

Lecture 14: The Open Economy

IS-LM (Continued)

- Current events (FT 10/27/99)
- Review Lecture 13
 - Exchange rate determination
 - Interest parity condition

The Exchange Rate

The Goods Market

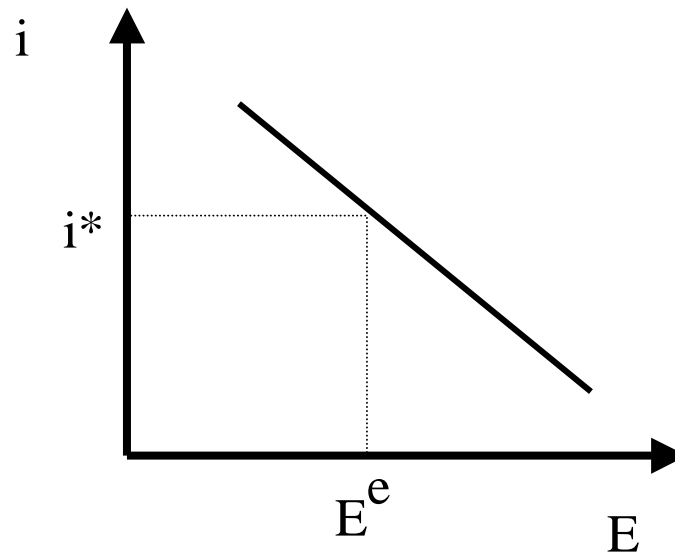
$$Y = C(Y-T) + I(Y,i) + G + NX(Y,Y^*, \underbrace{E P^*/P}_{\text{constant}})$$

