

Public Affairs 854
**Macroeconomic Policy and
International Financial Regulation**

Lecture 15
3/15/2021

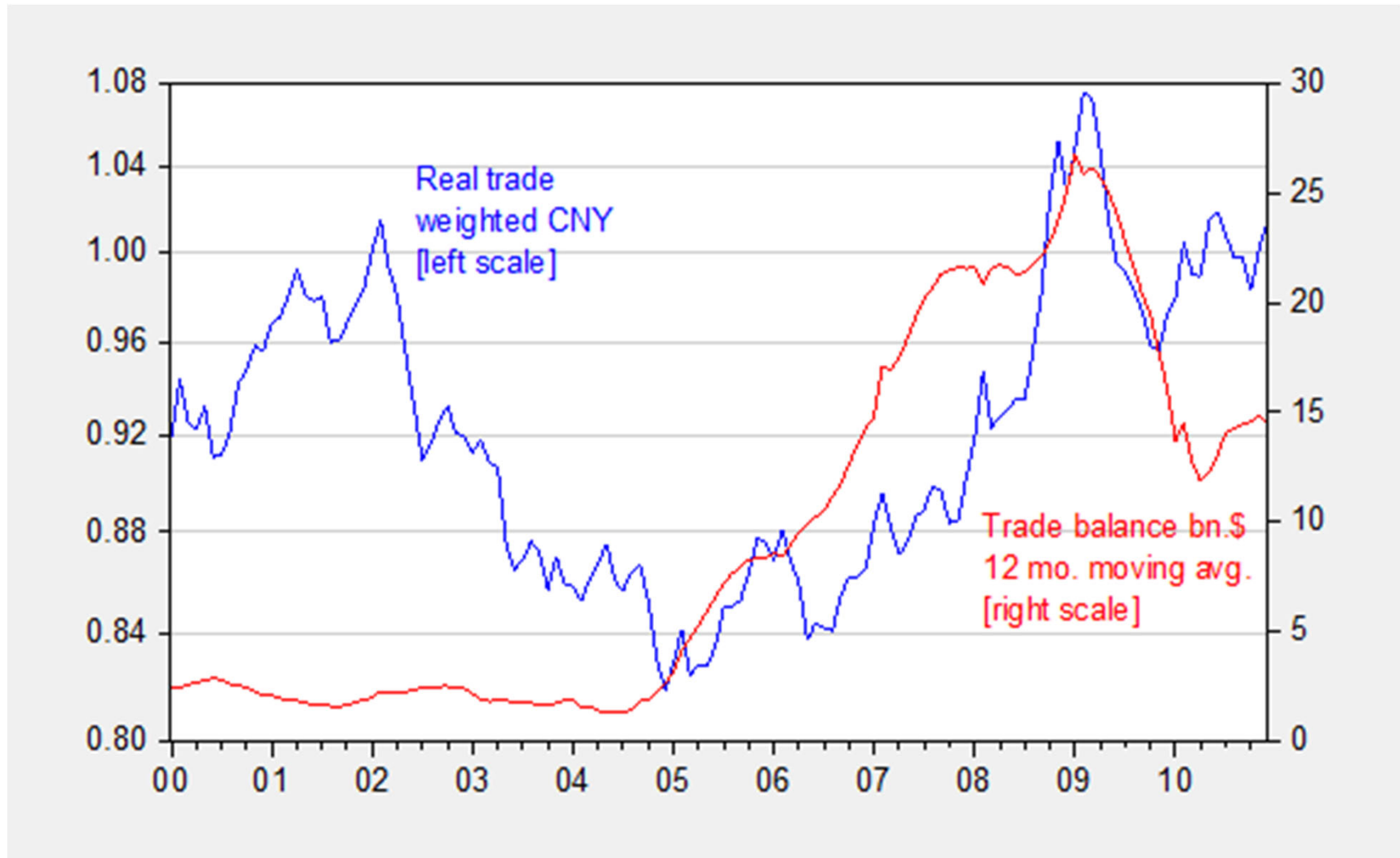
Prof. Menzie Chinn
La Follette School of Public Affairs
Spring 2021

