Lecture 12: The Open Economy IS-LM (II)

- Current Events
- Review
  - Exchange rate determination
  - Interest parity condition

The Exchange Rate

The Goods Market

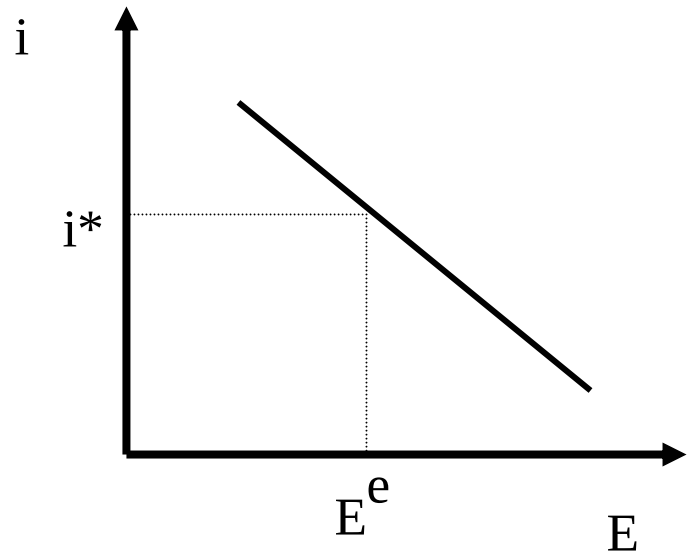
$$Y = C(Y-T) + I(Y,i) + G + NX(Y,Y^*, E \underbrace{P^*/P}_{\text{constant}})$$

