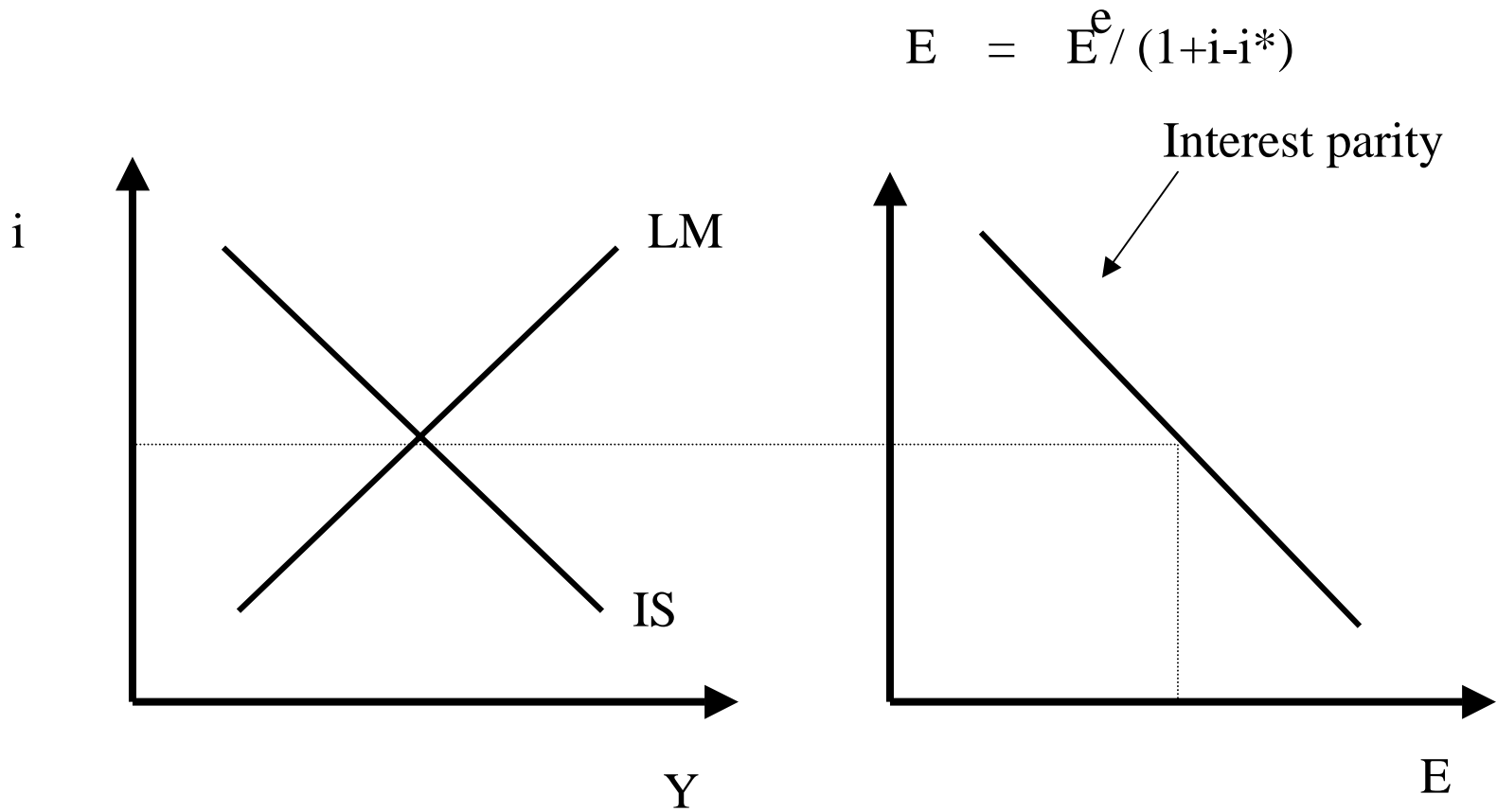


Lecture 15: Expectations and Exchange Rate Systems

- Current events (FT/Bloomberg 11/01/99)
- Review Lecture 14
 - Policy and financial crises in an open economy



* Fiscal and Monetary policy; flight to quality

$$E = E / (1+i-p-i^*)$$

=> Interest parity shifts
 [IS also shifts (small)]

