Discussion of “Dominant Currency Paradigm: A New Model for Small Open Economies”

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Very Insightful Paper

- In the Neo-Keynesian tradition, the literature has considered two standard assumptions to model currency invoicing:
    1. Producer Currency Paradigm (PCP)
    2. Local Currency Paradigm (LCP)
- This paper proposes a **new framework**:
    - The **Dominant Currency Paradigm** (DCP)
        - **Producers set their export prices in an international dominant currency** (for example, the U.S. dollar).
        - Using Colombian data, the authors provide evidence that supports this theory.
- In the presence of nominal rigidities, the currency of invoicing is crucial to determine international trade, pass-through to prices and monetary policy response to fluctuations in the nominal exchange rate.

Some Implications of DCP

- Stable terms of trade (p^X/p^I).
- The exchange rate pass-through (ERPT) to exports and imports is:
  - High if U's currency fluctuates, although dampened by Strategic Complementarities and Intermediate Inputs.
  - Negligible if the R currency fluctuates.
- An expenditure switching mechanism works via imports and not through exports.
  - Therefore, global trade falls if the U currency appreciates.
- Optimal monetary policy (OMP) targets deviations from the law of one price.
  - OMP calls for domestic producer price inflation targeting while the output gap fluctuates with the terms of trade.
  - The "divine coincidence" breaks down.

A Few Comments

1. The authors provide several very important implications of the DCP. However, **it would be interesting to discuss the type of frictions that drive exporting firms to settle their price in an international dominant currency.**

   - Matching frictions? International Payments Systems?

   - Multiplicity of equilibrium? DCP may be one but LCP and PCP could be alternative ones?

   - Lack of hedging instruments in other currencies?

A Few Comments

2. In the future, it may be important to work on **making endogenous the decision of currency of invoicing.**

   - Intuitively, it seems that if exporting firms could freely choose their currency of invoice, the economy as a whole must attain allocations that otherwise it couldn't.

   - Reminds me to "A dictum of monetary theory" by Neil Wallace.

     - <u>The currency of invoicing must be *essential*</u>

A Few Comments

3. In my view, **welfare implications should be derived**. Some experiments could be done.
    - In which world agents of this economy are better of?
        - DCP?
        - LCP?
        - PCP?
        - A mix of them? Is there an optimal one?

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