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FISCAL POLICY AND THE TERMS OF TRADE IN AN ANALYTICAL TWO-COUNTRY DYNAMIC MODEL

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Abstract

This paper presents a two-country dynamic perfect foresight Ricardian model with wealth effects to study the relationship between government spending financed by alternative taxation, the terms of trade and welfare. An increase in domestic government spending financed by a distortionary capital income tax leads the real exchange rate initially to appreciate (a pure demand effect). But along the transitional path an intertemporal terms of trade effect (a supply side effect) operates and the real exchange rate depreciates to a steady state value ultimately higher relative to the initial equilibrium. The welfare of the domestic resident *increases* due to a reversed immiserizing growth effect.

JELit Classification Codes: *F4, H87, C6.*

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