Financial Markets

$$M/P = YL(i)$$

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

Cont. The Exchange Rate



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

given E^e and i^*

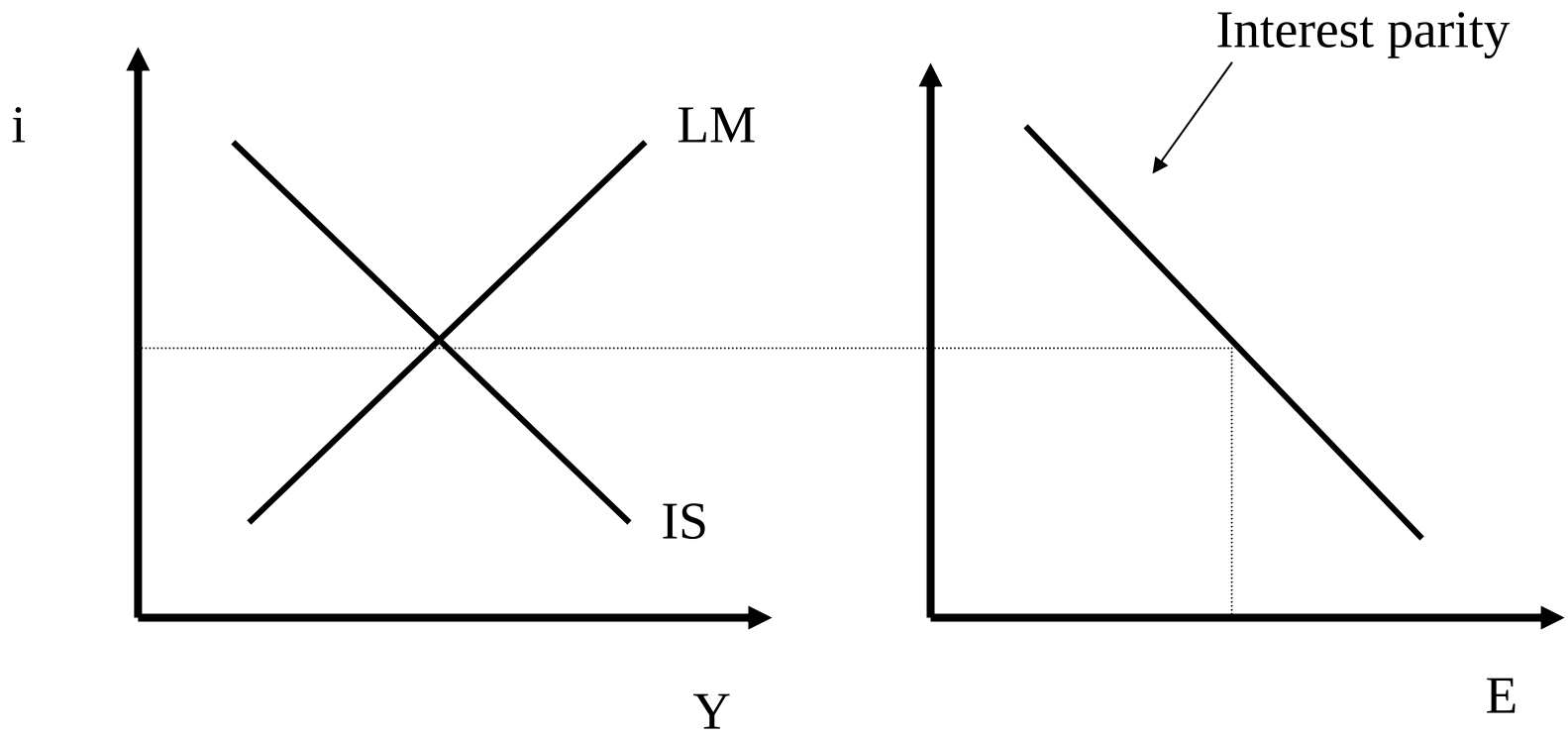
The Open Economy IS-LM

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

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

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

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



Two IS caveats:

a) Multiplier is smaller

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

* Fiscal and Monetary policy; flight to quality

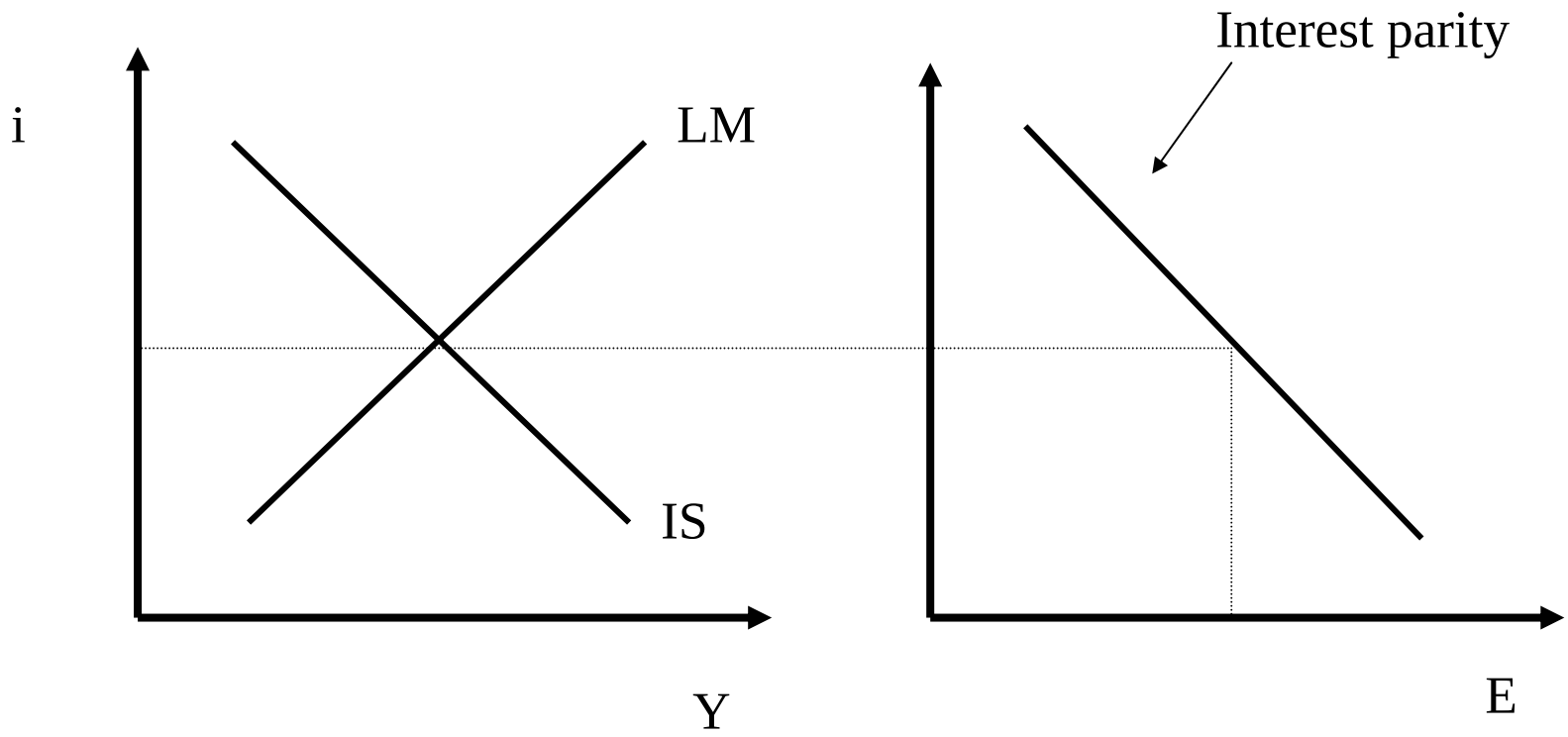
Fixed Exchange Rates (Credible)

