Lecture 12: The Open Economy IS-LM

- Washington, Oct. 17 (Bloomberg) -- The outlook for the U.S. economy over the next few months remains difficult to forecast, because recovery from the Sept. 11 terrorist attacks has been uneven, Federal Reserve Chairman Alan Greenspan said. Though the Fed has lowered interest rates to boost consumer and business confidence, a ``significant'' decline in the economy over the past few weeks has only begun to reverse, he said.

- Review Lecture 11
  - Exchange rate determination
  - Interest parity condition

The Exchange Rate

The Goods Market

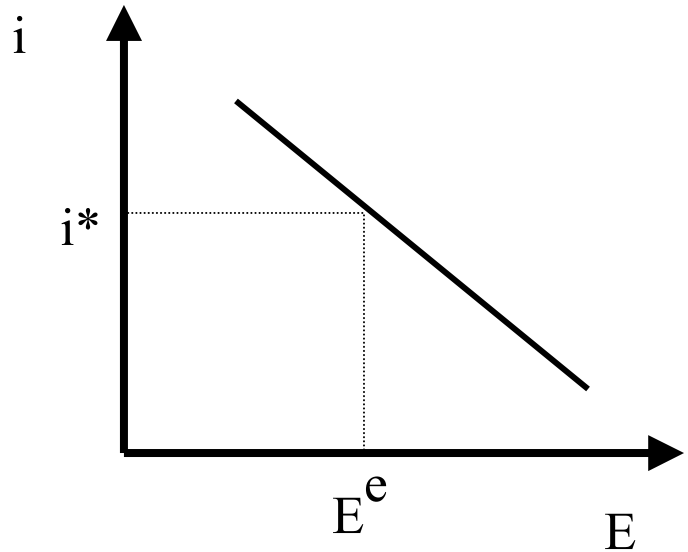
$$Y = C(Y-T) + I(Y,i) + G + NX(Y,Y^*, E\,\underbrace{P^*/P}_{\text{constant}})$$

