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Abstract

In this paper we expanded the closed economy model by Bernanke and Gertler (1999) in order to account for the macroeconomic effects of an asset price bubble in the context of a small open economy model. During the nineties emerging market economies opened their financial accounts to foreign investment but generated growing macroeconomic imbalances in these economies. Our goal in this paper is twofold: first we want to analyze if the conclusions of Bernanke and Gertler (1999) remain in the case of a small open economy. And second, we want to compare the results in terms of macroeconomic volatility of the model for a closed economy versus the model for a small open economy. Our results show that the conclusion about the fact that the Central Bank should not react to asset price remains as in the case of a closed economy model, and that small open economies are more vulnerable to asset prices bubbles due to capital inflows and the exchange rate mechanism of the monetary policy. Therefore in small open economies the business cycle is deeper. Finally, in the face of a boom followed by a bust in an asset price bubble, macroeconomic volatility would be dampened if the monetary authority focuses only on inflation.