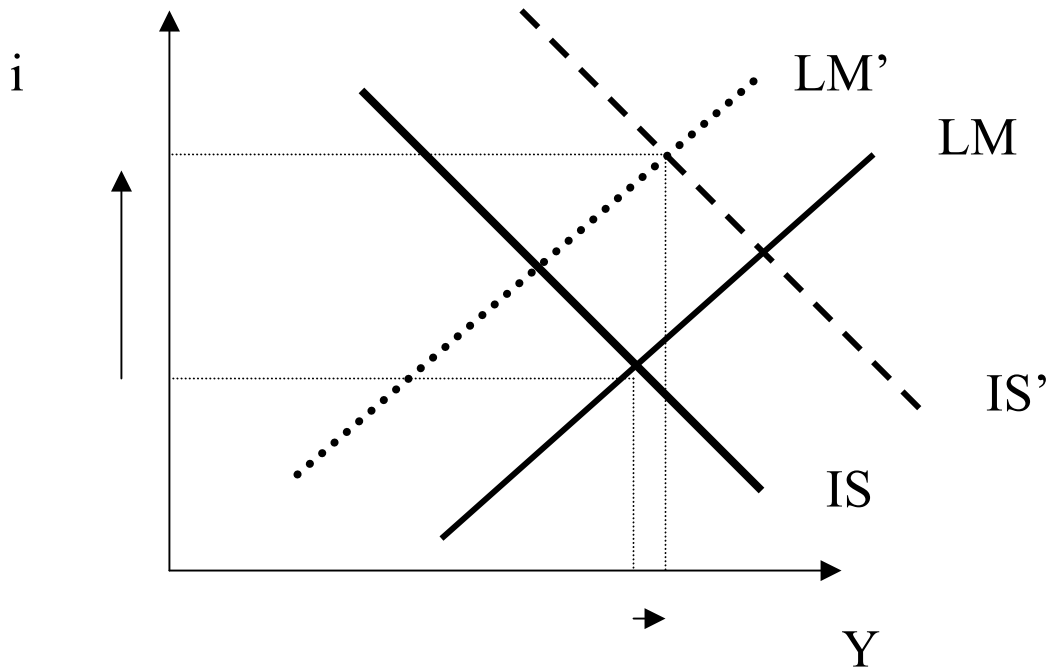


Lecture 9: Open Economy

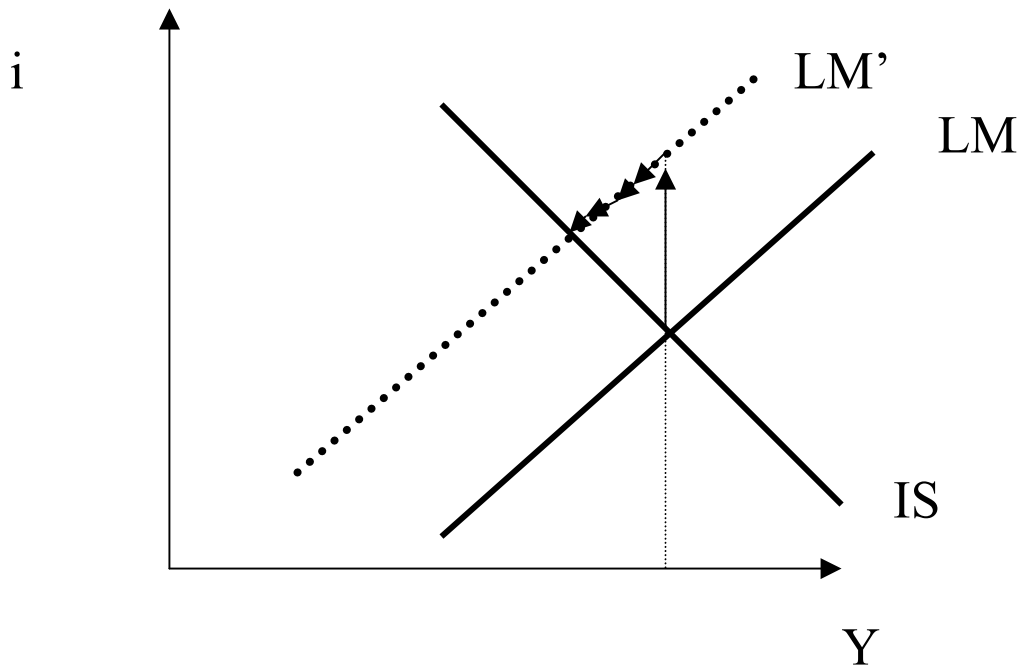
- Laurent Fabius and Didier Reynders, finance ministers of France and Belgium, said that low inflation gave the European Central Bank room for manoeuvre on interest rates, while Wim Duisenberg, the ECB's president, hinted that he saw no need to change interest rates for the moment.
- Review
 - IS-LM
- Dynamics
- Open Economy (introduction)

IS-LM Model



Mix; ERM crisis (Germany / France)

Dynamics



Monetary Contraction

SLOW GOODS MARKET / FAST FINANCIAL MARKETS

Opening the Economy

- Goods markets
 - Imports and exports
 - Tariffs and quotas
- Financial markets
 - Domestic and foreign financial assets
 - Capital controls
 - Emerging market crises
- Factor markets
 - Migration of firms and workers

Basics: Goods Markets

- Trends and U.S. trade deficit - Figure 18.1
- New decision:
 - whether to buy domestic or foreign goods
- Key ingredient: The Real Exchange Rate
 - The nominal exchange rate
 - Price levels

The Nominal Exchange Rate

- The price of foreign currency in terms of domestic currency
 - Chile $E = 720$ (pesos/dollar)
 - Japan $E = 120$ (yens/dollar)
 - Euro $E = 1.18$ (euros/dollar)
- To convert pesos prices into dollar prices; divide peso price by E
- Appreciation and depreciation (trend and cycle) -- Figure 18-6

The Real Exchange Rate

- The price of a foreign good in terms of domestic good

$$e = \frac{E P^*}{P}$$

Real appreciation and depreciation

Financial Markets

- Diversification and speculation
- Very large
- Trade deficits and surpluses become possible

The Balance of Payment

CURRENT ACCOUNT

Exports	+
Imports	-
	Trade Balance
Net investment income and transfers	+
<hr/>	
Current Account Balance	

CAPITAL ACCOUNT

Increase in foreign holding of domestic assets	+
Increase in domestic holding of foreign assets	-
Errors and omissions / statistical discrepancy	
Capital Account Balance	

Foreign or Domestic Assets

- Risk, etc
- Here: Compare returns
- (Uncovered) interest parity condition:

$$1 + i(t) \quad \text{versus} \quad (1/E(t)) (1 + i^*(t)) E^e(t+1)$$

Figure 18-9