

Essays in Macroeconomics of Small Open Economies

Research Abstract

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Two main themes run through the papers in this thesis. Firstly, the papers discuss the role of large countries on a small open economy's welfare and the side effects of policy choices made by these countries on small open economies. Secondly, the papers challenge some of the basic assumptions that have been widely used by open economy models and show that these assumptions are not always appropriate in small open economy analysis.

In analyzing the influence of external shocks on small open economies, the current literature takes the outside world as exogenous, partly because outside worlds' interaction is assumed not to be critical from the small country's stand point. The first essay questions this assumption and demonstrates that a three-country framework is far more appropriate to analyze the influence of external shocks on small open economies than the current analysis. Introducing other countries into this analysis helps us quantify the relative importance of the shocks that are transmitted to small countries after passing through another country. Moreover, it allows incorporating the role of large-country monetary policy choices in influencing the shocks that are transmitted to the small open economies. The game theoretic component of the model analyzing the interactions among large countries indicates that shocks transmitted to small countries depend upon the degree of coordination among large countries. The simulation results show that shocks that are transmitted to the small open economy through trading partners create significant volatility for the small economy. This volatility is mitigated when large countries coordinate their policies and intensified when they determine their policies based on their self interest.

Another assumption which is commonly used but not supported by empirical data is the uncovered interest parity assumption. The second essay starts from a basic observation: high ratios of banking sector concentration are very common among developing countries. The essay then tests the relationship between this observation and the deviations from uncovered interest parity. The theoretical model developed demonstrates that countries with greater market power in domestic financial institutions will have the ability to discourage financial flows through their manipulation of domestic interest rates. In these markets, domestic lenders' use of their market power leads to a different correlation between financial flows and excess returns as compared to those suggested by traditional models. I find that convergence in interest rates in these markets is a result of not capital movements, but of collusive behavior. Market power is found to have important welfare implications in this situation. Markets with monopoly power are found to have a chance to increase their welfare at the expense of the other country's welfare. In my panel data estimation, I find that there is significant evidence of the impact of financial market concentration on the relation between excess returns and the volume of the financial flows.

For many years, the U.S. economy has run an external deficit, while most of the world has run a current account surplus. The third essay examines implications of increased large-country current account deficits on small open economies. As a major player in the world financial markets, the U.S. has an advantageous position as a borrower compared to developing countries. Therefore, the large share of the US deficits limits developing countries' access to world financial markets. By introducing a time-to-build technology into an otherwise standard sudden-stop structure, I analyze the implications of intermissions of flows on agents' expectations. I find that a reduced borrowing prospect for future periods distorts agents' decisions and therefore decreases welfare. Panel data estimation and simulation results show that the increase in US borrowing from the world financial markets creates a sudden stop type of impact on developing countries. The smaller current account deficits of developing countries do not point out a decrease in their borrowing requirements, but indicate that these countries cannot borrow as much as they wish to.