



Capital mobility and the effectiveness of fiscal policy in open economies

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Abstract

This paper uses a dynamic general equilibrium two-country optimizing ‘new-open economy macroeconomics’ model to analyze the consequences of international capital mobility for the effectiveness of fiscal policy. Conventional wisdom suggests that higher capital mobility diminishes the effectiveness of fiscal policy. The model laid out in this paper provides an example that a higher degree of capital mobility can also increase the effectiveness of fiscal policy. This tends to be the case if the stance of monetary policy can be described by means of a simple monetary policy rule.

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1. Introduction

The globalization of financial markets has become one key manifestation of the increasing world-wide economic integration. This process of integration has been fostered by the abolition of legal restrictions on cross-border capital movements

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and by technological advances that have lowered information and communication costs considerably. As a result, international financial markets have grown rapidly during the past decades and international capital mobility has increased significantly. Because the degree of international capital mobility plays a key role for the effects and the effectiveness of macroeconomic policies, this can have important implications for economic policy.

As regards fiscal policy, the classic contributions of [Fleming \(1962\)](#) and [Mundell \(1963\)](#) imply that, in a flexible exchange rate regime, the effectiveness of fiscal policy, as measured by its effect on aggregate output, is an inverse function of the degree of international capital mobility. In the case of two large interdependent economies, the Mundell–Fleming model implies that capital mobility gives rise to an exchange-rate induced crowding-out effect and, thereby, diminishes the effectiveness of fiscal policy in the country in which it takes place. In the case of a small open economy, the results that can be derived from the Mundell–Fleming model are even stronger. This model suggests that in a world of perfect capital mobility the exchange-rate induced crowding out effect implies that fiscal policy has no effects on output at all in a small open economy (see, e.g., [Hallwood and MacDonald, 2000](#)). Even though researchers pointed out that the implications of capital mobility for the effectiveness of fiscal policy may be unclear ([Greenwood and Kimbrough, 1985](#)), the conventional wisdom derived from the Mundell–Fleming model has been that capital mobility diminishes the effectiveness of fiscal policy in open economies.

Recently, [Sutherland \(1996\)](#) and [Senay \(2000\)](#) have shown that this core result of the Mundell–Fleming analysis in principle also holds if one uses a micro-founded dynamic monetary general equilibrium macroeconomic model to study the output effects of fiscal policy in open economies. Using variants of the prototype two-country sticky-price ‘new-open economy macroeconomics’ (NOEM) model developed by [Obstfeld and Rogoff \(1995\)](#), they have derived the result that moving from imperfect to perfect capital mobility diminishes the effectiveness of fiscal policy. Thus, as in the traditional Mundell–Fleming model, the effectiveness of fiscal policy, as measured in terms of its short-run effect on output, tends to be an inverse function of the degree of capital mobility.

I argue that increasing the degree of capital mobility can increase the effectiveness of fiscal policy in a standard NOEM model if the stance of monetary policy can be described by means of a simple monetary policy rule. This result shows that in analyses of the implications of capital mobility for the effectiveness of fiscal policy the interaction between fiscal and monetary policy should be taken into account. In order to derive this result, I use a variant of the standard NOEM model also employed by [Sutherland \(1996\)](#). I extend Sutherland’s model to incorporate a richer specification of the monetary policy rule pursued by central banks. Sutherland uses a purely autoregressive process as a monetary policy rule. The monetary policy rule I add to Sutherland’s model contains this monetary policy rule as a special case and is general enough so that I can discuss the implications of various other monetary policy rules for the effectiveness of fiscal policy. I analyze the implications of monetary policy rules that imply that central banks adopt a policy of nominal income targeting, a policy of a strong response to inflation, and a ‘speed limit’ policy. The latter

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