Outline

• Overshooting, again
• Fixed exchange rates
• Challenge I: The US deficit
• Challenge II: China’s trade surplus
Overshooting, Again

R = R_w
M_0/P_0 = 1

T
M_1/P_0 = 1.5

R < R_w
M_1/P_t > M_0/P_0

t = \infty, R = R_w
M_1/P_{\text{Final}} = M_0/P_0
Price Adjustment

- An increase in the money supply eventually causes prices to rise.
- The price level will increase by the amount of the original increase in the money supply.
- The real exchange rate will return to normal so that the nominal exchange rate $E$ will depreciate by the amount of the increase in the price level.
- In the long run, money is neutral.
Price Adjustment

• An increase in government spending eventually causes an upward adjustment in prices
  – The reduction in real balances raises interest rates and further reduces investment and net exports.
  – Output returns to potential output, and the sum of investment and net exports declines by exactly the amount of the increase in government spending.
  – The real exchange rate and the real interest rate are permanently higher after the process is complete.
12.8 STABILIZING THE EXCHANGE RATE

• How might U.S. policy be changed to stabilize the exchange rate?
• The Fed would have to keep the interest rate constant by setting a horizontal LM curve.
• It would not be able to use monetary policy to achieve other goals such as stability of GDP and prices.
FIGURE 12.7 Effect of a Spending Shock and a Foreign Shock under Exchange-Rate Stabilization (top)
FIGURE 12.7 Effect of a Spending Shock and a Foreign Shock under Exchange-Rate Stabilization (bottom)
The exchange rate, price level, and monetary policy for an economy in the long run are related by

\[ PE = P_w \] (12.8)

- Equation 12.8 says that *purchasing power parity* holds in the long run.

Given an exchange-rate target \( E \), we can solve Equation 12.8 for the price level needed to achieve that exchange rate:

- \( P = \frac{P_w}{E} \) (12.9)
US Trade Deficit

Log real value of USD, broad, lagged 2 years [left scale]

Net Exports/GDP ex. oil

Net Exports/GDP
<table>
<thead>
<tr>
<th>Year</th>
<th>Current Account to GDP</th>
<th>Net Int'l Investment Position to GDP</th>
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<td>1980</td>
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US Net Indebtedness

- Current Account to GDP (left scale)
- Net Int'l Investment Position to GDP (right scale)
China in Perspective

US trade deficit (bn $/mo)

US-China trade deficit (not seasonally adjusted)
The Renminbi vs. USD, vs. RoW

USD/CNY (official) [right scale]

Log Trade Weighted CNY (BIS) [left scale]