Growth dynamics in a small open economy under political economy frictions

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Abstract

In this paper we present a full characterization of the growth process in a small open economy under political economy frictions and where politicians cannot commit to debt repayment or tax promises. We study how the dynamics are affected by the curvature of the utility function, the strength of the political economy friction, as well as by the assumptions regarding the shae of the autarky value. We extend the model by incorporating a traded and a non-traded sector and study the behavior of the real exchange rate. We show that countries that face stronger political frictions will tend to grow more slowly, accumulated more debt while maintaining a relatively undervalued real exchange rate. Countries that are able to overcome the political economy frictions, grow faster and save more abroad, while their real exchange rate appreciates.