CONTENTS

PREFACE  xlv

PART 1  INTERNATIONAL PAYMENTS AND EXCHANGE  1


Why It Is Important to Understand International Money and Finance  3
International Economic Integration: The Importance of Global Trade and Financial Markets  3
    The Real and Financial Sectors of an Economy  4
    World Trade in Goods and Services  4

FUNDAMENTAL ISSUES
How Important Is the Global Market for Goods and Services?  5
International Transactions in Financial Assets  6
The Most Globalized Nations  7

ON THE WEB  7
The Most Globalized Firms  8

FUNDAMENTAL ISSUES
How Important Are the International Monetary and Financial Markets?  10
The Balance of Payments  10

ON THE WEB  10
Balance of Payments as a Double-Entry Bookkeeping System  10
Contents vii

Balance-of-Payments Accounts 12
   The Current Account 12

POLICY NOTEBOOK

   The Combined Current Account Deficit of Developed Nations Translates into a Combined Current Account Surplus for Emerging Countries 13
   The Capital Account 14

ON THE WEB 15

   The Official Settlements Balance 15

   Deficits and Surpluses in the Balance of Payments 16
   Other Deficit and Surplus Measures 17

MANAGEMENT NOTEBOOK

   Trade Deficits: Faulty Indicators of Business Activity 17

Examples of International Transactions and How They Affect the Balance of Payments 18

   Example 1: Import of an Automobile 18
   Example 2: A College Student Travels Abroad 19
   Example 3: A Foreign Resident Purchases a Domestic Treasury Bill 19
   Example 4: The United States Pays Interest on a Foreign-Held Asset 20
   Example 5: A Charitable Organization in the United States Provides Humanitarian Aid Abroad 20
   Examples Combined 20

FUNDAMENTAL ISSUES

   What Is a Country's Balance of Payments, and What Does This Measure? 20

The Capital Account and the International Flow of Assets 21

   Example: A College Student 21
   A Capital Account Surplus 21
   The United States as a Net Debtor 22
CHAPTER 2 The Market for Foreign Exchange 28

Exchange Rates and the Market for Foreign Exchange 29
   The Role of the Foreign Exchange Market 29

ONLINE NOTEBOOK 31
   On the Internet, Currency Trading Spreads to the “Little Guy” 31

ON THE WEB 31

FUNDAMENTAL ISSUES
   What Is the Foreign Exchange Market? 32
   Exchange Rates as Relative Prices 32
      Currency Appreciation and Depreciation 32

FUNDAMENTAL ISSUES
   What Does It Mean When a Currency Has Appreciated or Depreciated? 33
      Cross Rates 33
   Bid–Ask Spreads and Trading Margins 34
      The Bid–Ask Spread 34
      The Bid–Ask Margin 34

ON THE WEB 35
   Real Exchange Rates 35
   The Effect of Price Changes 35
Measuring the Overall Strength or Weakness of a Currency: Effective Exchange Rates 36

Constructing an Effective Exchange Rate 36
A Two-Country Example of an Effective Exchange Rate 37

Constructing Bilateral Weights 37
Determining Relative Exchange Rates 38
What an Effective Exchange Rate Tells Us 38
Real Effective Exchange Rates 39

ON THE WEB 40

FUNDAMENTAL ISSUES
How Is the General Value of a Currency Measured? 40

Composite Currencies 40
Special Drawing Right (SDR) 40
Calculation of the SDR 41

Foreign Exchange Arbitrage 42

FUNDAMENTAL ISSUES
What Is Foreign Exchange Arbitrage? 43

The Demand for and Supply of Currencies 43
The Demand for a Currency 43
Illustrating the Demand Relationship: The Demand Curve 43

MANAGEMENT NOTEBOOK
Variations in the Dollar's Value Induce Colleges to Adjust Enrollments in Study-Abroad Programs 44

A Change in Demand 45
The Supply of a Currency 45
Illustrating the Supply Relationship: The Supply Curve 45
A Change in Supply 46
The Equilibrium Exchange Rate 47
Illustrating the Market Equilibrium 47
Example: A Change in Demand 47
Foreign Exchange Market Intervention 48
FUNDAMENTAL ISSUES
What Determines the Value of a Currency? 49
Absolute Purchasing Power Parity 49
Purchasing Power Parity 49
Arbitrage and PPP 50
Absolute PPP 50
Practical Problems and Shortcomings of Absolute PPP 51

MANAGEMENT NOTEBOOK
Significant Gains from Arbitrage Turn Out to Be Mainly Theoretical in Canada 52
Relative Purchasing Power Parity 52

ON THE WEB 52

FUNDAMENTAL ISSUES
Chapter Summary 54
Questions and Problems 55
Online Applications 56
Selected References and Further Readings 57

CHAPTER 3 Exchange-Rate Systems, Past to Present 58
Exchange-Rate Systems 59

ONLINE NOTEBOOK
Foreign Exchange Rates for Virtual Money Become a Reality 59

FUNDAMENTAL ISSUES
What Is an Exchange-Rate System? 60
The Gold Standard 60
The Gold Standard as an Exchange-Rate System 60
Contents xi