Financial Markets

$$M/P = YL(i)$$

$$i(t) = i^*(t) + \frac{E^e(t+1) - E(t)}{E(t)}$$

Cont. The Exchange Rate



$$i = i^* + \frac{E^e - E}{E}$$

given E^e and i^*

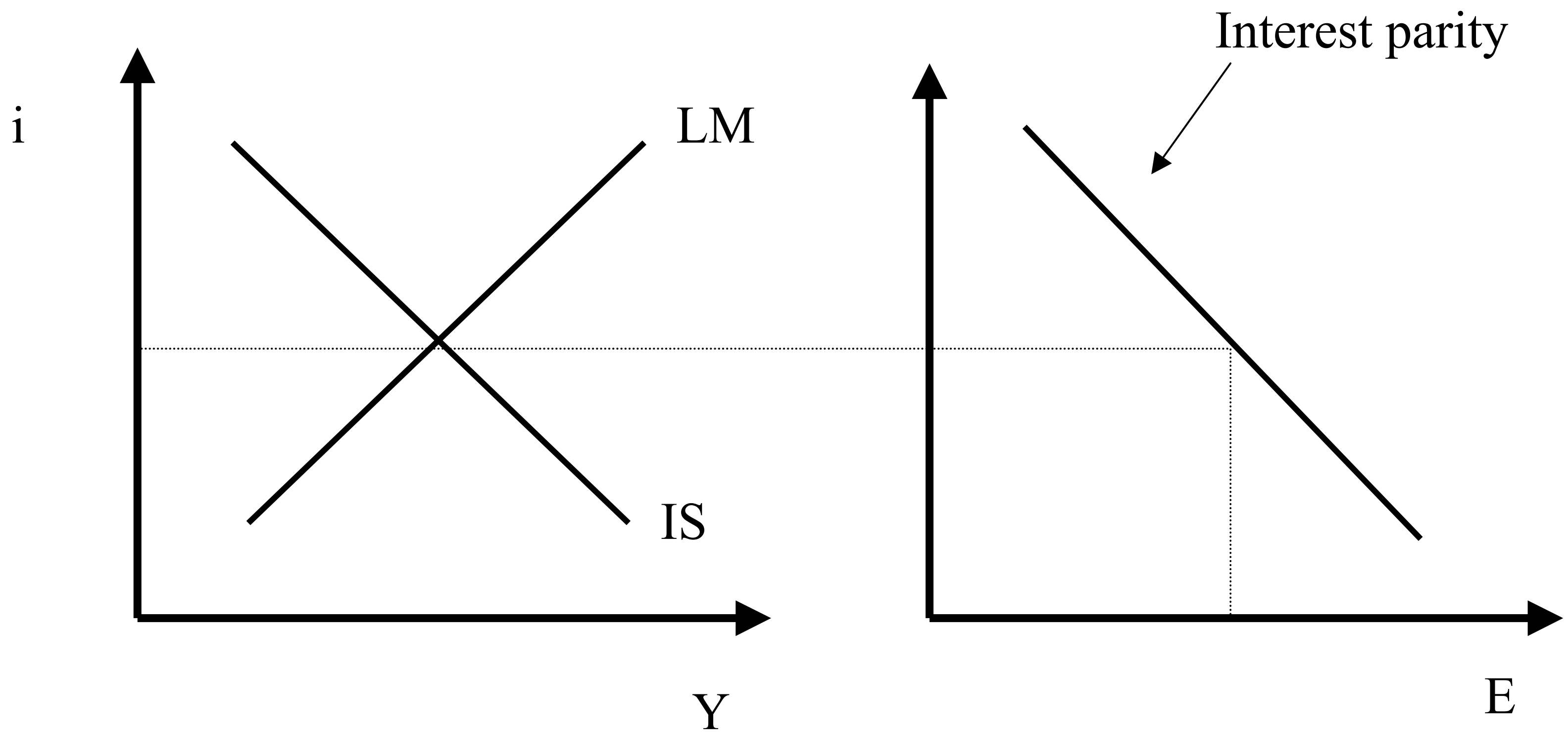
The Open Economy IS-LM

$$Y \;=\; C(Y-T) + I(Y,i) + G + NX(Y,Y^*,E)$$

$$\frac{M}{P} \;=\; Y\,L(i)$$

$$\mathbf{E} = \frac{\mathbf{E}^{e}}{\mathbf{1+i-i^*}}$$

$$IS\;:\; Y \;=\; C(Y-T) + I(Y,i) + G + NX(Y,Y^*,\; E^{e} / (1+i-i^*))$$



Two IS caveats:

a) Multiplier is smaller

b) Interest rate affects aggregate demand through the E as well.

* Fiscal and Monetary policy; flight to quality

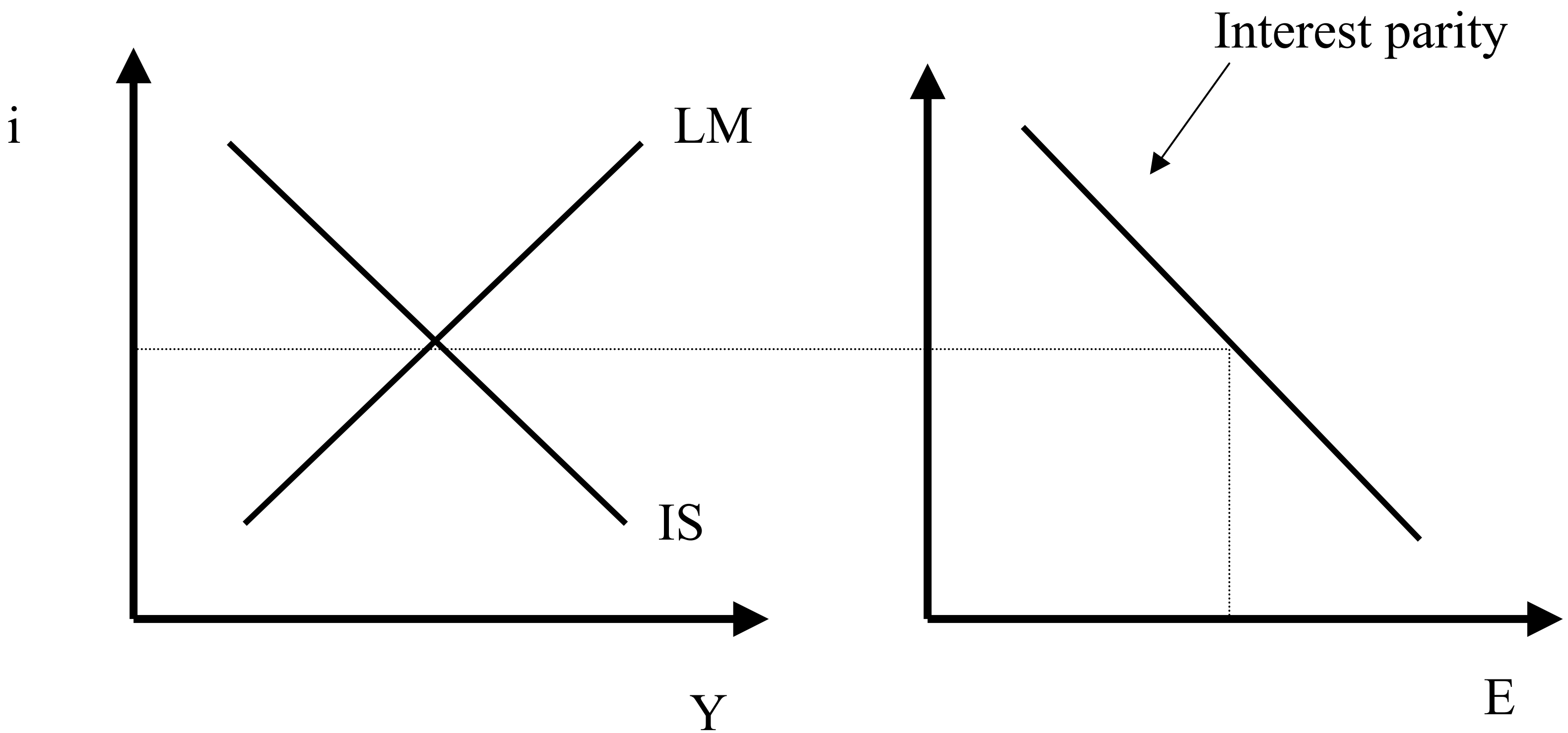
Fixed Exchange Rates (Credible)

- A little bit of it even in “flexible” exchange rates systems; “commitment” to E rather than M

$$\Rightarrow \qquad i = i^*$$

$$\Rightarrow \qquad \frac{M}{P} = YL(i^*)$$

- Central Bank gives up monetary policy



- Fiscal and Monetary policy
- Capital controls; imperfect capital flows

Expected Events

- Back to flexible exchange rates; expected M expansion