The role of local currency pricing in the international transmission effects of a government spending shock in an economy with vertical production linkage and foreign direct investment

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Abstract

By constructing a two-country model with asymmetry in price-setting behavior between home and foreign intermediate goods firms, vertical production and trade, and endogenous entry of three types of final goods firms, this paper examines the effects of a home government spending shock. In particular, it focuses on the role of asymmetry in price-setting behavior between home and foreign intermediate goods firms. A home government spending shock is shown to result in the entry of multinational firms from both countries, an increase in the aggregate outputs of both countries, a deterioration in home welfare, and an improvement in foreign welfare. In addition, with an increase in the ratio of home and/or foreign intermediate goods firms setting their export prices in the local currency, the effects of this shock on the entry of home multinational firms, the increase in aggregate foreign output, the deterioration in home welfare and the improvement in foreign welfare are shown to be weakened, while the effects of this shock on the entry of foreign multinational firms and the increase in aggregate home output are intensified.

Keywords: Local currency pricing, Vertical production and trade, Firm entry, Foreign direct investment, Government spending shock