FUNDAMENTAL ISSUES
How Does a Gold Standard Constitute an Exchange-Rate System? 61
Performance of the Gold Standard 62
Positive and Negative Aspects of a Gold Standard 62
The Economic Environment of the Gold Standard Era 62
The Collapse of the Gold Standard 63
The Bretton Woods System 63

ON THE WEB 64
The Bretton Woods Agreement 64

FUNDAMENTAL ISSUES
What Was the Bretton Woods System of “Pegged” Exchange Rates? 66
Performance of the Bretton Woods System 66
The Gold Pool 66
President Nixon Closes the Gold Window 68
The Smithsonian Agreement and the Snake in the Tunnel 68
The Flexible-Exchange-Rate System 69
The Economic Summits and a New Order 69
Performance of the Floating-Rate System 69

ON THE WEB 70
The Plaza Agreement and the Louvre Accord 70
The Euro 72

FUNDAMENTAL ISSUES
Other Forms of Exchange-Rate Arrangements Today 73
Dollarization 74

POLICY NOTEBOOK
U.S. Inflation Creates Economic Pain in El Salvador 74
Independent Currency Authorities 75
FUNDAMENTAL ISSUES
What Is Dollarization, and What Is a Currency Board? 76
Conventional Peg and Pegged with Bands 76
Currency Baskets 76
Selecting a Currency Basket 77

MANAGEMENT NOTEBOOK
A New Currency Basket Offers Weights
That Vary over Time 78
Managing the Currency Basket 78
Crawling Pegs 78
Nicaragua's Crawling-Peg Arrangement 79

FUNDAMENTAL ISSUES
What Types of Pegged-Exchange-Rate Arrangements
Are Used Today? 79
Fixed or Floating Exchange Rates? 80

FUNDAMENTAL ISSUES
Which Is Best, a Fixed- or Flexible-Exchange-Rate
Arrangement? 80
Chapter Summary 80
Questions and Problems 82
Online Applications 83
Selected References and Further Readings 83

PART 2  INTERNATIONAL FINANCIAL INSTRUMENTS, MARKETS,
AND INSTITUTIONS  85

CHAPTER 4  The Forward Currency Market and International
Financial Arbitrage 86
Foreign Exchange Risk 87
Types of Foreign Exchange Risk Exposure 87
Hedging Foreign Exchange Risk 88
Contents

Risk and Uncovered Interest Parity 101
Risks Other Than Foreign Exchange Risk 101
Tests of Uncovered Interest Parity 102

MANAGEMENT NOTEBOOK

The Carry-Trade Strategy for International Investment 102

FUNDAMENTAL ISSUES

What Is Uncovered Interest Parity? 103
Foreign Exchange Market Efficiency 103
Market Efficiency 104
Evidence on Foreign Exchange Market Efficiency 104

FUNDAMENTAL ISSUES

What Is Foreign Exchange Market Efficiency? 104
International Financial Markets 104
International Capital Markets 105
International Money Markets 105
Eurobonds, Euronotes, and Eurocommercial Paper 105
Eurocurrencies 106
Origins of the Eurocurrency Market 106
Relationship to the Forward Market 107

FUNDAMENTAL ISSUES

What Are the International Financial Markets? 108

Chapter Summary 108
Questions and Problems 109
Online Applications 110
Selected References and Further Readings 111

CHAPTER 5 Interest Yields, Interest Rate Risk, and Derivative Securities 112

Interest Rates 113
Interest Yields and Financial Instrument Prices 113
Contents

Interest Rates and Discounted Present Value  113
Discounted Present Value and the Market Price of Bonds  114

ON THE WEB  115

ON THE WEB  116
Perpetuities and the Relationship between Interest Yields and Bond Prices  116

MANAGEMENT NOTEBOOK
Recalculating Libor  117
Term to Maturity and Interest Rate Risk  118

FUNDAMENTAL ISSUES
How Are Interest Yields, Financial Instrument Prices, and Interest Rate Risk Interrelated?  119
The Term Structure of Interest Rates  119
Yield Curves  119
Segmented Markets Theory  120
The Expectations Theory  120
The Preferred Habitat Theory  122
The Risk Structure of Interest Rates  122
Default Risk  123
Liquidity  123
Tax Differences  124

FUNDAMENTAL ISSUES
Why Do Market Interest Yields Vary with Differences in Financial Instruments' Terms to Maturity?  124
Interest Rate Differentials—Excess Returns and Failure of Uncovered Interest Parity  124
Breakdowns of Uncovered Interest Parity and Excess Returns  125
Excess Returns  125
Evidence on Excess Returns  125
Accounting for Differences in Excess Returns to Help Explain International Interest Rate Differences  125
MANAGEMENT NOTEBOOK
Do Excess Returns Vary at Different Bond Maturities? 126

FUNDAMENTAL ISSUES
What Factors Explain Why International Interest Rate Differentials Are Often Inconsistent with the Uncovered-Interest-Parity Condition? 127

