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Stabilization policy in an open economy

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Abstract

The scope for an active demand management policy is considered for a small open economy. Business cycle fluctuations generated by supply and demand shocks are shown to imply welfare losses when agents are risk averse and the capital market incomplete. Public demand for non-tradeables has real effects and there is a welfare case for pursuing a demand management policy which stabilizes consumption. It is argued that this type of stabilization can be attained via automatic stabilizers based on nominal budgeting rules.

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1. Introduction

For more than a decade, reducing public budget deficits has been the overriding concern for fiscal policy analysis, and other issues have been devoted little attention. Yet in the last few years budget deficits have been reduced significantly in many industrialized economies, and while long-term issues related to pensions and demographic trends are still a matter of deep concern, more attention can again be given to the short-run effects of fiscal policy. However, much of the existing economic literature on fiscal policy is based on rather restrictive models that do not apply to

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the recent advances made in the macroeconomics literature. [1] In particular a significant achievement of the recent development in the open macroeconomics literature is the formulation of explicit intertemporal models (see e.g. Obstfeld and Rogoff (1996) for an introduction and references). Very little is, however, known about the policy implications of these models. One exception is that it is often argued that the explicit intertemporal interpretation of the current account in terms of the underlying savings and investment decisions makes it misleading to have the current account or the trade balance as an intermediary target for economic policy making (see e.g. Corden, 1991; Razin, 1993).

The aim of this paper is to consider the implications of business cycle fluctuations generated by supply or demand shocks in a small open economy. When agents are risk averse and capital markets incomplete, there is a welfare loss from the risks created by business cycle fluctuations. We show that demand management policy in the form of public demand for non-tradeables affects the real allocation. In particular there exists a demand management policy which can stabilize the tradeable sector and thereby consumption and thus lead to welfare improvements both when business cycle fluctuations are created by demand and supply shocks. The welfare case for this policy can be interpreted in the sense that it provides implicit or social insurance which mitigates the consequences of market failures precluding perfect consumption smoothing for households. Finally, we discuss whether simple forms of demand management policies can contribute to an appropriate stabilization, and we show that this can be accomplished via automatic stabilizers built into the public budget via nominal budget rules.

Specifically the present paper is based on a two-sector model for a small open economy, with one sector producing a tradeable and the other a non-tradeable. There is perfect capital mobility but the available set of assets does not allow perfect diversification of the shocks inducing business cycle fluctuations. Since households are risk averse, it follows that there is a welfare loss due to fluctuations in consumption. In the present setting changes in public demand affect the equilibrium via two routes. First, via the implied change in taxes and its effect on disposable income and secondly via a change in the relative demand for tradeables and non-tradeables and thereby the terms of trade.

An obvious objection to the topic of our paper is that stabilization should be the aim of monetary policy, and not of fiscal policy. We do not object to the view that monetary policy instruments should be used to stabilize the economy. However, for countries pursuing a fixed exchange rate policy (like all EMU countries) there is no autonomy in monetary policy. Moreover, even for countries with a floating exchange rate, recent experiences of the UK and New Zealand show that an active monetary policy may not prevent considerable imbalances between tradeables and non-tradeables sectors (see King, 2000; Brash, 2001). In contrast, as will be apparent from our analysis, fiscal policy may have a stabilizing effect on the sectoral distribution of the

[1] Important exceptions include Giavazzi and Pagano (1990), Baxter and King (1993) and Dixon and Lawler (1996).

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