International Trade in Open Economy Macroeconomics: Summary[*]

Fabio Ghironi[†]
University of Washington, CEPR, and NBER
Director, Research Program in International Trade and Macroeconomics, Central Bank Research Association

March 28, 2017

Modern international macroeconomics builds on micro-level specifications of the behavior of households and firms. The assumption that the latter have some monopoly power is widely used to motivate price-setting and, in turn, as a stepping stone to introduce imperfect price adjustment, and thus a role for monetary policy, in models. However, that is as far as the majority of open economy macro models go in specifying the micro-level behavior of producers. The most common assumption is that the economy is populated by a constant, exogenously given number of firms.

By contrast, international trade analysis has long acknowledged the role of entry decisions into domestic and foreign markets in shaping trade patterns and affecting consumer welfare. Since the early 2000s, a large literature has developed that studies the consequences of firm heterogeneity for trade, aggregate productivity, and welfare. While the typical approach of international macro analysis is to address questions of interest in dynamic models under uncertainty, trade models usually restrict attention to steady-state outcomes in the absence of aggregate uncertainty. Open economy macroeconomics allows for and often focuses on the dynamics of external imbalances; international trade models usually assume balanced trade.

This separation between the two fields is artificial, and it prevents each of them from addressing many interesting questions, or from reaching more reliable, empirically relevant conclusions on questions they do address. But the gap between the two fields can be easily bridged once one recognizes the de-facto convergence of the microfoundations in both fields.

Replacing the assumption of a fixed, exogenous number of firms in the benchmark New Keynesian open economy framework with the assumption of endogenous market entry subject to entry costs, and allowing for heterogeneous productivity across firms, yields an open economy macro framework that encompasses the current workhorse model of international trade—essentially, extending the latter in the direction of dynamics and general equilibrium under aggregate uncertainty.

This has made it possible to shed new light on classic questions in international macroeconomics and to address new questions raised by recent events. Combined with the increased availability

[*] This document summarizes the topics I will discuss in a paper in preparation for the Oxford Research Encyclopedia of Economics and Finance. The views I express are personal and do not reflect the views or policies of the CEPR, NBER, and the Central Bank Research Association.

[†] Department of Economics, University of Washington, Savery Hall, Box 353330, Seattle, WA 98195, U.S.A. E-mail: ghiro@uw.edu. URL: http://faculty.washington.edu/ghiro.

of micro-level data, the introduction of deeper trade foundations into open macro models has made it possible better to confront the models with empirical evidence. In turn, this has resulted in analysis of key policy questions that is more reliable and nuanced than with traditional New Keynesian models.

The fast growing literature at the intersection of open economy macroeconomics and international trade has addressed questions that range from the effect of productivity on international relative prices to the role of offshoring in business cycle synchronization across countries, from the consequences of trade for aggregate volatility to the role of differences in labor market institutions in shaping dynamics after trade integration, from the effects of structural reforms to the interaction of trade and monetary policy, and many more.

The establishment of global value chains across multiple borders as the world economy became increasingly integrated, the importance of financial market imperfections and failures underscored by the global crisis of 2007-08, concerns about the distributional consequences of trade and macro policies, and the looming threat of protectionism raise a host of interesting, important questions for future research.