Real Interest Rates and Real Interest Parity 127
Real Interest Rates: The Fisher Equation 128
Real Interest Parity 128
Combining Relative Purchasing Power Parity and Uncovered Interest Parity 128
Deviations from Real Interest Parity as a Measure of International Market Arbitrage 129

MANAGEMENT NOTEBOOK
How Long Does It Take for Real Interest Rates to Converge? 129

FUNDAMENTAL ISSUES
What Are Real Interest Rates, and How Can Real-Interest-Rate Differentials Serve as Indicators of the Extent to Which International Markets Are Open to Arbitrage? 130

Hedging, Speculation, and Derivative Securities 130
Possible Responses to Interest Rate Risk 130
Some Strategies for Limiting Interest Rate Risk 131
Hedging 131
Derivative Securities 131
Hedging with Forward Contracts 132
Speculation with Derivatives 132
Speculative Gains and Losses 133

FUNDAMENTAL ISSUES
What Are Derivative Securities? 134

Common Derivative Securities and Their Risks 135
Forward Contracts 135
Futures 135
Contents

ON THE WEB

Interest Rate Futures 136
Stock-Index Futures 136
Currency Futures 136

ON THE WEB 137

Hedging with Currency Futures 137
Daily Futures Settlement 138

Options 139

Stock Options and Futures Options 139
Currency Options 139
Netting 142

Swaps 143

Currency Swaps 143
Types of Swaps 144

Derivatives Risks and Regulation 145

Measuring Derivatives Risks 145
Types of Derivatives Risks 145

FUNDAMENTAL ISSUES

What Are the Most Commonly Traded Derivative Securities? 146

Chapter Summary 146
Questions and Problems 147
Online Applications 149
Selected References and Further Readings 150

CHAPTER 6

International Banking, Central Banks, and Supranational Financial Policymaking Institutions 151

International Dimensions of Financial Intermediation 152

Financial Intermediation 152

Asymmetric Information 153
Adverse Selection 153
Moral Hazard 153
Economies of Scale 154
Financial Intermediation across National Boundaries 154
International Financial Intermediation 155
Economies of Scale and Global Banking 155

FUNDAMENTAL ISSUES
What Accounts for International Financial Intermediation, and
How Do National Banking Systems Differ? 156

Global Payments and Financial System Risks 156
Global Payment Systems 157
Nonelectronic Payment Systems 157
Electronic Payment Systems 158

ON THE WEB 158
Payment-System Risks 158
Liquidity Risk 159
Credit Risk 159
Systemic Risk 160
Herstatt Risk 160

FUNDAMENTAL ISSUES
What Are the World's Major Bank Payment Systems, and How
Do the Risks That Arise in National Financial and Banking
Systems Contribute to the Potential for Financial Instability
and Crises? 161

Financial Instability and International Financial Crises 161
Economic Imbalances and International Financial
Crises 161
Self-Fulfilling Expectations and Contagion Effects 162
Structural Moral Hazard Problems 162

MANAGEMENT NOTEBOOK
From Fish to Finance—and Back to Fish Again? 163

Bank Regulation and Capital Requirements 163

ON THE WEB 164
The Goals of Bank Regulation 164
Limiting the Scope for Bank Insolvencies and Failures 164
Maintaining Bank Liquidity 164
Promoting an Efficient Banking System 164
POLICY NOTEBOOK
Engaging in War Games Pays Off for Bank Regulators 165

ON THE WEB 165
Bank Capital Requirements 166
The Three Pillars of the Basel Regulatory System 167

POLICY NOTEBOOK
Will More Risk-Based Capital Regulation Make Banking More Procyclical? 167
Market-Based Regulation? 168

FUNDAMENTAL ISSUES
What Objectives Do National Banking Regulators Seek to Achieve, and How Do They Implement Their Regulations? 169

Central Banks 169

ON THE WEB 169
Central Bank Assets 170
Central Bank Liabilities and Net Worth 171

FUNDAMENTAL ISSUES
What Are the Main Assets and Liabilities of Central Banks? 172

What Do Central Banks Do? 172
Central Banks as Government Banks 172
Central Banks as Government Depositories 172
Central Banks as Fiscal Agents 172
Central Banks as Bankers’ Banks 173
Do Banks “Need” a Central Bank? 173
Lenders of Last Resort 173
Central Banks as Monetary Policymakers 174
Interest Rates on Central Bank Advances 174
Open-Market Operations 176
Reserve Requirements 177
Interest Rate Regulations and Direct Credit Controls 177
CHAPTER 7 The International Financial Architecture and Emerging Economies 187

International Capital Flows 188
Explain the Direction of Capital Flows 188
Foreign Direct Investment and Developed Nations 188

ON THE WEB 188
Cross-Border Mergers and Acquisitions 189

ON THE WEB 190
The Emerging Economies 190

FUNDAMENTAL ISSUES
What Are the Most Important Developments in the Recent Evolution of Global Capital Markets? 191

Capital Allocations and Economic Growth 191
How Capital Inflows Can Smooth the Domestic Economy 192
How Capital Inflows Can Contribute to Long-Term Development 192

