The Effects of Money-financed Fiscal Stimulus in a Small Open Economy

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Abstract

In this paper, we extend a closed economy model in Gali, Jordi (2020), ``The Effects of a Money-financed Fiscal Stimulus,'' *Journal of Monetary Economics*, 115, 1-19, to a small open economy model and analyze the effects of money-financed (*MF*) fiscal stimulus and compare them with those resulting from a conventional debt-financed (*DF*) fiscal stimulus in a small open economy. In normal times in a small open economy, *MF* fiscal stimulus is not always essential because an increase in government expenditure under the *DF* scheme is more effective than in a closed economy, although Gali (2020) argues that it is much less effective. In a liquidity trap, however, the *MF* fiscal stimulus is more important because an increase in government expenditure under the *DF* scheme is less effective, irrespective of nominal exchange rate pass-through, that is, even if imperfect pass-through is assumed, *DF* scheme is less effective in a small open economy, although Gali (2020) emphasizes the effectiveness of the government expenditure under the *DF* scheme in a liquidity trap. In addition, we find an increase and overshooting in the nominal interest rate in a liquidity trap in the case of *no response* in which there is no fiscal stimulus. This phenomenon evoking the lifting of the zero-interest-rate policy in August 2000 in Japan.