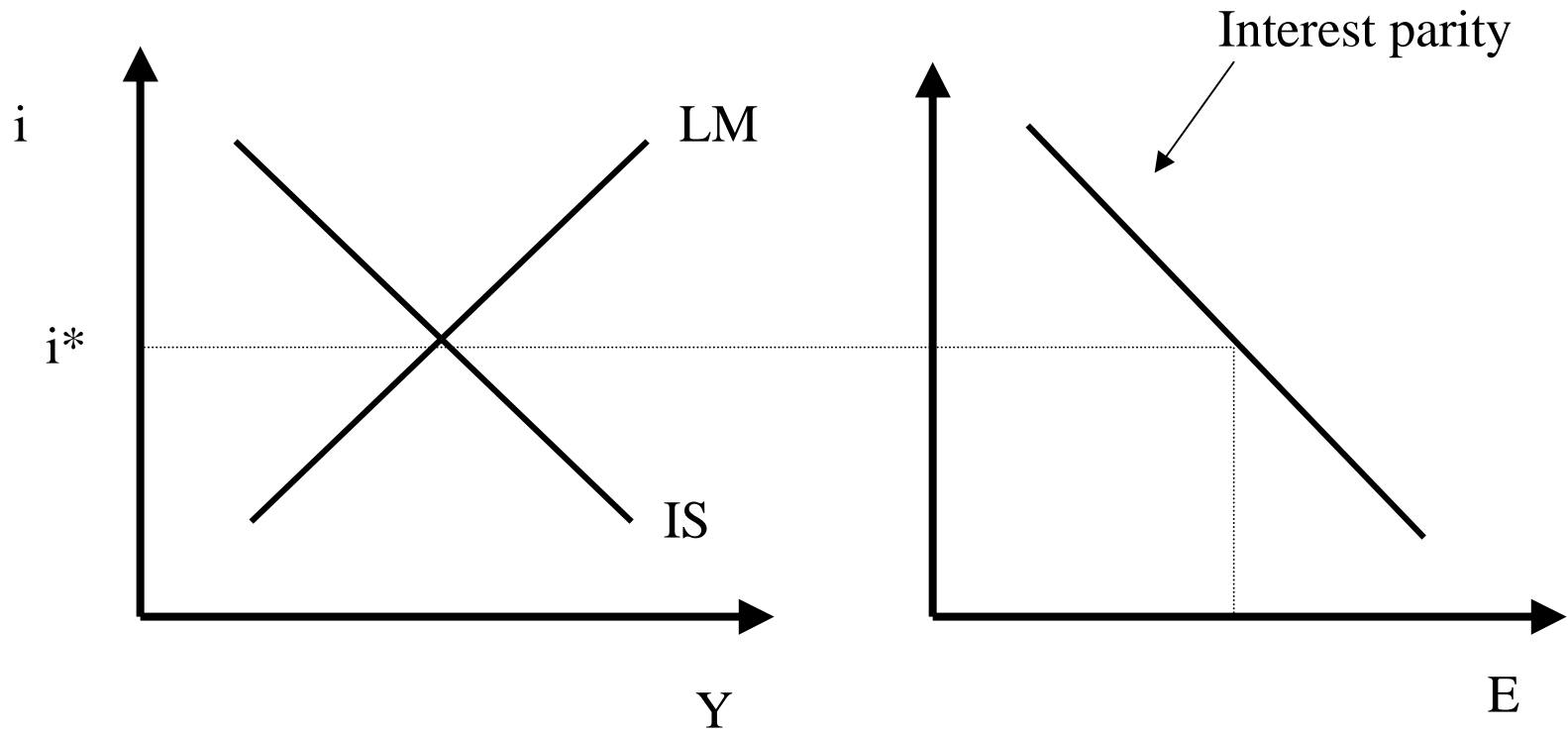
Fixed Exchange Rates (Credible)