Capital Misallocations and Their Consequences 193
Market Imperfections 193
Policy-Created Distortions 193
Financial Instability and Financial Crises 194
Maximizing Benefits and Minimizing Risks 194
Where Do Financial Intermediaries Fit In? 195

FUNDAMENTAL ISSUES
What Is the Relationship between Capital Allocations and Economic Growth, and What Is the Role of Financial Intermediaries in This Relationship? 195

Capital Market Liberalization and International Financial Crises 196
Are All Capital Flows Equal? 196
Portfolio Capital Flows 196
Foreign Direct Investment 196

MANAGEMENT NOTEBOOK
Private Capital Flows: Source of Instability or Engine of Economic Development? 197
The Role of Capital Flows in Recent Crisis Episodes 198

ON THE WEB 198
Foreign Direct Investment as a Stabilizing Element 198
Is There a Role for Capital Controls? 199

FUNDAMENTAL ISSUES
What Is the Difference between Portfolio Capital Flows and Foreign Direct Investment, and What Role Did These Types of Capital Flows Play in Recent Financial Crises? 200

Exchange-Rate Regimes and Financial Crises 200
Schools of Thought on Exchange-Rate Regimes 200
The Corners Hypothesis 201
Dollarization 201
The Benefits of Dollarization 201
The Costs of Dollarization 202
Dollarized Economies 202
Peg, Take the Middle Road, or Float? 202
The “Trilemma” 203
POLICY NOTEBOOK
Differences in Cross-Country Patterns in Addressing the Trilemma Issue 204

FUNDAMENTAL ISSUES
What Type of Exchange-Rate Regime Is Most Appropriate for Emerging Economies? 205
Evaluating the Status Quo 205
Ex Ante versus Ex Post Conditionality at the IMF 205

ONLINE NOTEBOOK
Data Dissemination via the Internet 206
Searching for a Mission at the World Bank 206

POLICY NOTEBOOK
Should National Policymakers Promote Microlending? 207

ON THE WEB 208
Debt Relief for the Heavily Indebted Poor Countries 209

FUNDAMENTAL ISSUES
What Aspects of IMF and World Bank Policymaking Have Proved Controversial in Recent Years? 210
Does the International Financial Architecture Need a Redesign? 210
Crisis Prediction and Early-Warning Systems 210
Rethinking Economic Institutions and Policies 211
Rethinking Long-Term Development Lending 211
Alternative Institutional Structures for Limiting Financial Crises 212

FUNDAMENTAL ISSUES
What Changes in the International Financial Architecture Have Economists Proposed in Recent Years? 214
Chapter Summary 214
Questions and Problems 215
Online Applications 216
Selected References and Further Readings 217
PART 3 EXCHANGE-RATE AND BALANCE-OF-PAYMENTS DETERMINATION  219

CHAPTER 8 Traditional Approaches to Balance-of-Payments and Exchange-Rate Determination  220

Common Characteristics of the Traditional Approaches  221
Exports, Imports, and the Demand for and Supply of Foreign Exchange  221
   Derivation of the Demand for Foreign Exchange  221
   Elasticity and the Demand for Foreign Exchange  222
   Derivation of the Supply of Foreign Exchange  223
   Elasticity and the Supply of Foreign Exchange  224

FUNDAMENTAL ISSUES
   How Do the Supply of Exports and Demand for Imports Determine the Supply of and Demand for Foreign Exchange?  226
The Elasticities Approach  226
   The Exchange Rate and the Balance of Payments  226
   The Role of Elasticity  227

ON THE WEB  228
   The Marshall–Lerner Condition  228

FUNDAMENTAL ISSUES
   What Is the Elasticities Approach to Balance-of-Payments and Exchange-Rate Determination?  229
Short- and Long-Run Elasticity Measures and the J-Curve  229
   Short-Run versus Long-Run Time Horizons  229
   The J-Curve Effect  230

MANAGEMENT NOTEBOOK
   Industry-Level Evidence of J-Curve Effects for Bilateral Trade between Canada and the United States  231
FUNDAMENTAL ISSUES
What Is the J-Curve Effect? 231
Pass-Through Effects 232

ON THE WEB 232

MANAGEMENT NOTEBOOK
Market Power and Variations in U.S. Exchange-Rate Pass-Through Effects 232

FUNDAMENTAL ISSUES
What Are Pass-Through Effects? 233

The Absorption Approach 233
Modeling the Absorption Approach 233
Absorption 234
Real Income 234
The Current Account 234

Determination of the Current Account Balance 234
Economic Expansion and Contraction 235
An Economic Expansion 235
An Economic Contraction 235

ON THE WEB 236

FUNDAMENTAL ISSUES
What Is the Absorption Approach to Balance-of-Payments and Exchange-Rate Determination? 236
Policy Instruments 236

FUNDAMENTAL ISSUES
How Do Changes in Real Income and Absorption Affect a Nation's Current Account Balance and the Foreign Exchange Value of Its Currency? 237

Chapter Summary 238
Questions and Problems 239
Online Applications 240
Selected References and Further Readings 241
The Monetary Approach to Balance-of-Payments and Exchange-Rate Determination 255

