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Closing small open economy models

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Abstract

The small open economy model with incomplete asset markets features a steady-state that depends on initial conditions and equilibrium dynamics that possess a random walk component. A number of modifications to the standard model have been proposed to induce stationarity. This paper presents a quantitative comparison of these alternative approaches. Five different specifications are considered: (1) A model with an endogenous discount factor (Uzawa-type preferences); (2) a model with a debt-elastic interest-rate premium; (3) a model with convex portfolio adjustment costs; (4) a model with complete asset markets; and (5) a model without stationarity-inducing features. The main finding of the paper is that all models deliver virtually identical dynamics at business-cycle frequencies, as measured by unconditional second moments and impulse response functions. The only noticeable difference among the alternative specifications is that the complete-asset-market model induces smoother consumption dynamics.

Keywords

Small open economy; Stationarity; Complete and incomplete asset markets

JEL classification

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