

## Policy volatility and growth

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**Abstract** The paper aims to examine how fiscal and monetary volatility might affect the balanced economic growth rate using a standard monetary growth model characterized by nominal wage rigidity and productive public spending. The model shows that any type of shock — monetary or fiscal — can generate either a negative or positive relationship between short-run volatility and long-run growth, critically depending on the size of government and the elasticity of output with respect to labor/ capital. In particular, given the labor income share, it shows that excessive government spending may cause the impact of fiscal volatility on long-run growth to turn from positive to negative. In addition, a rise in the volatility of the monetary shock is capable of generating either an increase or decrease in the mean of growth. With the range of the labor share values in reality, the model produces results consistent with the fact that the relationship between volatility and growth is generally found empirically to be more negative in developing than in developed countries. The model can be seen as a further explanation for the ambiguous empirical evidence in the existing literature.

**Keywords** Growth · Volatility · Nominal wage rigidity · Productive public spending · Labor share

**JEL classification** E32 · E60 · O42

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