The Cambridge Approach to Money Demand 255

Money, the Balance of Payments, and the Exchange Rate 256

The Relationship between the Money Stock and the Balance of Payments 256

The Relationship between Domestic Prices, Foreign Prices, and the Spot Exchange Rate 256

The Monetary Equilibrium Condition 256

The Monetary Approach and a Fixed-Exchange-Rate Arrangement 257

A Change in Domestic Credit 257

A Change in the Quantity of Money Demanded 258

POLICY NOTEBOOK

The Oil-Rich Middle East Begins to Desert the Sinking Dollar 258

The Monetary Approach and a Flexible-Exchange-Rate Arrangement 259

A Change in Domestic Credit 259

A Change in the Quantity of Money Demanded 260

FUNDAMENTAL ISSUES

What Is the Monetary Approach to Balance-of-Payments and Exchange-Rate Determination? 260

Applying the Monetary Approach: A Two-Country Setting 260

A Two-Country Monetary Model 260

An Example of Exchange-Rate Determination for Two Nations 261

ON THE WEB 262

FUNDAMENTAL ISSUES

How Is the Monetary Approach a Theory of Exchange-Rate Determination in a Two-Country Setting? 263
PART 4 OPEN ECONOMY MACROECONOMICS
AND POLICY ANALYSIS

CHAPTER 10 An Open Economy Framework

Measuring an Economy's Performance: Gross Domestic Product and Price Indexes

Gross Domestic Product
Nominal GDP, Real GDP, and the GDP Price Deflator

Real versus Nominal GDP
The GDP Price Deflator
ON THE WEB 277
Denoting a Base Year 277

POLICY NOTEBOOK
Global Real GDP Calculations Reveal the Rapid Pace of World Economic Growth 279

ON THE WEB 279
Fixed- and Flexible-Weight Price Measures 279
The GDP Price Deflator: A Flexible-Weight Price Index 280
Fixed-Weight Price Indexes 280
The Consumer and Producer Price Indexes 280

MANAGEMENT NOTEBOOK
The Tenuous Link from Chinese Wages to U.S. Consumer Prices 280

ON THE WEB 281
Real Income and Expenditures: The IS Schedule 282
The Income Identity 282
The Product Identity 283

FUNDAMENTAL ISSUES
How Do Economists Measure a Nation’s Flow of Income and Expenditure and Its Overall Level of Prices of Goods and Services? 284
Private and Public Expenditures 284
Saving, Import Spending, and Domestic Consumption Spending 284

MANAGEMENT NOTEBOOK
The Declining Impact of Interest Rate Variations on U.S. Real Consumption Expenditures 288
Desired Investment Spending 288
Government Spending and Net Taxes 290
Export Spending 291
Equilibrium Income and Expenditures 291
Aggregate Desired Expenditures 292
Equilibrium National Income 292
The Income–Expenditure Equilibrium 293

FUNDAMENTAL ISSUES
How Is Equilibrium Real Income Determined in an Open Economy? 293
The IS Schedule 293
The Derivation of the IS Schedule 294
Determining the Position of the IS Schedule 295
The Multiplier Effect 295
Explaining the Multiplier Effect 297

FUNDAMENTAL ISSUES
What Is the IS Schedule, and What Factors Determine Its Position? 297
The Market for Real Money Balances: The LM Schedule 298
The Demand for Money 298
The Transactions and Precautionary Motives for Holding Money 298

ONLINE NOTEBOOK
Using the Web to Convert Dollars into African Vouchers 299
The Portfolio Motive for Holding Money 300
The Demand for Real Money Balances 301
The LM Schedule 302
Money Market Equilibrium and the LM Schedule 303
Determining the Position of the LM Schedule 304

FUNDAMENTAL ISSUES
What Is the LM Schedule, and What Factors Determine Its Position? 305
The Balance of Payments: The BP Schedule and the IS–LM–BP Model 305
Maintaining a Balance-of-Payments Equilibrium: The BP Schedule 305
Real Income and the Balance of Payments 305
The Nominal Interest Rate and the Balance of Payments 306

The IS–LM–BP Model 307
IS–LM Equilibrium 307

FUNDAMENTAL ISSUES
Determining a Nation's Balance-of-Payments Position 307

FUNDAMENTAL ISSUES
What Is the BP Schedule, and How Can We Use the IS–LM–BP Model to Determine a Nation's Balance-of-Payments Status? 309

Chapter Summary 309
Questions and Problems 310
Online Applications 311
Selected References and Further Readings 312

CHAPTER 11 Economic Policy with Fixed Exchange Rates 314

The Objectives of Policy 315
Internal Balance Objectives 315
Real-Income Goals 315

ON THE WEB 316
Employment Goals 317
Inflation Goals 318

External Balance Objectives 319
International Objectives and Domestic Goals 319
External Balance for Its Own Sake 319

FUNDAMENTAL ISSUES
What Are the Economic Goals of National Policymakers? 320

The Role of Capital Mobility 320
Capital Mobility and the BP Schedule 321
The Case of Low Capital Mobility 321
The Case of High Capital Mobility 322
Perfect Capital Mobility  322

