International Macroeconomic Fluctuations: A New Open Economy Macroeconomics Interpretation

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Summary

"New Open Economy Macroeconomics" (NOEM) has become the conceptual anchor of research in the field of open economy macroeconomics and has replaced, for many researchers, the celebrated Mundell-Fleming-Dornbusch model as the central tenet of open-macro models. Brisk theoretical progress notwithstanding, the empirical literature has been relatively scant. This paper provides a comprehensive empirical analysis of open economy business cycles on the basis of a NOEM framework.

First, this paper investigates the sources of international macroeconomic fluctuations, that is, the role of each structural shock in explaining cross-country movements in aggregate variables over business cycles. We focus on four key variables in open economies (relative labor productivity and output across countries, the real exchange rate, and the current account) and four structural shocks (relative technology, labor supply, taste, and nominal shocks). Second, this paper examines the transmission of structural shocks, interpreting the empirical evidence on the effects of each structural shock in light of theory. This paper considers the three largest economies (the U.S., the Euro Area, and Japan) over the post Bretton Woods period.

The main results are: (1) theoretical predictions of the NOEM model is roughly consistent with data; (2) supply-side shocks (technology and labor supply shocks) explain most of fluctuations in cross-country output deviations; (3) taste shocks to home vs. foreign goods are the dominant source of real exchange rate fluctuations; (4) while the current account has usually been influenced by all four shocks, with no single shock dominant in all periods, technology shocks played a prominent role in the recent global imbalances (large U.S. external deficit), which contrasts with the previous large deficit episode of the 1980s, when taste shocks are found to have played a dominant role; (5) a large negative shock to labor supply for the Euro Area in the 1980s and the 1990s offset the positive contribution of strong productivity performance in the 1990s.