The international transmission effects of tariff shocks: The role of various financial structures and local currency pricing

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Abstract

By incorporating the factors of asymmetry in price-setting behavior between home and foreign intermediate goods firms and vertical production and trade into a two-country model with international financial integration, this paper examines the effects of two types of positive tariff shocks separately. In particular, it focuses on the roles of various financial structures and asymmetry in price-setting behavior between home and foreign intermediate goods firms. First, a rise in home tariffs on imported final goods is shown to yield an increase in the short-run aggregate home output, a decrease in the short-run aggregate foreign output, an increase in the quantity of net foreign assets, an improvement in home welfare, and a deterioration in foreign welfare. In this case, an improvement in home welfare and a deterioration in foreign welfare are smallest in a bond-only economy. Additionally, an improvement in home welfare and a deterioration in foreign welfare are also smallest in a situation of full LCP. Second, a rise in home tariffs on imported intermediate goods is shown to yield a decrease in the short-run aggregate home output, an increase in the short-run aggregate foreign output, a decrease in the quantity of net foreign assets, a deterioration in home welfare, and an improvement in foreign welfare. In this case, a deterioration in home welfare and an improvement in foreign welfare are smallest in an equity-only economy. Additionally, a deterioration in home welfare and an improvement in foreign welfare are smallest in a situation of full LCP.

Keywords: Valuation effect, International financial integration, Local currency pricing, Vertical production and trade, Tariff shocks