Perfect Capital Mobility and the BP Schedule  322

 ONLINE NOTEBOOK
A Web Route to Avoiding Lines for Currency Exchange  323

The Domestic Interest Rate and Balance of Payments with Perfect Capital Mobility  323

 FUNDAMENTAL ISSUES
How Does the Degree of Capital Mobility Influence the Slope of the BP Schedule?  324

Fixed Exchange Rates and Imperfect Capital Mobility  324

Monetary Policy under Fixed Exchange Rates and Imperfect Capital Mobility  325

 POLICY NOTEBOOK
To Make Its Official Exchange Rate Credible, Venezuela’s Government Has Sometimes Effectively Given Away Caribbean Vacations  325

 ON THE WEB  325

Monetary Policy, the Nominal Interest Rate, and Real Income  325

Monetary Policy and the Balance of Payments with Imperfect Capital Mobility  327

Sterilized Monetary Policy  327

Nonsterilized Monetary Policy  328

The Monetary Approach Revisited  329

 POLICY NOTEBOOK
What Determines the Choice of a Peg for a Nation’s Fixed-Exchange-Rate System?  329

 FUNDAMENTAL ISSUES
To What Extent Can Monetary Policy Actions Influence the Real Income Level of a Small Open Economy with Imperfect Capital Mobility and a Fixed Exchange Rate?  330

Fiscal Policy under Fixed Exchange Rates  330

Fiscal Policy, the Nominal Interest Rate, and Real Income  330
Fiscal Policy and the Balance of Payments with Imperfect Capital Mobility 331
The Effects of Fiscal Policy Actions with and without Monetary Sterilization 332

FUNDAMENTAL ISSUES
To What Extent Can Fiscal Policy Actions Influence the Real Income Level of a Small Open Economy with Imperfect Capital Mobility and a Fixed Exchange Rate? 334

Fixed Exchange Rates and Perfect Capital Mobility 335

POLICY NOTEBOOK
Brazilian Policymakers Try to Have It Both Ways 335

ON THE WEB 335
Economic Policies with Perfect Capital Mobility and a Fixed Exchange Rate: The Small Open Economy 336
Monetary Policy with Perfect Capital Mobility and a Fixed Exchange Rate 336
Fiscal Policy with Perfect Capital Mobility and a Fixed Exchange Rate 337

FUNDAMENTAL ISSUES
In What Ways Does Perfect Capital Mobility Alter the Relative Effectiveness of Monetary and Fiscal Policy Actions in a Small Open Economy That Adopts a Fixed Exchange Rate? 337

Economic Policies with Perfect Capital Mobility and a Fixed Exchange Rate: A Two-Country Example 338
A Two-Country Model with Perfect Capital Mobility and a Fixed Exchange Rate 338
The Effects of a Foreign Monetary Expansion 339
The Effects of a Foreign Fiscal Expansion 340
The Effects of a Domestic Monetary Expansion 342
The Effects of a Domestic Fiscal Expansion 343
FUNDAMENTAL ISSUES

In a Two-Country Setting in Which One Nation's Central Bank Fixes the Exchange Rate, to What Extent Can Policy Actions in One Nation Influence Economic Activity in the Other Nation? 344

Chapter Summary 344
Questions and Problems 345
Online Applications 346
Selected References and Further Readings 347

CHAPTER 12 Economic Policy with Floating Exchange Rates 348

Floating Exchange Rates and Imperfect Capital Mobility 349
The Effects of Exchange-Rate Variations in the IS–LM–BP Model 349

Exchange-Rate Variations and the IS Schedule 349
Exchange-Rate Variations and the BP Schedule 350

Monetary Policy under Floating Exchange Rates 350

POLICY NOTEBOOK

Current Account Balances and Exchange-Rate Adjustments 351
Fiscal Policy under Floating Exchange Rates 353
The Case of Low Capital Mobility 353
The Case of High Capital Mobility 354

ONLINE NOTEBOOK

Betting That Higher Capital Mobility and Greater Spending Will Fuel an Iraqi Dinar Appreciation 354

FUNDAMENTAL ISSUES

How Do Monetary and Fiscal Policy Actions Affect a Nation's Real Income Under a Floating Exchange Rate? 355

Floating Exchange Rates and Perfect Capital Mobility 355
Economic Policies with Perfect Capital Mobility and a Floating Exchange Rate: The Small Open Economy 355
Monetary Policy with Perfect Capital Mobility and a Floating Exchange Rate  355
Fiscal Policy with Perfect Capital Mobility and a Floating Exchange Rate  356
Perfect Capital Mobility and Fixed versus Floating Exchange Rates  357

FUNDAMENTAL ISSUES
How Does Perfect Capital Mobility Influence the Relative Effectiveness of Monetary and Fiscal Policy Actions in a Small Open Economy That Permits Its Exchange Rate to Float?  358
Economic Policies with Perfect Capital Mobility and a Floating Exchange Rate: A Two-Country Example  358
The Effects of a Domestic Monetary Expansion  358

