An alternative model to the open-economy "new consensus"

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Abstract

In this paper we present a heterodox open-economy macroeconomic model aiming to establish an alternative view to the "New Consensus" model and analyze the determinants of long-run inflation, the monetary policy transmission channels, the costs of such policy and its implementing limitations.

The open-economy New Consensus model with inflation targeting is based on the following theoretical structure: (i) the potential output is determined according to the neoclassical theory of value and distribution; (ii) output depends on the real interest rate and the real exchange rate (iii) the Phillips curve is accelerationist (iv) the exchange rate determination depends on the uncovered interest rate parity in the short run and on the purchasing power parity in the long run; (v) a Taylor rule.

The main results of this model are well known. There is no trade-off between inflation and productive capacity, since the later is independent of the effective output; and such policy can always be applied, because it is always possible to the Monetary Authority to fix the real interest rate in line with the natural rate of interest.

The alternative model proposed follows the same simplified scheme of the New Consensus model, but altering significantly some theoretical assumptions. (i) First, the potential output or productive capacity of the economy follows the long-run expected effective demand. We use the Sraffian supermultiplier to model the demand led growth of productive capacity. (ii) the output growth rate depends on the real interest rate (through the effect on autonomous spending) and the real exchange rate (through the effect on exports), (iii) the Phillips curve is non accelerationist (partial inertia hypothesis) and depends on the role of nominal exchange rate, on the imported inflation and on the degree of distributive conflict, (iv) the nominal exchange rate depends on the interest rate differential and is subject to speculation, and (v) a Taylor rule.

We analyze the alternative model in terms of analytic solution and computer simulations. The main results of this model is that the long-run inflation will depend on imported inflation, on the distributive conflict and on the inertia degree in the economy; demand shocks influences inflation only in the short run, so the main channel to control inflation by MA is by controlling the nominal exchange rate appreciation through the maintenance of an interest rate differential with the rest of the world.

From the cost of policy standpoint, the results also differ from that proposed by the New Consensus. First, we show that the policy of inflation control is not neutral in terms of growth rate of productive capacity. This means that a higher inflation targeting or a lower imported inflation ultimately lead to a higher growth rate of productive capacity (so the external constraint can appear in the form of higher imported inflation); moreover, as the policy of inflation control depends largely on a process of nominal exchange rate appreciation, the consequence is that the real exchange rate will also appreciate and this will bring a deteriorating trend on the Balance of Trade and Current Account. Finally, the anti-inflationary policy is not neutral in terms of functional income distribution.

We also show that there are limitations to applying such policy. International liquidity conditions and opposition of political groups to a process of real exchange rate appreciation are important sources of such limitations. In sum, there are constraints in implementing such policy, which depends on the external, political and institutional factors.