

OCCASIONAL MACRO SEMINAR  
Monday November 5, 2007 at 12:45 pm  
Room 44, Via Sarfatti 25

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"Optimal Stabilization Policy in a Model with Endogenous Sudden Stops"

Abstract:

We study optimal stabilization policy in a simple two-good production economy with an occasionally binding credit constraint as in Mendoza (2002). In the model, the policy instrument of the government is a distortionary tax wedge on consumption of non-tradable goods that can be interpreted as a monetary distortion, with a balanced budget rule by lump sum transfers. We find that, for a plausible calibration of the model, the optimal policy is highly non linear. If the liquidity constraint is not binding, the optimal tax rate is zero, as in an economy without credit constraint. If the liquidity constraint is binding, the optimal tax rate is negative, meaning that the government subsidizes nontradable consumption. Therefore, in this relatively simple economy without capital and government debt, the optimal policy when the constraint is not binding is no different from that in an economy in which there is no credit constraint. This suggests that the optimal stabilization policy does not have a precautionary component, but it does not imply that the optimal policy is unimportant in tranquil times. When comparing the solution of the model with and without the optimal policy in the presence of the borrowing constraint, we find that agents accumulate 25 percent more debt under the optimal policy, and thus on average save significantly less and consume more. Simple tax rules in which the rate is fixed at different values also shows that the region of the state space in which the constraint may bind can be reduced significantly, given all other structural parameters.