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Dominant Currency Paradigm:
A New Model for Small Open Economies

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Abstract

Most trade is invoiced in very few currencies. Despite this, the Mundell-Fleming benchmark and its variants focus on pricing in the producer's currency or in local currency. We model instead a 'dominant currency paradigm' for small open economies characterized by three features: pricing in a dominant currency; pricing complementarities, and imported input use in production. Under this paradigm: (a) the terms-of-trade is stable; (b) dominant currency exchange rate pass-through into export and import prices is high regardless of destination or origin of goods; (c) exchange rate pass-through of non-dominant currencies is small; (d) expenditure switching occurs mostly via imports, driven by the dollar exchange rate while exports respond weakly, if at all; (e) strengthening of the dominant currency relative to non-dominant ones can negatively impact global trade; (f) optimal monetary policy targets deviations from the law of one price arising from dominant currency fluctuations, in addition to the inflation and output gap. Using data from Colombia we document strong support for the dominant currency paradigm.

JEL Classification Numbers: E0, F0.

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