MANAGEMENT NOTEBOOK
A Beggar-Thy-Neighbor Effect Hits Auto Markets of U.S. Trading Partners  360
The Effects of a Foreign Monetary Expansion  360
The Effects of a Domestic Fiscal Expansion  361
The Effects of a Foreign Fiscal Expansion  362

FUNDAMENTAL ISSUES
In a Two-Country Setting with a Floating Exchange Rate, to What Extent Can Policy Actions in One Nation Influence Economic Activity in the Other Nation?  362
Fixed versus Floating Exchange Rates  363
Efficiency Arguments for Fixed versus Floating Exchange Rates  363
Social Costs Stemming from Foreign Exchange Risks  363
Efficiency via a Fixed Exchange Rate?  364
The Pain of Realigning  364

ON THE WEB  365

FUNDAMENTAL ISSUES
What Is the Basic Economic Efficiency Trade-off Faced in Choosing between Fixed and Floating Exchange Rates?  366
Stability Arguments for Fixed versus Floating Exchange Rates 366

Autonomous Expenditure Volatility and Fixed versus Floating Exchange Rates 366

Financial Volatility and Fixed versus Floating Exchange Rates 368

The Stability Trade-Off 370

Monetary Policy Autonomy and Fixed versus Floating Exchange Rates 371

FUNDAMENTAL ISSUES

Chapter Summary 372
Questions and Problems 373
Online Applications 374
Selected References and Further Readings 374

CHAPTER 13 The Price Level, Real Output, and Economic Policymaking 376

Aggregate Demand 377
The Aggregate Demand Schedule 377

FUNDAMENTAL ISSUES
What Is the Aggregate Demand Schedule? 378

Factors That Determine the Position of the Aggregate Demand Schedule in an Open Economy 379

Monetary Policy and Aggregate Demand 379

Monetary Policy and Aggregate Demand in an Open Economy with a Fixed Exchange Rate 380

Monetary Policy and Aggregate Demand in an Open Economy with a Floating Exchange Rate 382

Exchange-Rate Policy and Aggregate Demand in an Open Economy 384
FUNDAMENTAL ISSUES
What Factors Determine the Extent to Which Changes in the Quantity of Money Can Influence Aggregate Demand in an Open Economy? 384

Fiscal Policy and Aggregate Demand 384
Fiscal Policy and Aggregate Demand in an Open Economy with a Fixed Exchange Rate 385
Fiscal Policy and Aggregate Demand in an Open Economy with a Floating Exchange Rate 387

FUNDAMENTAL ISSUES
What Factors Determine the Extent to Which Fiscal Policy Actions Can Influence Aggregate Demand in an Open Economy? 389

Aggregate Supply 389
Output and Employment Determination 389
The Production Function 389
The Marginal Product of Labor 390
The Demand for Labor 391
Wage Flexibility, Aggregate Supply, and the Price Level 392
The Determination of Nominal Wages 392

MANAGEMENT NOTEBOOK
In a Globalized Economy, Higher Corporate Income Taxes Translate into Lower Wages for Workers 393

Employment and Aggregate Supply with Fixed versus Flexible Nominal Wages 394
The Aggregate Supply Schedule with Partial Wage Adjustment 396

FUNDAMENTAL ISSUES
What Is the Aggregate Supply Schedule? 397
Real Output, the Price Level, and Economic Policymaking 397
The Equilibrium Price Level and the Equilibrium Real Output Level 398
The Output and Price-Level Effects of Economic Policies with Floating versus Fixed Exchange Rates 399
PART 5 DOMESTIC AND MULTINATIONAL POLICYMAKING IN A GLOBAL ECONOMY 417

CHAPTER 14 Domestic Economic Policymaking in a Global Economy 418

The Policy Assignment Problem 419

Finding the Best Policy Mix for Internal and External Balance 419

Achieving External Balance 420
Achieving Internal Balance 421

Assigning Internal and External Objectives 421

An Incorrect Assignment 422

Difficulties in Solving the Assignment Problem 423

FUNDAMENTAL ISSUES

What Is the Policy Assignment Problem? 423

Exchange-Rate Responses to Policy Actions with Sticky Wages and Prices—Exchange-Rate Overshooting 423

The Long-Run Adjustment of the Exchange Rate to a Monetary Expansion 424

Long-Run Equilibrium 424
Exchange-Rate Adjustment in the Long Run 424

Exchange-Rate Overshooting 425

Moving from the Short Run to the Long Run 425
Tracing the Adjustment of the Exchange Rate 425
Implications of Exchange-Rate Overshooting 427

FUNDAMENTAL ISSUES

What Is Exchange-Rate Overshooting, and Why Might It Occur? 427
Openness and the Output–Inflation Relationship—How
Globalization Alters the Effects of Policies  427
How Increased Openness Can Make Output Less Responsive
to Inflation  428

POLICY NOTEBOOK
Measuring Openness  429
  Partially Indexed Wage Contracts  430
  Greater Openness and Imported Inputs  430
How Greater Openness Can Increase the Sensitivity of Output
to Inflation  430
  Openness and Competition in Domestic Product
  Markets  430

