The New Open Economy Macroeconomics: A Critical Appraisal

DAVID D. VANHOOSE  
David.VanHoose@baylor.edu  
Professor of Economics and Herman Lay Professor of Private Enterprise, Hankamer School of Business, Baylor University, P.O. Box 8003, Waco, TX 76798-8003, USA

Key words: open economy macroeconomics, new open economy macroeconomics

JEL Classification Numbers: F41, F42

Abstract

Within only a few years, the new open economy macroeconomics (NOEM) has emerged as a potential rival to the Mundell-Fleming framework, as modified by Dornbusch and others in the 1980s and 1990s using linear-quadratic models, as the dominant analytical framework in the study of open economies. This paper reviews some of the main developments in this literature. It offers a critical appraisal of its contributions to date and discusses potential pitfalls of taking a pure NOEM approach by dismissing work not based in explicit utility maximization as “ad hoc.” The paper proposes broadening the NOEM literature to include consideration of heterogeneities within and across open economies. In light of the complexities involved in modeling heterogeneous agents or structures, the field of open economy macroeconomics may stand to gain from the pursuit of an impure NOEM. Work along these lines would de-emphasize dynamics, general equilibrium, and explicit optimization in favor of a focus on the true innovation of the NOEM literature, which has been highlighting the crucial importance of accounting for imperfect competition and price and wage rigidities in macroeconomic theories of open economies.

Anyone who keeps up with working papers and recent articles in open economy macroeconomics knows that an article and textbook by Obstfeld and Rogoff (1995a, b) have had, together with follow-up efforts by these two authors and a number of other researchers, a significant impact on research in the area. Already, some researchers are calling it the new “Workhorse Model” of open economy macroeconomics (Canzoneri, Cumby, and Diba, 2002). It is being applied to such diverse topics as currency crises (Aghion, Bacchetta, and Banerjee, 2000), how exchange-rate stability affects international trade (Bacchetta and Van Wincoop, 2000), and the currency denomination of international trade (Bacchetta and Van Wincoop, 2002).

What are those of us who advise policymakers, who do policy-oriented research, or who teach undergraduate and graduate students to make of this so-called new open economy macroeconomics (NOEM)? Should we be worried that our policy advice, policy analysis, or teaching about international
macroeconomic policymaking is rapidly becoming—or may already have become—out of date?

Or should we be skeptical? Have NOEM contributions truly deepened our understanding of macroeconomic issues faced by open economies? Is the NOEM approach really “better” than much of the vast literature in open economy macroeconomics that had preceded the recent outpouring of NOEM contributions? Or does the descriptor “new” essentially serve only to differentiate the NOEM “product” from its competition—namely the Mundell-Fleming/linear-quadratic models previously used in policy analysis? Do the models and results developed so far in the NOEM literature mainly glorify analytical elegance that, upon closer scrutiny, provides little more—or perhaps even less, along certain dimensions—depth than the “old-style” approaches?

The objective of this paper is to provide some tentative answers to these questions. It should be emphasized at the outset that this paper is not an exhaustive review of this literature. Taken together, recent surveys by Sarno (2000, 2001), Obstfeld (2001), and Lane (2001a)—which a reader otherwise uninitiated to this literature can most profitably read in this order—provide a much broader perspective on the various branches of the NOEM literature. This paper focuses its attention on a point that those of us who regularly teach undergraduates commonly stress in our classes, which is that any theory is an artificial representation of the essential relationships hypothesized to be sufficient to analyze a particular problem of concern. The bulk of the discussion that follows focuses on the following overarching question: Are all of the features of the pure NOEM approach truly of essential, first-order, importance for analyzing how policy actions exert macroeconomic effects, for forming predictions about the responses of macroeconomic variables, and for evaluating the predictive capabilities of the theory?

1. Why a new open economy macroeconomics?

Much of the new open economy macroeconomics incorporates intertemporal optimization and dynamic general-equilibrium analysis into open-economy theories in settings with imperfectly competitive product markets. Within most models in the NOEM vein, macroeconomic policies can have real short-run effects because of nominal and/or relative price stickiness in markets for goods and services, nominal and/or real wage stickiness in labor markets, and/or incomplete information in financial markets.

1.1. More rigorous microfoundations and dynamics

Beyond a doubt, there are significant entry barriers to those considering becoming practitioners of what I shall call pure NOEM—the development and application of new open economy macroeconomics incorporating explicit