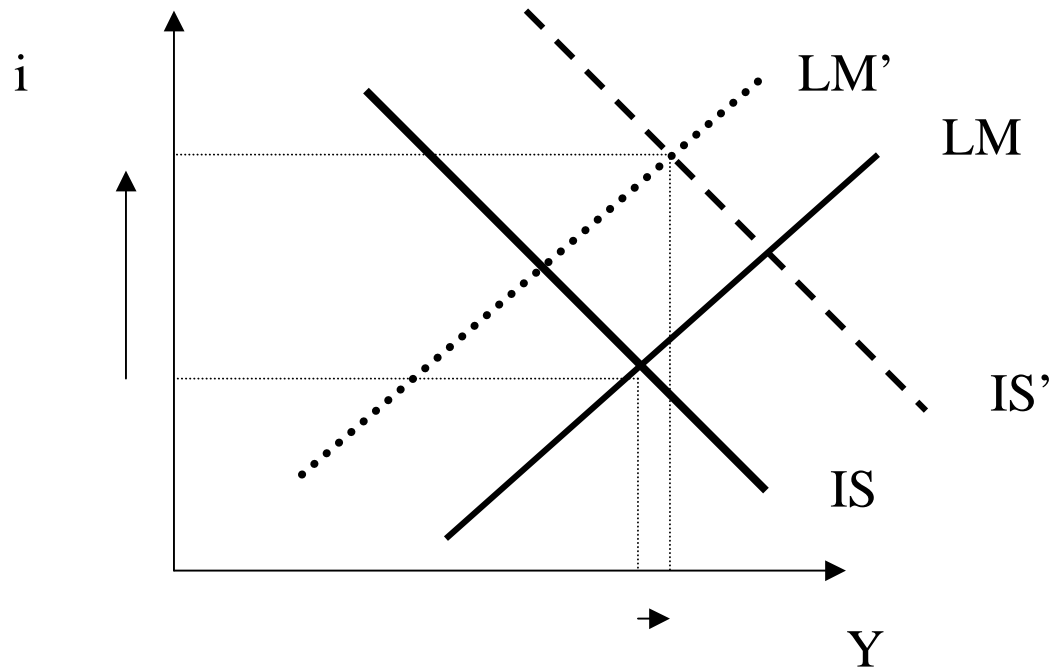


# Lecture 10: Open Economy

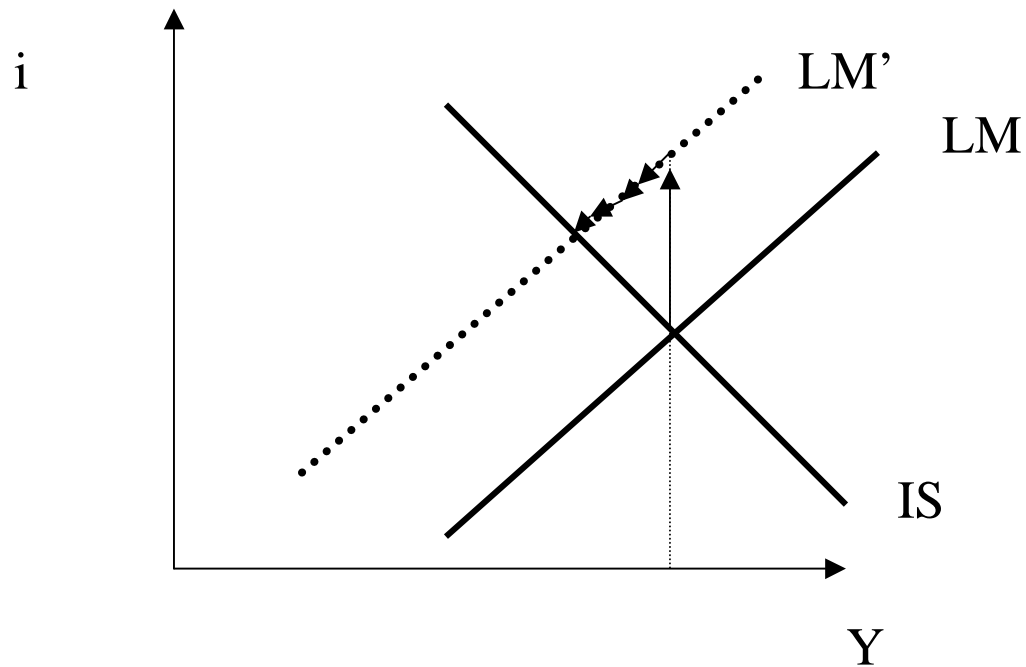
- Current events (FT 10/13/99)
- Review Lecture 9
  - IS - LM
  - Dynamics
- Nobel Prize

# IS-LM Model



C) Mix; ERM crisis

# 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

- Clear trend / trade deficits and surpluses
- 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  $E = 530$  (pesos/dollar)
  - Japan  $E = 107$  (yens/dollar)
  - Euro  $E = 0.95$  (euros/dollar)
- To convert pesos prices into dollar prices; divide peso price by  $E$
- Appreciation and depreciation (trend and cycle)

# 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
- Clear trend / very large
- Trade deficits and surpluses become possible



# The Balance of Payment

## CURRENT ACCOUNT

Exports +

Imports -

Trade Balance

Net investment income and transfers +

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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:

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