

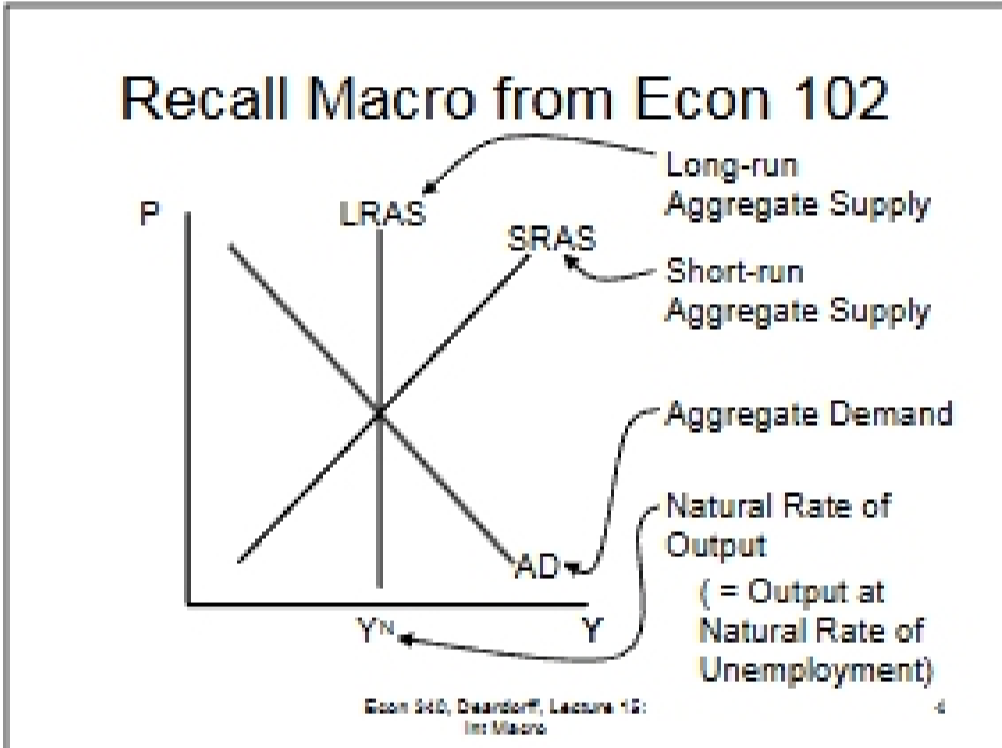
Econ 340

Lecture 15

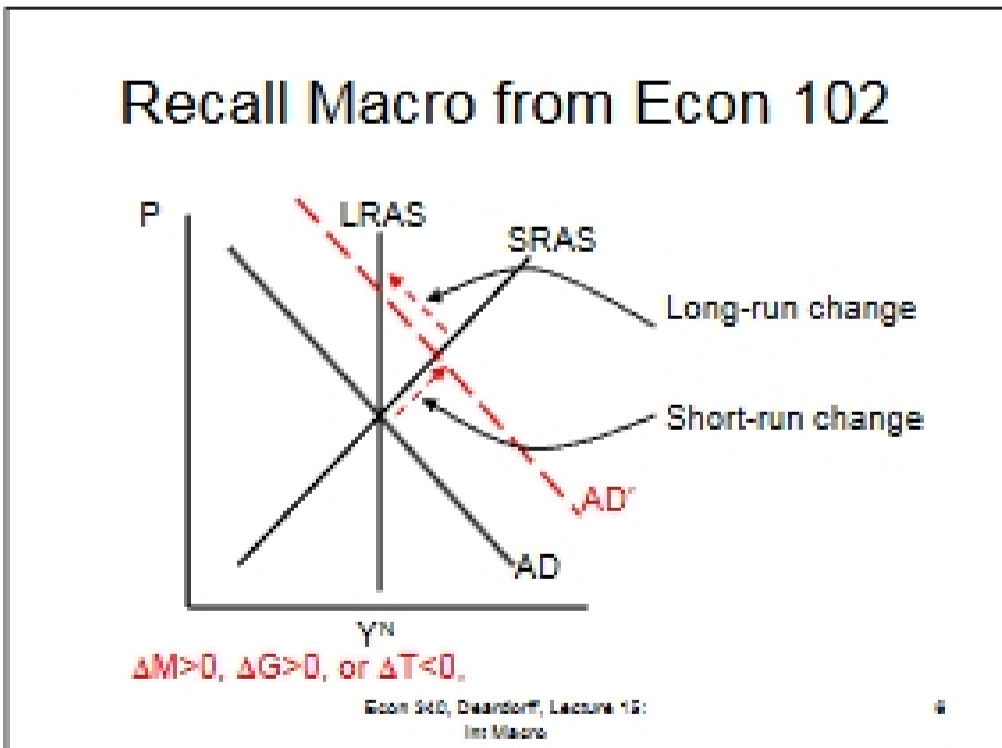
International Macroeconomics

- ### Outline: International Macroeconomics
- Recall Macro from Econ 102
 - Aggregate Supply and Demand
 - Policies
 - Effects ON the Exchange Market
 - Expansion
 - Interest Rate
 - Effects OF the Exchange Market
 - Depreciation via Trade
 - Depreciation via Net Wealth
 - Effects THROUGH the Exchange Market
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- ### Recall Macro from Econ 102
- Aggregate Supply and Demand Determine
 - $Y = \text{GDP} = \text{Output} = \text{Income}$
 - This in turn implies level of Employment
 - $P = \text{Price level}$
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- ### Recall Macro from Econ 102
- Macroeconomic Policies
 - Monetary Expansion = Increase in Money Supply (M)
 - Open market operations: purchase bonds
 - Reserve requirement: reduce it
 - Discount rate: reduce it
 - Usually Indicated by Fed target for Federal Funds Rate
 - Fiscal Expansion
 - Increase government purchases (G)
 - Reduce taxes (T)
- All of these have the effect of
- Increasing aggregate demand
 - Shifting AD curve to the right
- They differ in effects on interest rate (i):
- $\Delta M > 0$ lowers i
 - $\Delta G > 0, \Delta T < 0$ raise i
