MONETARY-FISCAL POLICY ASSIGNMENT UNDER FLOATING EXCHANGE RATES

BY

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This paper examines the use of monetary and fiscal policy in a small open economy in which the exchange rate is floating, and in which the government attempts to achieve several macroeconomic objectives. Because of sticky wages and prices, full employment does not necessarily prevail, and the level of economic activity, therefore, is taken to be a basic policy target. In addition, the government is concerned with the composition of output, in terms of the fraction of gross national product devoted to investment spending, as part of an overall growth policy; and it also regards the country’s current account position as an important objective. With respect to the latter possibility, Dornbusch, for example, has suggested that

External balance, of course, is no problem if we think of it as overall balance of payments equilibrium that is insured by the flexible rate. External balance remains an objective, though, if we think of current account targets. A country may wish a particular current account or trade balance because it may not wish to borrow or lend abroad excessively.

For a given level of economic activity, it will be shown in Section 1 below that a trade-off exists between the level of domestic investment spending and the country’s current account position as the monetary-fiscal policy mix changes. Ideally, then, policy-makers can select the monetary-fiscal mix that produces the target level of economic activity and an optimum combination of investment spending and current account position. However, in the absence of reliable quantitative information about the economy’s macroeconomic structure (and by implication the above trade-off in quantitative terms), policy-makers must resort to assigning instruments to targets. Therefore, Section 2 of the paper discusses the assignment of monetary and fiscal policy to the

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1 For example, see Gordon [4, pp. 140-142].
2 Dornbusch [1, p. 198]. For extensive discussion of the current account as a possible target of government policy, and a compilation of official statements indicating such a target, see Salop and Spitäller [11, esp. pp. 124-128]; and on possible determinants of the current account, see Dornbusch [2] and Sachs [10].
3 The classic discussion of monetary-fiscal assignment under fixed exchange rates is, of course, Mundell [7]. A major critique is Johnson [5, pp. 314-318].
targets of economic activity and domestic investment spending; and Section 3 analyzes the monetary-fiscal assignment when economic activity and the current account are the targets. The results of the paper are summarized in Section 4. The major conclusion is that monetary and fiscal policy can be feasibly assigned to either set of targets, although in both cases the system may respond with oscillations.

1 THE TRADE-OFF BETWEEN INVESTMENT SPENDING AND THE CURRENT ACCOUNT

The basic premise of this paper is that a target for the level of economic activity, achieved by the use of monetary and fiscal policy, implies a specific rate of domestic investment spending and a specific position for the current account under a floating exchange rate system. Furthermore, changing the monetary-fiscal mix at the target level of economic activity, so as to, say, raise the investment component of GNP, will simultaneously increase the country's current account position. Ideally then, the optimum monetary-fiscal mix is the one that achieves the most desirable combination of investment spending and balance of payments structure at the target level of income.

These conclusions can be derived from the standard Keynesian open economy static macro model under floating exchange rates, given below:

\[ S(\dddot{Y}) + \frac{1}{\pi} M(\dddot{Y}, \ddot{\pi}) = I(\ddot{\pi}) + X(\ddot{\pi}) + G \]

\[ Q = L(\dddot{Y}, \ddot{\pi}) \]

\[ X(\ddot{\pi}) - \frac{1}{\pi} M(\dddot{Y}, \ddot{\pi}) + K(\ddot{\pi}) = 0 \]

where \( Y \) = real GNP; \( \pi \) = exchange rate on the home currency (units of foreign currency per unit of domestic currency); \( \dot{r} \) = domestic interest rate; \( S \) = domestic saving; \( I \) = domestic investment spending; \( G \) = government spending on domestic goods and services; \( M \) = volume of imports; \( X \) = volume of exports; \( Q \) = money supply; \( L \) = demand for money; and \( K \) = net sustained capital inflows. Parameter signs are shown above the arguments. Equation (1) is the equilibrium condition for the goods market. Here, for simplicity, taxes have been omitted, and government spending is taken to be the fiscal control variable. (Alternatively, one can imagine that taxes are included in the saving

4 The rate of inflation is not an explicit target in this paper. However, one can imagine that the government chooses a particular rate of monetary growth consistent with its goal for the long-run inflation rate. The actual rate of monetary growth is then allowed to deviate from this number as monetary policy is assigned to one of the targets considered here.