Ch. 11 Open Economy Analysis

- Economies open to trade in goods, services and assets are sensitive to developments outside their borders (eg. supply shocks, monetary policy)
- 11.1 Exchange Rates
- 11.2 Determination of Exchange Rates
- 11.3 The IS-LM Model for an Open Economy
- 11.4 Macroeconomic Policy in a SOE
- 11.5 Macroeconomic Policy in a LOE
- 11.6 Fixed Exchange Rates

11.1 Exchange Rates

- Nominal exchange rate: number of units of foreign currency that can be bought with one unit of domestic currency:

  e_{nom} = \$0.6870 US/\$ CDN   March 7, 2000
- Foreign exchange market - market for international currencies
- Flexible/floating *e* system - determined by demand and supply conditions
- Fixed exchange rate system -central banks buy and sell domestic currency to maintain a set rate

  GOLD STANDARD - pegged to gold

  BRETTON WOODS - pegged to US $

11.1 Exchange Rates

- Real exchange rate: the number of units of foreign goods that can be exchanged for a unit of domestic good(s)
- Real exchange rates give an indication of purchasing power
- $e = e_{nom} P/P_{for}$
- Nominal depreciation (appreciation): when e_{nom} falls (rises) - devaluation (revaluation)

11.1 Exchange Rates

- Purchasing Power Parity - in free markets with no transport costs, we would expect goods to be traded one-for-one across borders - $e = 1$, so that $e_{nom} = P_{for}/P$.
- Evidence: PPP may hold in the long-run, but fails in the short-run
- Reasons:
  - nontraded goods and services
  - countries produce nonstandard 'baskets'
  - transport costs
  - legal barriers

11.1 Exchange Rates

- Relationship between real and nominal exchange rates:
- Relative purchasing power parity:

- Why are we concerned with these rates?
  1. trade
  2. net exports and overall domestic production
- The higher is e, the lower is NX