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

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

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

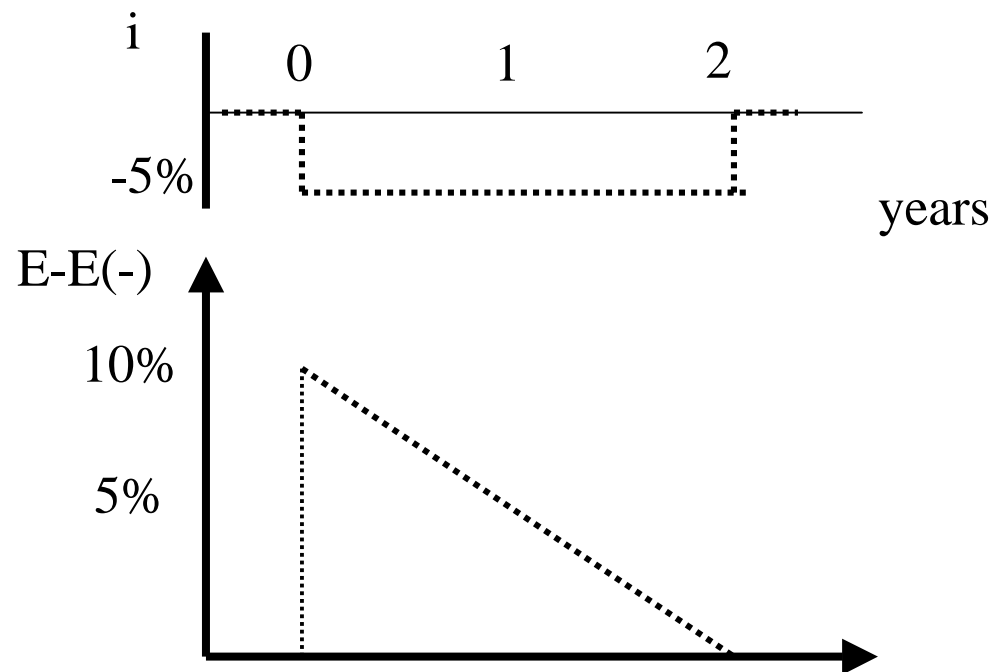
- Central Bank gives up monetary policy



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

Expected Events

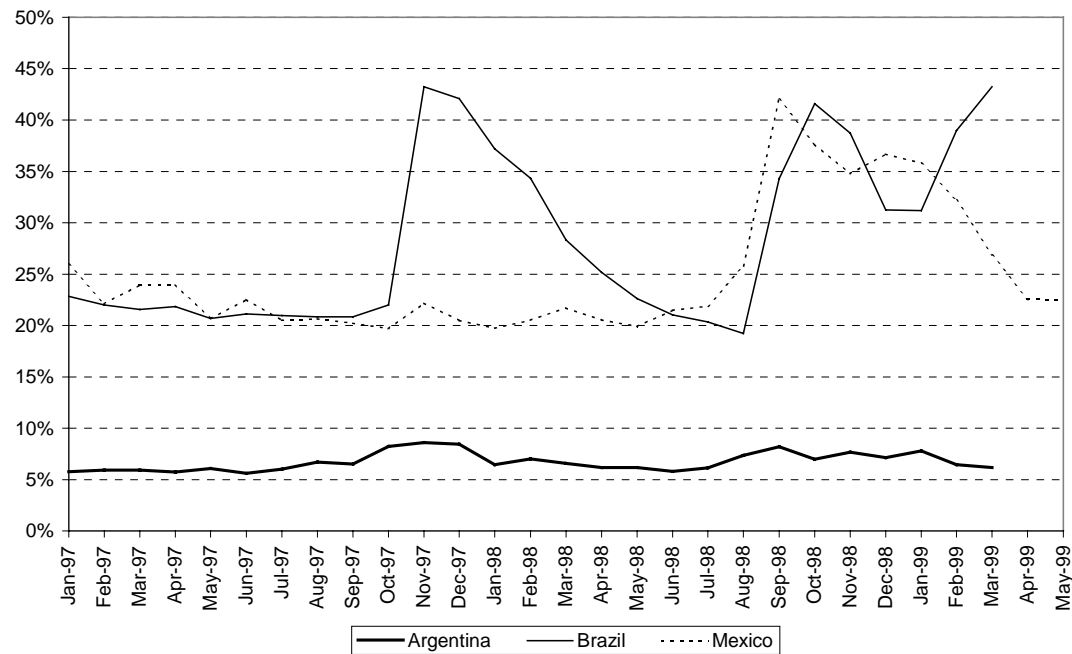
- Back to flexible exchange rates; expected M expansion



Crises in Fixed Exchange Rate Systems

$$i = i^* + (E^e(t+1) - E) / E$$

(a) Interbank Interest Rates



* ERM crisis: Sweden (500%)