Fiscal and monetary policy rules in an unstable economy

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Abstract:
This paper examines the implications of different monetary and fiscal policy rules in an economy characterized by Harrodian instability. We show that (i) a monetary rule along Taylor lines can be stabilizing for low debt ratios but becomes de-stabilizing if the debt ratio exceeds a certain threshold, (ii) a `Keynesian' fiscal policy rule can stabilize the economy at full employment, (iii) a fiscal `austerity' rule that links fiscal parameters to deviations from a target debt ratio fails to adjust the `warranted' to the `natural' growth rate and destabilizes the warranted path, (iv) instability may arise from a combination of fiscal and monetary policy rules which separately would stabilize the system, and (v) austerity rules can in some circumstances enhance the stabilizing effects of monetary policy.

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