Issues in International Finance

Policy in the open economy III

UW – Madison // Fall 2018

Roadmap

- Where we have been
  1. IS-LM ties together forex, money, and goods markets
  2. IS-LM will be our workhorse open economy macro model
- Today: IS-LM-FX and policy
  1. Fiscal policy in an open economy
  2. Monetary policy in an open economy
  3. How policy effects depend on fx regime

IS-LM-FX

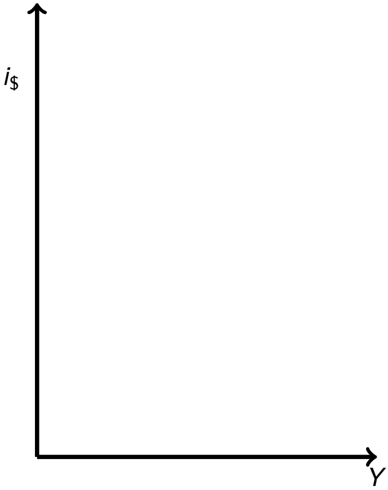
- Where IS-LM intersect
  - Goods and FX market in equilibrium (IS curve)
  - Money market in equilibrium (LM curve)
- IS shifts:
  - $\downarrow T, P$ or $\uparrow G, i^*, E^e, P^*$ shift demand up and IS right
  - Any change in $C(\ )$, $I(\ )$, or $TB(\ )$ that shifts demand up, shifts IS right
- LM shifts:
  - $\uparrow M$ shifts LM down
  - Any change in money demand function that shifts money demand down, shifts LM down

Policy in an open economy

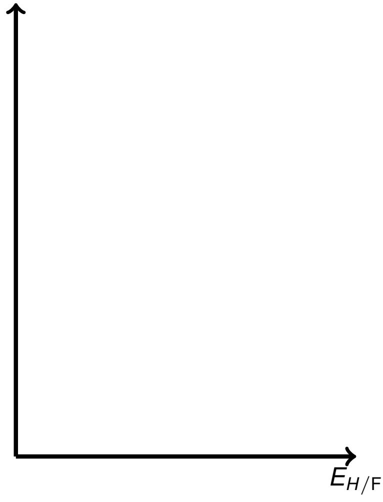
- Work through monetary and fiscal policy
- Assumptions
  1. **1.** Temporary policy changes: Long run expectations are constant
  2. **2.** Short-run analysis: prices sticky
  3. **3.** Free movement of capital (UIP holds)
  4. **4.** Variables in foreign country held fixed
- Think about #1 and #2 as policy responding to business cycle conditions
- Coming up
  1. **1.** Economy in initial equilibrium
  2. **2.** Change a policy
  3. **3.** Work though its effects
- Start with flexible exchange rates, then look at fixed

Initial equilibrium

IS-LM



FX market

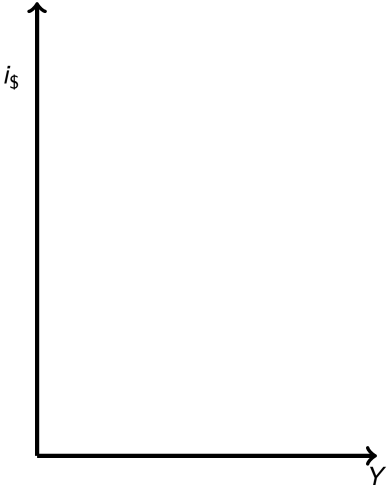


Monetary policy: flexible exchange rate

- Central bank temporarily expands the money supply
- Does IS or LM shift? Which way?
- What are the effects?

Increase in M, flexible fx rate

IS-LM



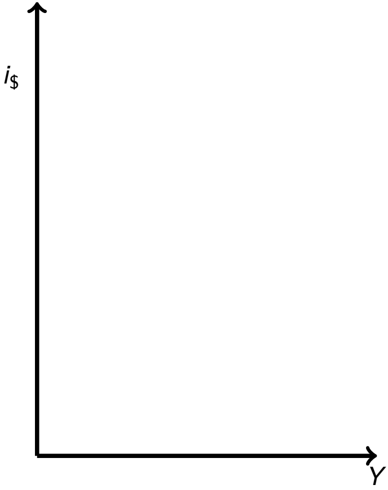
FX market

Fiscal policy: flexible exchange rate

- Congress temporarily lower taxes
- Does IS or LM shift? Which way?
- What are the effects?

Decrease in T, flexible fx rate

IS-LM



FX market

Monetary policy: fixed exchange rate

- Nope!
- The trilemma
- Fixed exchange rate + free capital movement $\rightarrow$ no monetary policy

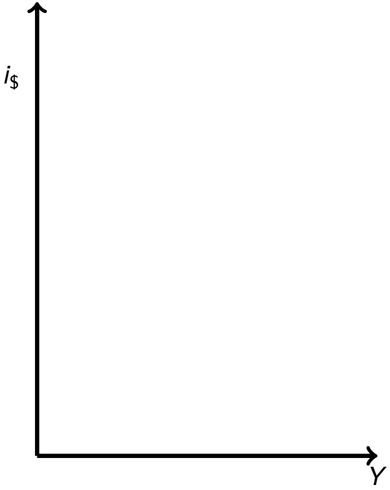
Fiscal policy: fixed exchange rate

- Congress temporarily lower taxes
- Does IS or LM shift? Which way?
- What are the effects?

- With fixed fx rate, more complicated
- How does the central bank respond?

Decrease in T, fixed fx rate

IS-LM



FX market

Summary

fx regime	policy	i	E	I	TB	Y
floating	$\uparrow M$	$\downarrow$	$\uparrow$	$\uparrow$	$\uparrow$	$\uparrow$
	$\downarrow T$	$\uparrow$	$\downarrow$	$\downarrow$	$\downarrow$	$\uparrow$
fixed	no mon. pol.	0	0	0	0	0
	$\downarrow T$	0	0	0	$\downarrow$	$\uparrow$

- Worked through the mechanics of fiscal and monetary policy
- Fixed fx rate regime $\rightarrow$ monetary policy amplifies fiscal policy
- Next up will be how to use policy to respond to “shocks”