Monetary Policy Rule, Exchange Rate Regime, and Fiscal Policy Cyclicality in a Developing Oil Economy

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Abstract

According to Frankel and Catao (2011), a commodity exporting developing economy is advised to target the output price index rather than consumer price index, as the former monetary policy is automatically countercyclical against the volatile terms of trade shock. This paper constructs a dynamic stochastic general equilibrium model of joint monetary and fiscal policies for a developing oil economy, to find an appropriate monetary rule combined with a pro/counter/acyclical fiscal stance based on a loss measure. The foreign exchange interventions distinguish between a managed and flexible exchange rate regime, while fiscal policy cyclicality depends on the oil output response of public consumption and public investment. The study reveals that the best policy combination is a countercyclical fiscal stance and CPI inflation monetary targeting under a flexible exchange rate regime to stabilize equally the domestic price inflation, aggregate output, and real exchange rate in a small open economy. This result is conditional on weights for those three variables used in the loss measure.

Keywords: oil economy, monetary policy, fiscal policy, exchange rate, oil price shock, interventions, SWF

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