



Optimal monetary policy in the presence of pricing-to-market

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Abstract

This paper presents a general-equilibrium framework to revisit the issues of optimal monetary policies and international policy coordination in a two-country model, focusing on the role of a pricing-to-market (PTM) policy by firms. Both countries may be different with respect to PTM. Using the set-up developed by Corsetti and Pesenti [Corsetti, G., Pesenti, P., 2001. Welfare and macroeconomic interdependence. *Quarterly Journal of Economics* 116, 421–445] and Betts and Devereux [Betts, C., Devereux, M., 2000a. International monetary policy coordination and competitive depreciation: A reevaluation. *Journal of Money, Credit, and Banking* 32, 722–745; Betts, C., Devereux, M., 2000b. Exchange rate dynamics in a model of pricing-to-market. *Journal of International Economics* 50, 215–244], we show that (i) for a given Foreign monetary stance, a Home monetary expansion is beneficial for both countries only if Home PTM is at an intermediate range; (ii) in a world Nash equilibrium Home and Foreign welfare are bell-shaped in the degrees of PTM; (iii) relative welfare crucially depends on the degrees of PTM; (iv) there is a welfare gain from cooperation even in the cases of no and full PTM.

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1. Introduction

It is a truism that in a world with increasingly integrated national economies, monetary policy in each country affects economic welfare both at home and abroad. Due to the presence of beggar-thy-neighbor and beggar-thyself effects, however, the welfare effects are difficult to sign. The exploration of the international spillovers and the design of an optimal monetary policy in closed and open economies has become a cottage industry for that reason (see, e.g., Corsetti and Pesenti, 2001, 2005; Obstfeld and Rogoff, 2002; Devereux and Engel, 2003; Sutherland, 2004). Given that wages and/or prices are predetermined, the core of the problem is a simple trade-off: monetary policy is useful for closing the output gap arising from monopolistic competition but may have an adverse terms-of-trade effect. The purpose of this paper is to ask whether monetary policy is beggar-thy-neighbor or beggar-thyself and to compare non-cooperative and cooperative optimal monetary policies.

To address the issues of interest, we set up a non-stochastic two-country general equilibrium model with imperfect competition on goods and labor markets and nominal wage and price rigidities. Some firms segment markets by country, they can charge different prices in domestic and foreign markets. In a similar framework Betts and Devereux (2000a,b) have shown that the sign of the terms-of-trade effect very much depends on the pricing policy of firms. If firms pre-set their export prices in the currency of the producer (consumer), the terms of trade of the expanding country will worsen (improve). In their model, the fraction of exporters who set prices in local currency of sale (pricing to market PTM) is symmetric across countries. Our framework instead allows the fraction of PTM firms to differ across the home and the foreign country, so that any change in the terms of trade can be separated in a change in export prices depending on home PTM and a change in import prices depending on PTM abroad. This distinction is crucial, since the increase in world aggregate demand is a function of the difference of the degrees of PTM, and since a given movement of the terms of trade is now compatible with various consumption and output (employment) allocations.¹

Optimal policies are derived using as objective criterion welfare of the representative agent defined over the discounted flow of consumption, the utility of real balances and the disutility of work effort. Somewhat surprisingly, this most natural criterion is not very common in the related literature, where many contributions assume away the real balance term (see, e.g., Corsetti and Pesenti, 2005; Sutherland, 2004). If, however, real balances are important for determining allocations of agents, and monetary authorities are maximizing the welfare of agents, then it should be included in the policymakers' problem. But this comes at a price. To get an exact solution for the welfare term we have to choose specific functional forms. In particular, utility is logarithmic in consumption and the elasticity of substitution between home and foreign goods is restricted to unity. The latter precludes

¹ Corsetti and Pesenti (2005) take up a similar approach by allowing the degrees of PTM to differ across countries. They consider the case in which exporters pre-set prices in foreign currency but are able to modify them after observing exchange-rate changes. The pass-through elasticity is assumed to be constant and exogenous to the model. This approach, however, appears inconsistent with working from first principles. If there are no menu costs or the like impeding a price change, the profit-maximising response to an exchange-rate change is a complete pass-through. In other words, the assumption of incomplete pass-through contradicts with the assumption of profit-maximising firms.

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