Beyond Competitive Devaluations: The Monetary Dimensions of Comparative Advantage

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As policymakers and economists are debating the pros and cons of monetary union and the implications of competitive devaluation, we propose a new perspective on how monetary and exchange rate policies can contribute to a country's international competitiveness. We refocus the analysis on the implications of alternative monetary regimes for a country's comparative advantage.

Theoretically, we develop a two-country New-Keynesian model allowing for two tradable sectors in each country: firms in one sector are perfectly competitive; firms in the other sector produce differentiated goods under monopolistic competition subject to sunk entry costs and nominal rigidities. Because of this, the performance of firms in the second sector is more sensitive to macroeconomic uncertainty.

We show analytically and numerically how monetary stabilization fosters the competitiveness of firms producing differentiated manufacturing goods, encouraging investment and entry in the sector, and ultimately affecting the composition of domestic output and exports.

Empirically, we carry out extensive panel regressions based on worldwide exports to the U.S. by sector. In line with theory, we show that constraining monetary policy with an exchange rate peg lowers a country's share of differentiated goods in exports between 4 and 12 percent.

To clarify our contribution to policy debate: in our model, an effective stabilization policy requires contingent expansion and contractions in response to shocks affecting the output gap, which ex post foster the international price competitiveness of a country. But such a policy regime by no means would aim to gain short-run gains by opportunistic exchange rate policy---exchange rate movements would be an implication of efficient domestic stabilization. In this sense, our results suggest that monetary stabilization affects the comparative advantage of a country in a way that is completely separate from the competitive devaluations familiar from traditional policy models.

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By the same token, our analysis marks an important departure from a key conclusion of recent New Keynesian models, that monetary policy should trade-off output gap stabilization with stronger terms of trade. In our model, efficient stabilization makes differentiated good manufacturing more, not less, competitive. But it also results in a shift in the sectoral allocation of resources and composition of exports, in favor of manufacturing. Because of this shift, the manufacturing terms of trade may fall (enhancing competitiveness) at the same time that the overall terms of trade of a country may improve.