Macroeconomic Policy in the SOE

Economic policy covers a broad range of measures which differ, *inter alia*, with respect to their objectives, decision mechanisms, instruments, transmission channels and time frame. A key distinction is between macroeconomic and microeconomic policies. The latter affect particular sectors of the economy or are otherwise selective in their impact and are usually called structural policies. They are for good reasons also referred to as supply-side, long-term or sectoral policies. The role of the EU for structural policies will be reviewed in Chapter 7.

Macroeconomic policies have their main effect on the overall economic situation. They are for good reasons often referred to as demand, short-term, cyclical or stabilisation policies. The reference to demand is appropriate because these policies affect overall economic activity by influencing total demand for goods and services. The effect on demand may be direct, as when the government spends more on goods and services. More often the effect is indirect. For instance, the government may reduce taxes in order to leave more disposable income in the hands of households with a view to increasing private consumption, or the central bank may influence financial conditions with a view to affecting private investment. The reference to the cyclical situation and stabilisation is appropriate because macroeconomic policies are typically geared to keeping overall activity stable at a satisfactory level. The aim is to achieve a high rate of utilisation of existing productive resources and healthy economic growth without inflationary pressure. The focus of macroeconomic policy is on managing the economy in the short term (though subject to forecasting errors and political failures), while economic growth in the long term will mainly depend on the supply side (productive capacity) and on structural policies.
This chapter sets out a simple analysis of macroeconomic policy in a ‘small open economy’ (SOE). Building on the analysis, the next chapter will focus on macroeconomic interdependence in EMU and on the issues of economic policy coordination to which this interdependence gives rise. It will be practical to set out the analysis in formal terms, using some simple equations and graphs. In particular, the analysis recapitulates the so-called Mundell–Fleming (MF) model,¹ which is still the workhorse for much of the analysis of open economy macroeconomics (and is well established in basic macroeconomic text books).

5.1 The SOE-model

The key simplifying assumption invoked is that the economy or area under consideration is small relative to the world economy in the sense that the global rate of interest, world income and the foreign price level may be treated as given. A main point of the MF model is to clarify the importance of the exchange-rate regime for the effectiveness of macroeconomic policies, and a distinction is therefore made between the cases of fixed and flexible exchange rates. The model is set out by focusing on the conditions for the short-term equilibrium of the economy.

A first condition is that the level of domestic output must equal total demand for it. The SOE is producing a (homogeneous) domestic output which is absorbed domestically or exported abroad. Total demand is composed of domestic demand and net exports (the excess of exports over imports). Domestic demand consists of private demand and government expenditure. The condition may be formulated as:

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Y = E[(1 - t)Y, R] + G + T(Y, S/P) + X
\]

where \(Y\) is output or income (these being equal by definition), \(R\) the domestic rate of interest, \(G\) government expenditure and \(t\) the tax rate, \(X\) autonomous demand (other than government expenditure), \(P\) the domestic price level and \(S\) the exchange rate and the domestic price of foreign goods (the foreign price being normalised at unity). It is assumed in Equation (5.1) that demand of the private sector \(E\) (consumption and investment) is a positive function of net or disposable income and a negative function of the rate of interest (as indicated by the signs), while government expenditure is a policy parameter. Net exports \(T\) is taken to be a negative function of domestic income (which