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^*

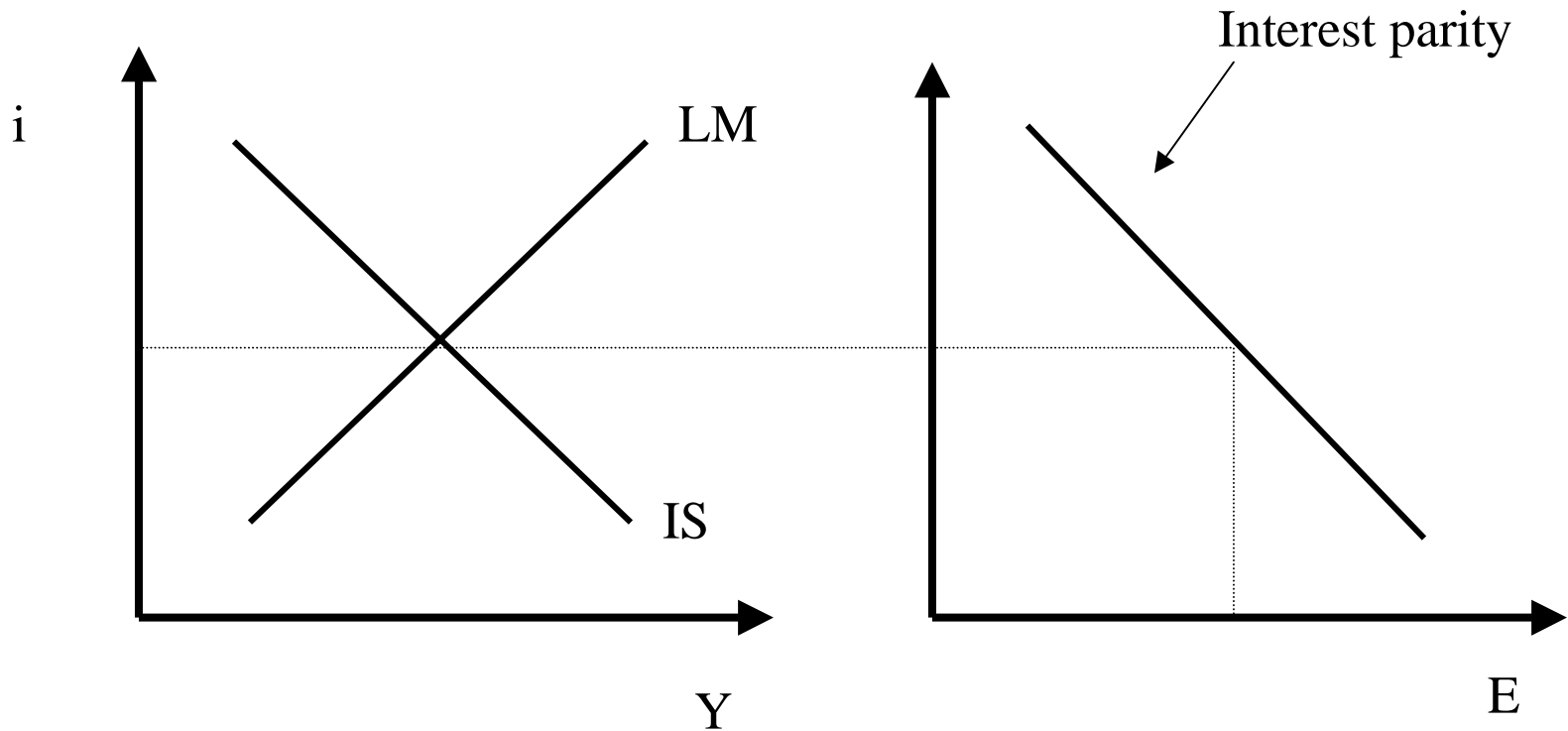
The Open Economy IS-LM

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

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

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

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



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

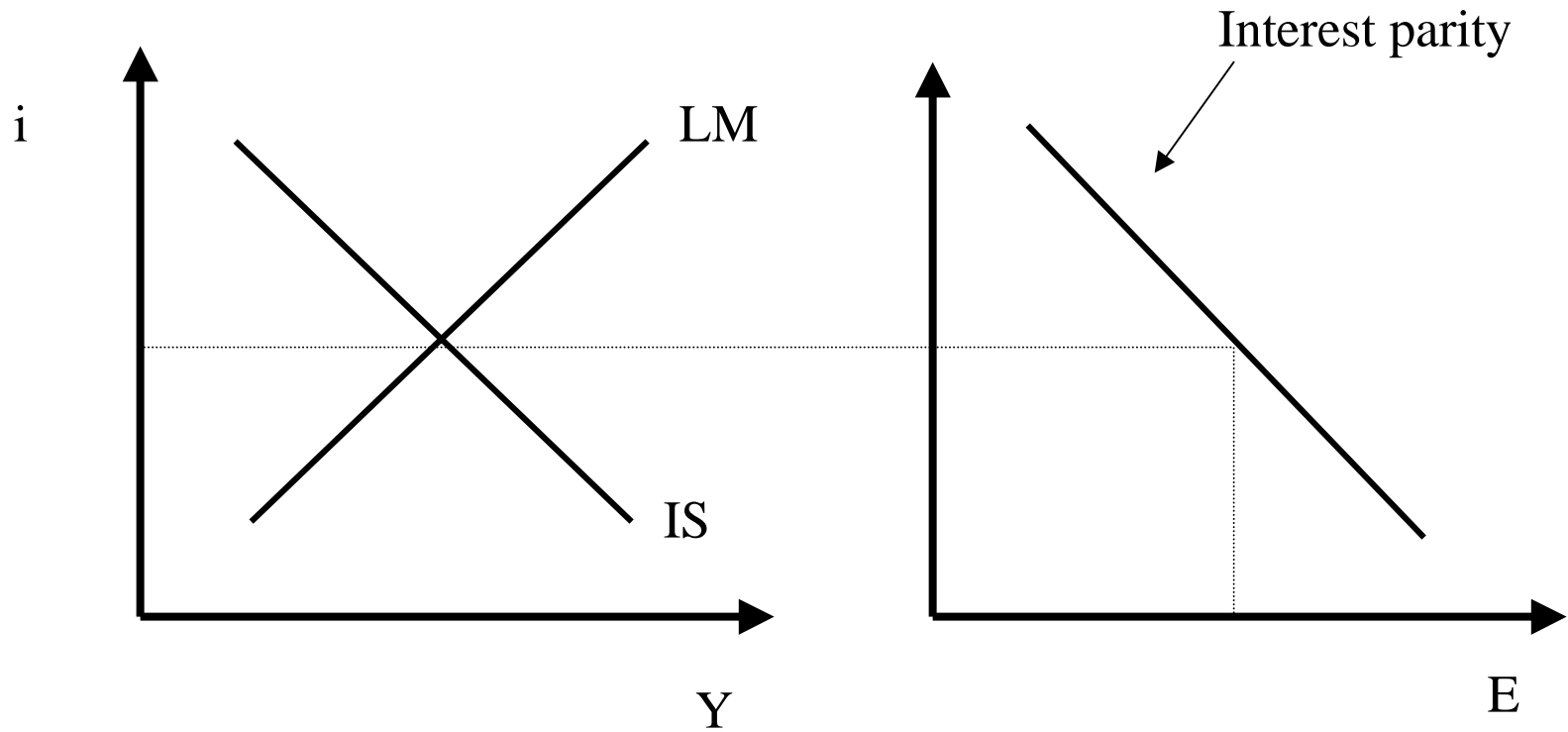
Fixed Exchange Rates (Credible)

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

$$\Rightarrow \quad i = i^*$$

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

- 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

