

## Lecture session 5

### 5. Interest Rates, Capital Flows and Exchange Rates

#### 5.3. Modeling asset demand: relationship between interest and exchange rates

5.3.1 Interest parity:  $i_H = [i_F]^e + ([E_{lc/fc}]^e - E_{lc/fc})/E_{lc/fc}$

5.3.2 Foreign exchange equilibrium:  $E^*$ ,  $[i_F]^e$ , and  $i_H$

5.3.3 Foreign exchange equilibrium and link to the money market

5.3.4 Changes in equilibrium: shocks to MS, MD, and expected earnings on foreign assets

#### 5.4. Modeling dynamic adjustment: price rigidity

5.4.1 Short-run vs long-run changes

5.4.2 Exchange rate overshooting hypothesis

5.4.3 Fisher effect: long-run relationship between interest rate and inflation

### 6. General Equilibrium Analysis: Mundell-Fleming Model

#### 6.1. Goods market equilibrium: $Y = C(Y) + I(i) + G_0 + BOT(E \cdot P_F/P_H; Y)$

6.1.1 Aggregate demand and the relationship with income, output

6.1.2 Equating aggregate demand and supply

6.1.3 Deriving DD schedule: relationship between E and income when P are fixed

6.1.4 Deriving IS schedule: relationship between E and interest rate

6.1.5 Shifts in the DD and IS curves (G, T, I, relative P, MPC, relative demand)

#### 6.2. Balance-of-payments (BOP) or foreign-exchange equilibrium (FE) curves

6.2.1 BOP eqblm:  $BOP = BOT(E \cdot P_F/P_H; Y) + K\text{-inflows}(i) = 0$

6.2.2 Slope of BP or FE curve: importance of capital mobility

6.2.3 Shifts in the BP/FE curve (X, M, K-flows)

#### 6.3. Asset / money market equilibrium

6.3.1  $MS/P = MD/P = L(i; Y)$

6.3.2 Deriving the LM curve ( $MS = MD$ )

6.3.3 Deriving the AA curve ( $MS, P, E^e, [i^e]_{US}, \text{real MD}$ )

6.3.4 Shifts in the LM / AA schedule

#### 6.4. General eqblm: AA-DD model; IS-LM-BP model (Mundell-Fleming Model)

### 7. Fiscal and Monetary Policy: Theoretical Considerations

#### 7.1. Fiscal policy

7.1.1. Objectives

7.1.2. Instruments

7.1.3. Theory on G, T and national budget

#### 7.2. Monetary policy

7.2.1. Objectives

7.2.2. Instruments

7.2.3. Central bank independence

#### 7.3 Effectiveness of fiscal and monetary policy – exercise 2

7.3.1. Under different capital mobility assumptions

7.3.2. Under different exchange rate regimes

Study questions: What is exchange rate overshooting hypothesis? What is the cause of it? What is the Fisher effect and how does it relate to the dynamic adjustment process? What is the relationship between income and exchange rates? What is the relationship between interest rates and income? What is the relationship between interest and exchange rates? What is general equilibrium? What does goods markets equilibrium imply? What is BOP equilibrium? What is money market equilibrium? How is the Mundell-Fleming model useful for macroeconomic analysis? What are fiscal and monetary policy instruments? How do monetary policy and fiscal policy affect the macroeconomy? How can the modeling framework be used to study other shocks? What is the relationship between Y and E in the relevant markets? What is the relationship between interest rates (i) and exchange rates (E) in the relevant markets? What does the theory say about the use of fiscal policy and monetary policy? How does the use of fiscal and monetary policy instruments affect the macroeconomy?