

Economic Stability in a Small Open Economy with Income Effect on Leisure Demand

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Abstract : This paper studies a two-sector growth model with a technology of social constant returns and with a utility that features either a zero or a positive income effect on the demand for leisure. The purpose is to investigate how the existence of aggregate instability or equilibrium indeterminacy depends on both the intensity of the income effect on the demand for leisure and the value of the labor supply elasticity. The main finding is that when there is a factor intensity reversal between the private perspective and the social perspective, indeterminacy arises even if the utility has a positive income effect on leisure demand. Moreover, we find that a smaller value of the labor supply elasticity increases the range of the income effect on leisure demand and thus increases the possibility of equilibrium indeterminacy. JEL classification: E3; O41

Keywords : indeterminacy, non-separable preferences, income effect, labor supply elasticity

Conference Title : ICEA 2018 : International Conference on Economics and Accounting

Conference Location : Kyoto, Japan

Conference Dates : November 15-16, 2018