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# The new open economy macroeconomics of government debt<sup>☆</sup>

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## Abstract

In this paper we introduce an overlapping generations structure of the Blanchard (J. Polit. Econ. 93 (1985) 121) type in a New Open Economy Macroeconomics (NOEM) model. This allows us to study a wider range of fiscal shocks compared to the traditional Mundell–Fleming (MF) and to the baseline *Redux* models. We show that a debt-financed tax cut appreciates the short-run exchange rate, but this result is reversed in the long run. A debt-financed increase of government spending, on the other hand, has ambiguous exchange rate effects. Our model also provides a bridge between the NOEM framework and the MF model.

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## 1. Introduction

The study of the international effects of fiscal policy shocks is a classical exercise in open economy macroeconomics, that dates back at least to the original development of the Mundell–Fleming (MF) model.<sup>1</sup> Fiscal policy, however, has received comparatively less attention than monetary policy in recent theoretical research based on

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<sup>☆</sup> The views expressed in this paper are those of the author and should not be interpreted as reflecting those of the International Monetary Fund.

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<sup>1</sup> Mundell (1968) and Fleming (1962).

microfounded models. An obvious example of this unbalance can be found in the development of the New Open Economy Macroeconomics (NOEM) literature.<sup>2</sup> The NOEM literature has to date concentrated on monetary issues, with the fiscal side receiving scant attention. The main reason why fiscal policy has been so far under-researched in this framework is that, with Ricardian Equivalence holding in the basic NOEM model, the analysis of fiscal issues was necessarily limited to balanced-budget policies.<sup>3</sup>

In the NOEM model presented in this paper, Ricardian Equivalence does not hold.<sup>4</sup> This is an important difference from the earlier contributions, which allows us to enrich the original NOEM setup in order to study a menu of alternative fiscal policy actions. In particular, we can analyze the real effects of debt policies on the main macroeconomic variables in an open economy framework and compare them to the effects of balanced-budget policies.

The possibility of considering alternative fiscal policy options means that our analysis can also give some insights on the consequences of different ways of financing a given level of government spending, by contrasting tax financing with debt financing. The latter is another important difference with the existing literature on fiscal policy, which usually focuses on changes in the level of government spending rather than on changes in the financing choices of a given amount of spending.

The main channel at work in the model is the interaction between consumption, money demand and the price level. We show that, with finite horizons, a debt-financed tax cut generates a short-run increase in domestic consumption, which in turn increases the domestic money demand relative to the foreign. For a given money supply, and in the presence of complete pass-through of exchange rate fluctuations to prices, this determines an appreciation of the domestic nominal exchange rate in the short run. The fall in net foreign assets caused by this policy, however, implies that this result is reversed in the long run.

The effect on the exchange rate depends on the temporal horizon, with the domestic currency actually depreciating in the long run. When the fiscal expansion is implemented through a balanced-budget increase in government spending, short-run private consumption is crowded out and the short-run exchange rate effect is a nominal depreciation of the domestic currency. These results have important implications for the study of the consequences of different financing choices of a given level of government spending, which we discuss in Section 3.5.

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<sup>2</sup> The starting point of this literature is usually considered to be the *Redux* model (Obstfeld and Rogoff, 1995). For a survey, see Lane (2001). Ganelli and Lane (2003) focus on more recent developments in the field.

<sup>3</sup> The few NOEM papers that consider the fiscal side, such as Obstfeld and Rogoff (1995), Betts and Devereux (1999), Caselli (2001), Corsetti and Pesenti (2001) and Ganelli (2003) limit their analysis to balanced-budget policies. Ghironi (1998) carries out an analysis in which taxes have distortionary effects.

<sup>4</sup> From the technical point of view, this is achieved by combining the *Redux* (Obstfeld and Rogoff, 1995) model with an overlapping generations structure of the Blanchard (1985) type. Another NOEM model in which Ricardian Equivalence does not hold is provided by Ghironi (2000), who combines the NOEM framework with infinitely lived overlapping generations of the Weil (1989) type. He shows how this can solve the “stationarity problem” displayed by several models in the literature.

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