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

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

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

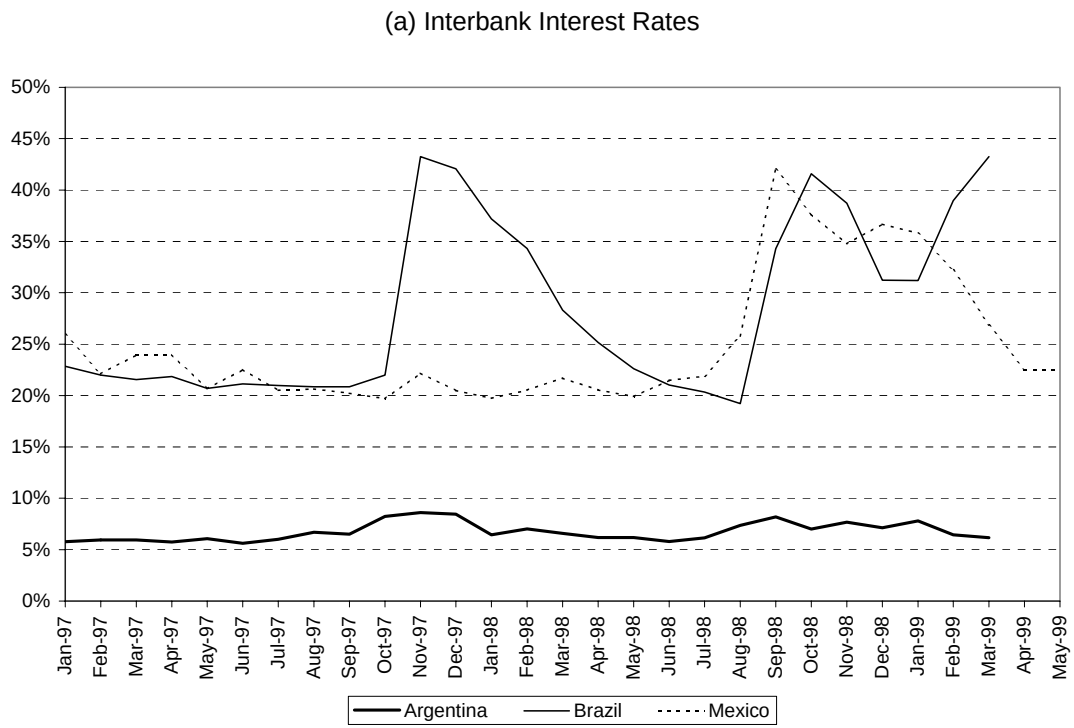
-Central Bank gives up monetary policy
-Fiscal policy becomes very effective



