

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

Marcelo Bianconi*

*Department of Economics
Tufts University*

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.*

Mailing Address: *Marcelo Bianconi*
Associate Professor of Economics
Tufts University
Department of Economics, 111 Braker Hall
Medford, MA 02155
USA
Ph. (617) 627-2677;
Fax (617) 6273917;
E-Mail: mbiancon@emerald.tufts.edu
Web: www.tufts.edu/~mbiancon

Revised version, September 2001

* *I thank the participants at the Macroeconomics Seminar of the Institute for Advanced Studies, Vienna, and Stephen Turnovsky for useful comments on a previous version of this paper. I thank the insightful comments and suggestions of three anonymous referees for this journal, as well as the co-editor Jack Mintz for valuable comments and suggestions. Any errors or shortcomings are my own.*