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Recall Macro from Econ 102

- Macroeconomic Policies
 - Contractionary policies ($\Delta M < 0$, $\Delta G < 0$, or $\Delta T > 0$) are just the opposite
 - All have only temporary effects on output and employment, but lasting effects on price level
 - Policies can be useful (if done right) for dealing with temporary problems such as a recession

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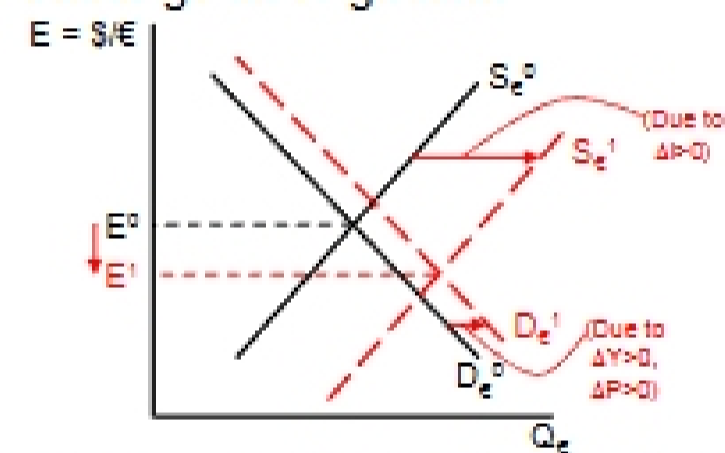
Effects ON the Exchange Market

- Non-Monetary Expansion
 - Y rises } \Rightarrow imports rise $\Rightarrow D_e$ shifts right
 - P rises } \Rightarrow imports rise $\Rightarrow D_e$ shifts right
 - i rises \Rightarrow capital inflow $\Rightarrow S_e$ shifts right
 - We'll always assume that the interest rate effect is larger, because capital today is very mobile
 - Three cases to consider:
 - Floating exchange rate
 - Pegged exchange rate at overvalued rate
 - Pegged exchange rate at undervalued rate

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- US Non-Monetary Expansion:
Floating Exchange Rate

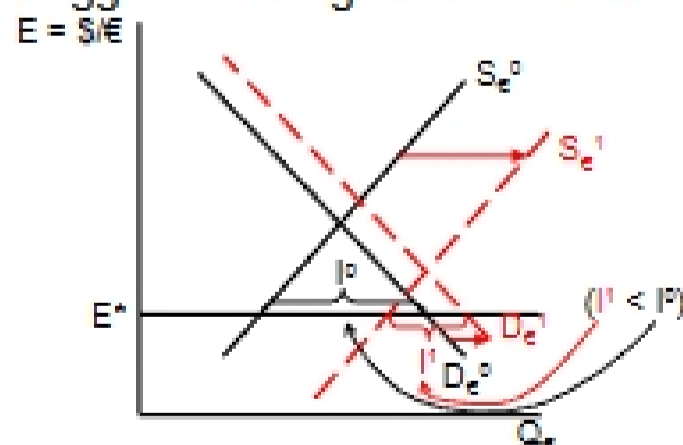


$\Delta G > 0, \Delta T < 0 \Rightarrow$ Causes dollar to appreciate

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- US Non-Monetary Expansion:
Pegged Exchange Rate - Overvalued