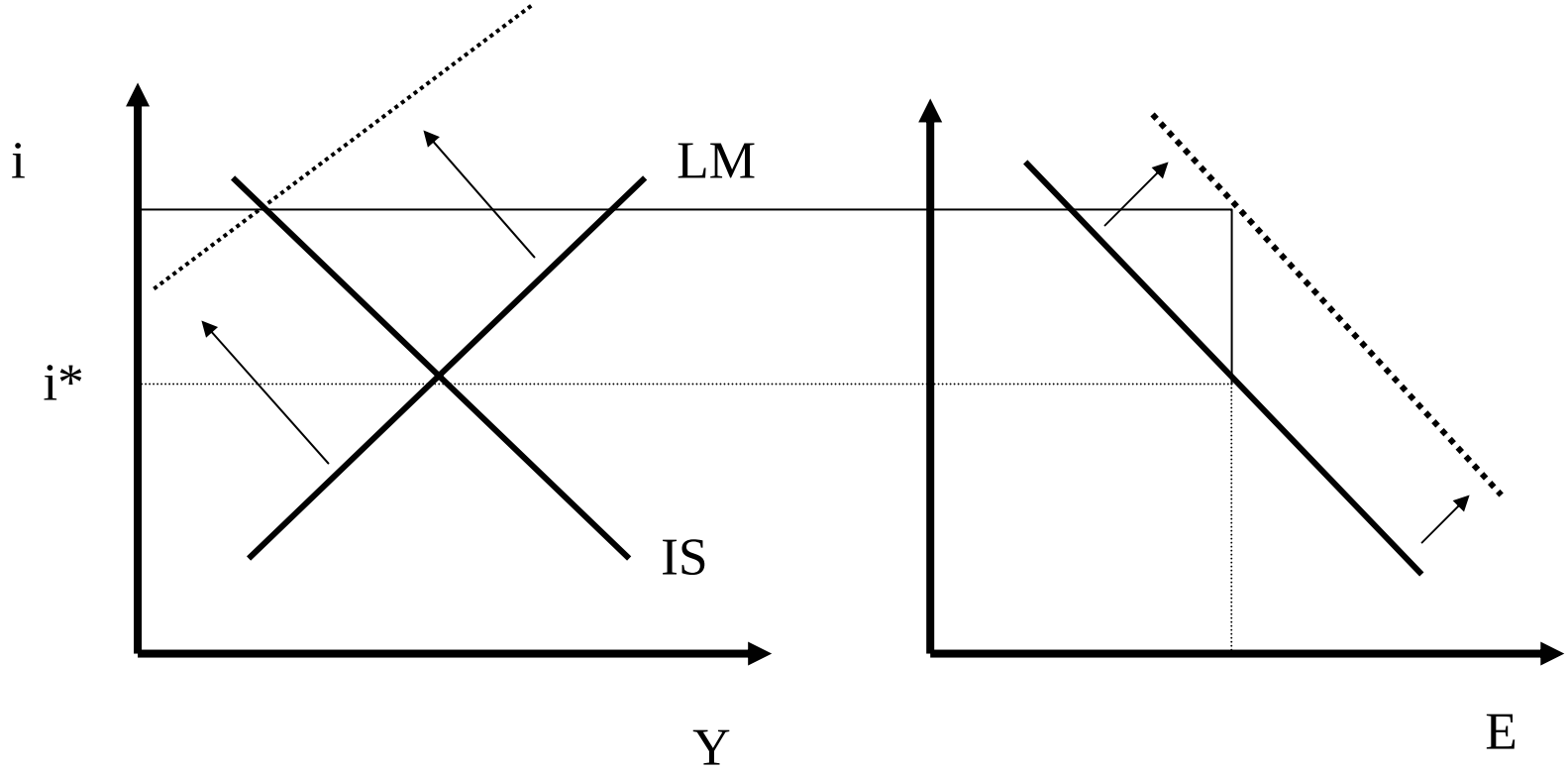
- Fiscal and Monetary policy
- Capital controls; imperfect capital flows

Crises in Fixed Exchange Rate Systems

$$i = i^* + (E^e_{(t+1)} - E) / E$$



* ERM crisis: Sweden (500%)


i
LM
i*
IS
Y
E

Expected Events

- Back to flexible exchange rates; expected M expansion