MANAGEMENT NOTEBOOK
Which Nations' Industries Face the Most Extensive
Regulations?  431
  Openness, Wage Stickiness, and Central Bank
  Independence  432
Evidence on Openness and the Output–Inflation
Relationship  433
  Responsiveness of Output to Inflation: International
  Evidence  433
  Central Bank Independence, Openness, and the Output–
  Inflation Relationship  434
  Additional Evidence Regarding the Interaction between
  Openness and the Output–Inflation Relationship  435

FUNDAMENTAL ISSUES
Why Does Increased Openness of a Nation's Economy Have
an Uncertain Net Effect on the Responsiveness of Output to
Changes in the Price Level?  435
Openness and Inflation  436
  The Global Openness–Inflation Relationship  436

POLICY NOTEBOOK
Is a More Open Economy More or Less Prone to "Sudden
Stops"?  437
Just How Strong Is the Openness–Inflation Relationship? 437

Differences in How Openness and Inflation Relate in Developed versus Less Developed Nations 437

Accounting for Cross-Country Differences in the Impacts of Globalization 439

FUNDAMENTAL ISSUES

Is There an Inverse Relationship between Openness and Inflation? 439

New Open Economy Macroeconomics and Its Policy Implications 439

Features of the New Open Economy Macroeconomics 440

Sources of Price Stickiness 440

MANAGEMENT NOTEBOOK

Are Product Prices Really Sticky? 440

Imperfect Competition 441

Dynamic Analysis 442

Policy Implications of the New Open Economy Macroeconomics 442

Welfare Evaluations 442

Still a Long Way to Go 443

FUNDAMENTAL ISSUES

What Is the New Open Economy Macroeconomics? 443

Chapter Summary 444

Questions and Problems 445

Online Applications 446

Selected References and Further Readings 447

CHAPTER 15  Policy Coordination, Monetary Union, and Target Zones 448

International Interdependence 449

Structural Interdependence and International Policy Externalities 449
Structural Interdependence and Its Consequences 449
International Policy Externalities 449

Accounting for Interdependence: International Policy Cooperation and Coordination 450

International Policy Cooperation 450
International Policy Coordination 450

FUNDAMENTAL ISSUES
What Is Structural Interdependence, and How Can It Lead Nations to Cooperate or to Coordinate Their Policies? 451

Perfect Capital Mobility Revisited: Can International Policy Coordination Pay? 451

The Aggregate Demand Effects of National Monetary Policies 451

Conflicting Monetary Policies and the Potential Role of Policy Coordination 453

A Potential Gain from Policy Coordination 454

The Pros and Cons of International Policy Coordination 455

Potential Benefits of International Policy Coordination 456

Internalizing International Policy Externalities 456

Getting the Most Out of Limited Sets of Policy Instruments 456

Gaining Support from Abroad 456

FUNDAMENTAL ISSUES
What Are the Potential Benefits of International Policy Coordination? 457

Some Potential Drawbacks of International Policy Coordination 457

How Much Autonomy Should a Nation Sacrifice? 457

Can Other Countries Be Trusted? 457

Putting Faith in Other Nations’ Policymakers 458

Could “Successful” Coordination Actually Be Counterproductive? 459
FUNDAMENTAL ISSUES
What Are the Potential Drawbacks of International Policy Coordination? 462

The Economics of Monetary Unions 462
Optimal Currency Areas 462
How Separate Currencies and a Floating Exchange Rate Can Be Beneficial 463
  A Shift in Relative Demands 463
  A Flexible Exchange Rate 464
  When Could Using a Single Currency Pay Off? 464

POLICY NOTEBOOK
Will North Americans Eventually Use the “Amero” as a Medium of Exchange? 465
Rationales for Separate Currencies 465
  Removal of Currency Competition 465
  Lack of Fiscal Integration 466
Trials and Tribulations of the European Monetary Union 467

ON THE WEB 467
Does the Eurozone Constitute an Optimal Currency Area? 467

POLICY NOTEBOOK
Pros and Cons of an East Asian Monetary Union 468
  Fiscal Crisis and the Euro 468

POLICY NOTEBOOK
When Have Past Currency Unions Collapsed? 470

FUNDAMENTAL ISSUES
Could Nations Gain from Adopting a Common Currency? 470
Vehicle Currencies 470

POLICY NOTEBOOK
Determination of Invoicing Currencies in International Trade 471
The Dollar’s Predominance 471
Evidence Regarding Today’s Vehicle Currencies 471

**FUNDAMENTAL ISSUES**

*What Are Vehicle Currencies?* 473

Splitting the Difference: Exchange-Rate Target Zones 473

Target Zones 473

*Establishing a Target Zone* 473

*The Behavior of the Exchange Rate Inside the Target Zone* 474

Does the Target Zone Model Fit the Facts? 476

*Real-World Evidence* 476

*Salvaging the Target Zone Theory* 476

**FUNDAMENTAL ISSUES**

*What Is an Exchange-Rate Target Zone?* 477

Chapter Summary 477

Questions and Problems 479

Online Applications 480

Selected References and Further Readings 480

GLOSSARY 483

INDEX 493