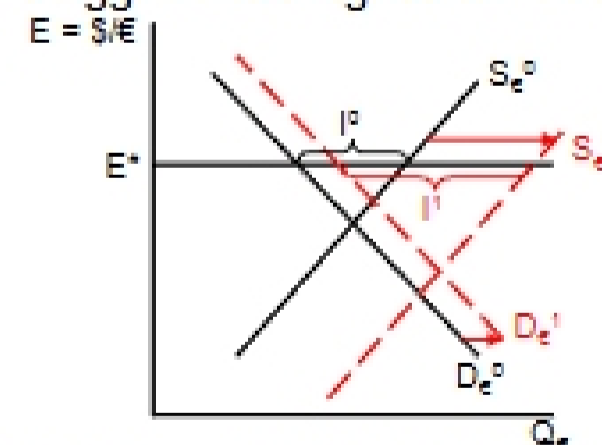


$\Delta G > 0, \Delta T < 0 \Rightarrow$ Less intervention (sells)

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- US Non-Monetary Expansion:
Pegged Exchange Rate - Undervalued



$\Delta G > 0, \Delta T < 0 \Rightarrow$ More intervention (buys)

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Effects ON the Exchange Market

- Summary: Non-Monetary Expansion
 - Results: Effects of non-monetary expansion
 - Floating exchange rate appreciates
 - Pegging the exchange rate becomes easier
 - If reserves were falling (overvalued case) they now fall less rapidly
 - If reserves were rising (undervalued case) they now rise more rapidly

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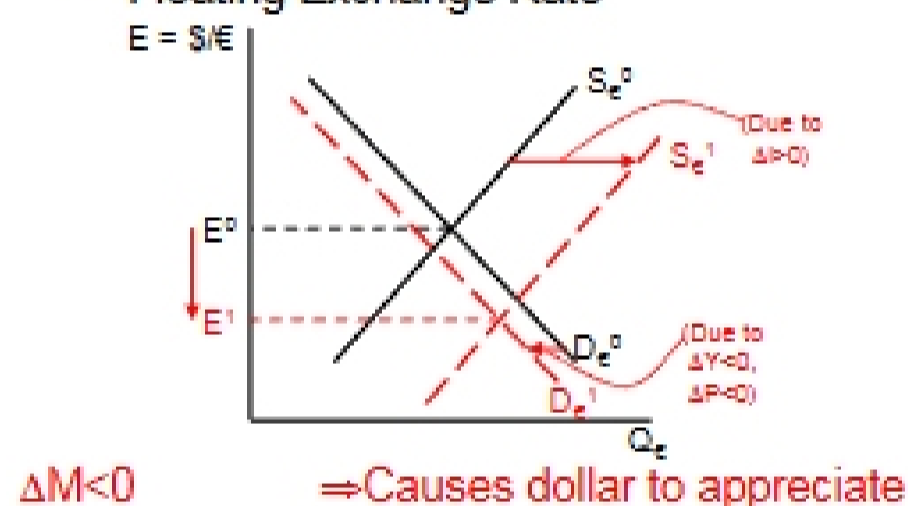
Effects ON the Exchange Market

- Monetary Contraction (i.e., rise in interest rate)
 - $$\left. \begin{array}{l} Y \text{ falls} \\ P \text{ falls} \end{array} \right\} \Rightarrow \text{imports fall} \Rightarrow D_e \text{ shifts left}$$
 - $$i \text{ rises} \Rightarrow \text{capital inflow} \Rightarrow S_e \text{ shifts right}$$
 - Assume again that the interest rate effect is larger
 - Same three cases
 - Will only show floating case; others are similar

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- US Monetary Contraction:
Floating Exchange Rate



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Effects ON the Exchange Market

- Summary: Monetary Contraction
 - Assuming (always) that the interest-rate effect on capital flows is larger than the income and price effects on trade
 - Monetary contraction has essentially the same effects as a non-monetary (e.g., fiscal) expansion
 - Reason:
 - Only the interest rate really matters, due to assumption that capital flows dominate
 - And both fiscal expansion and monetary contraction raise the interest rate

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Effects OF the Exchange Market

- Under a pegged exchange rate, the exchange market has little effect on the economy unless the pegged rate itself is changed
 - Exception: without sterilization, domestic money supply is sensitive to trade and capital flows
- Under a floating exchange rate, movement of the exchange rate can matter a lot

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