginal productivity of labour in the non-tradeable sector is reduced due to the fall in the quantity of imported intermediate goods.
- Higher labour supply plus lower MPL in non-tradeables pushes down wages precipitously, driving down domestic tradeable prices and, to a lesser extent, domestic non-tradeable prices (since higher input costs partly offset wage reductions)
- This is a model of a crisis (Canada? Border regions of Mexico?), not of a gradually unfolding fragmentation. Domestic tradable prices would often rise in practice:
 1. Substitution elasticity between tradeables may be higher;
 2. Tradeables also use imported inputs

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- Let's trace through the gradual fragmentation shock modelled as lower tradeable TFP abroad and at home.
- This is a little closer to how Australia will experience it.
- Australia sits at the beginning and the end of global supply chains – a producer of commodities and a consumer of final goods.
- Rising barriers to international trade raise the price of intermediate inputs through supply chains, which work a little like a decrease in TFP in equilibrium. Australia will experience that as a decrease in foreign tradable productivity.
- Australia appears to be independently good at lowering its own tradable productivity.

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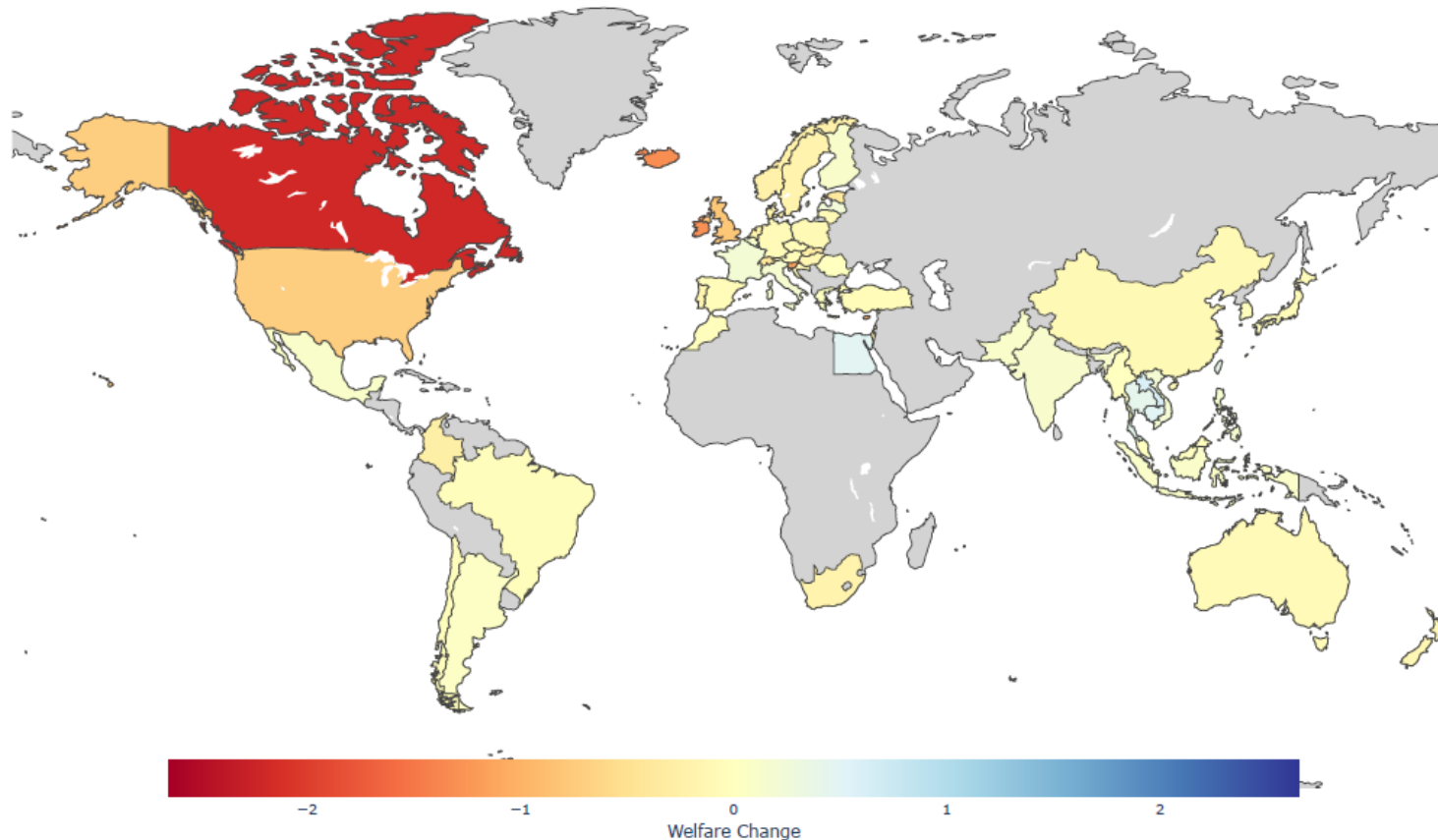
- The unit elasticities again make it relatively easy to trace the main contours of the shock.
- Expenditure shares on tradeables and on imports are all unchanged. The lower productivity in tradeables mean that more labour is devoted to tradeables and less to non-tradeables.
- MU of consumption rises, inducing more labour supply.
- Wages fall due to higher labour supply and lower MPL, offsetting some of the cost/price effects of the negative productivity shock, though the price of tradables still rises.

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- International reallocations are strangely placid in this model; all expenditure shares are nicely fixed.
- Trade fragmentation will be experienced very differently by different countries depending on where they are in various supply chains. Rather than predictable expenditure shares, dramatic changes are possible in many cases.
- The unravelling of a supply chain potentially benefits some countries.
- Do we have a framework that can capture this?
- On the real side, we do, “structural gravity” models are a parsimonious way of modelling trade fragmentation.

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- A chart from Trung Nguyen’s draft master’s thesis analysing the 2025 trade cost shocks:



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- This very simple structural gravity model captured a lot of heterogeneity.
- It can be relatively easily enriched to explicitly model supply chains.
- Can you add a plausible monetary side to it?