Lecture 10: The Goods Market and the Exchange Rate

- Devaluations (static and dynamic responses)
- Exchange rate determination (capital markets)
- The open economy IS-LM

The Goods Market

$$Z = C + I + G + X - eQ$$

$$C(Y-T) + I(Y,I) + G$$

$$Q = Q(Y,e)$$
$$\quad\quad + -$$

$$X = X(Y^*,e)$$
$$\quad\quad + \ +$$

Figures

- Figs 19-4, 19-5
- Increase in foreign demand
- games countries play
- depreciation

The J-Curve

- eQ(Y,e) : increase or decrease with e?
- In the very short run: it may increase!
- And if strong enough: X(Y*,e) - eQ(Y,e) may do the same.
- Dynamics of NX in response to a depreciation; fig 19-6

The Exchange Rate

The Goods Market

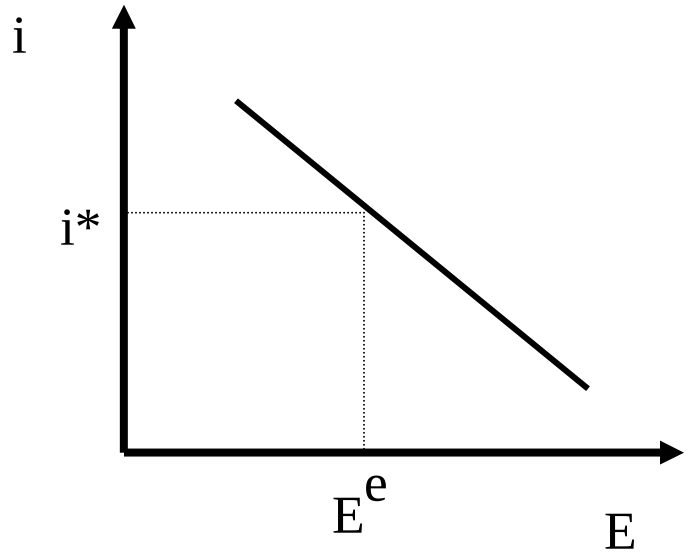
$$Y = C(Y-T) + I(Y,i) + G + NX(Y,Y^*, E \underbrace{P^*/P}_{\text{constant}})$$

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^*

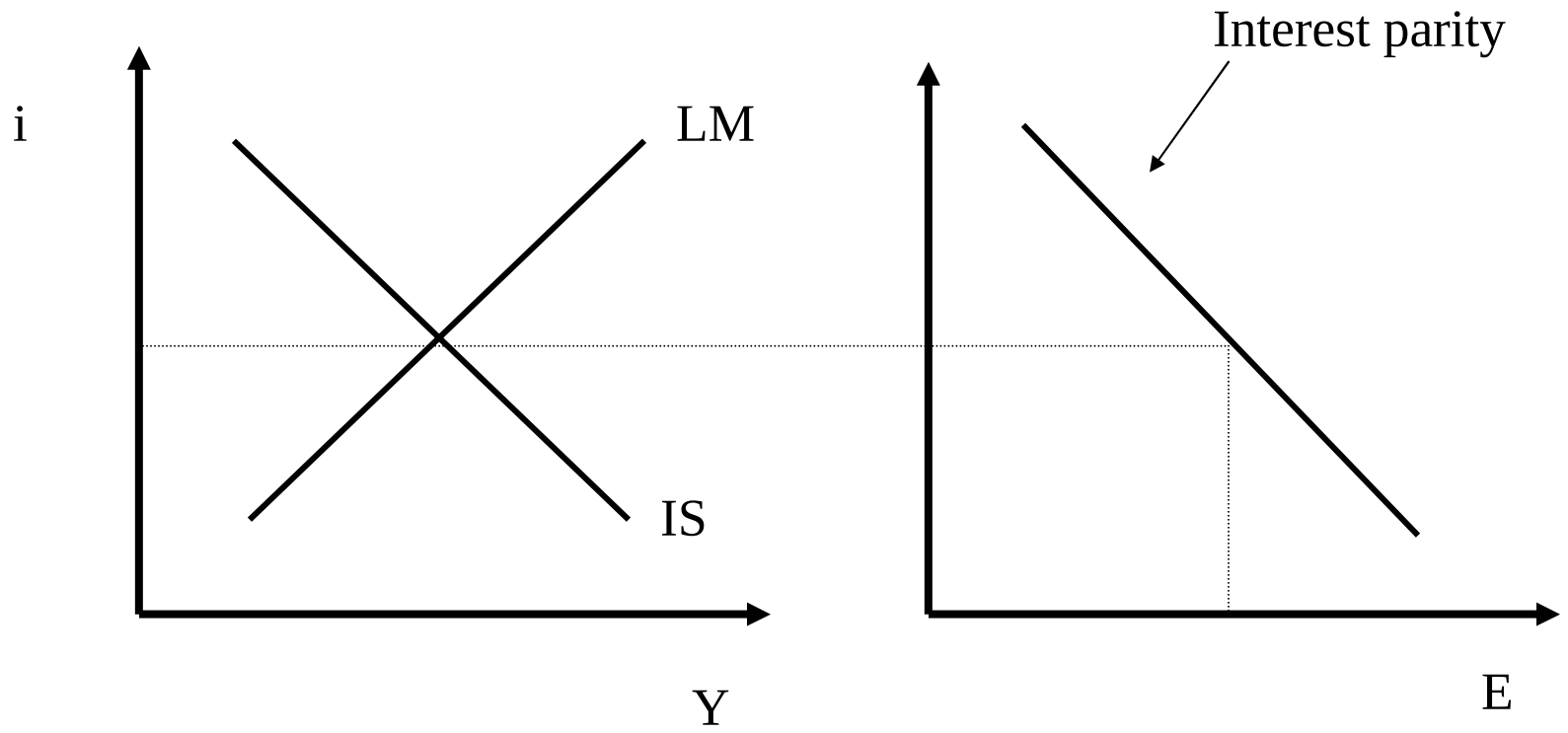
The Open Economy IS-LM

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

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

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

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



Two IS caveats:

a) Multiplier is smaller

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

* Fiscal and Monetary policy