Outline

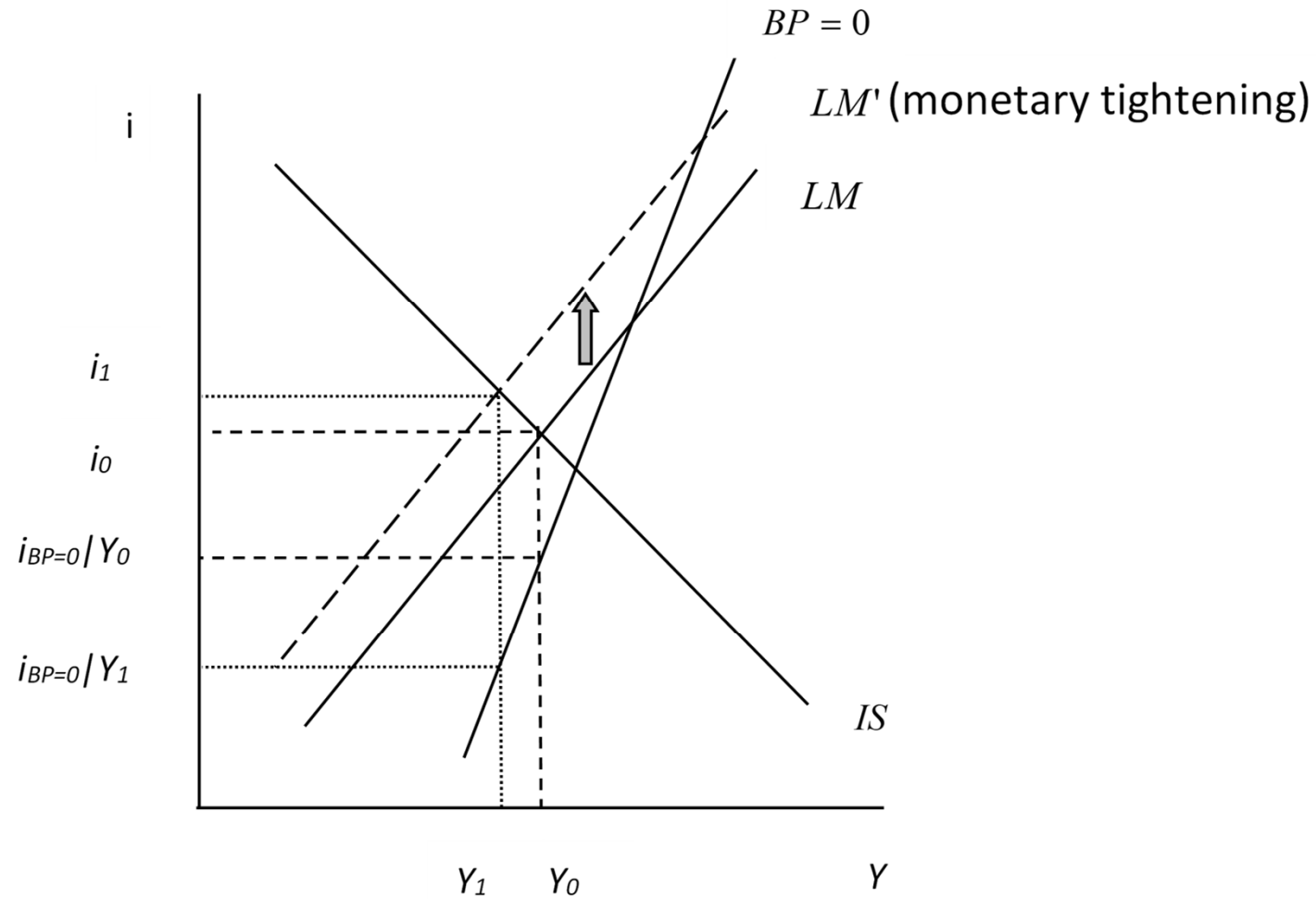
- China's Balance of Payments in 2000's
- Mundell-Fleming or IS-LM-BP=0 under Floating Exchange Rates
- The Trilemma

China's Balance of Payments in the 2000's

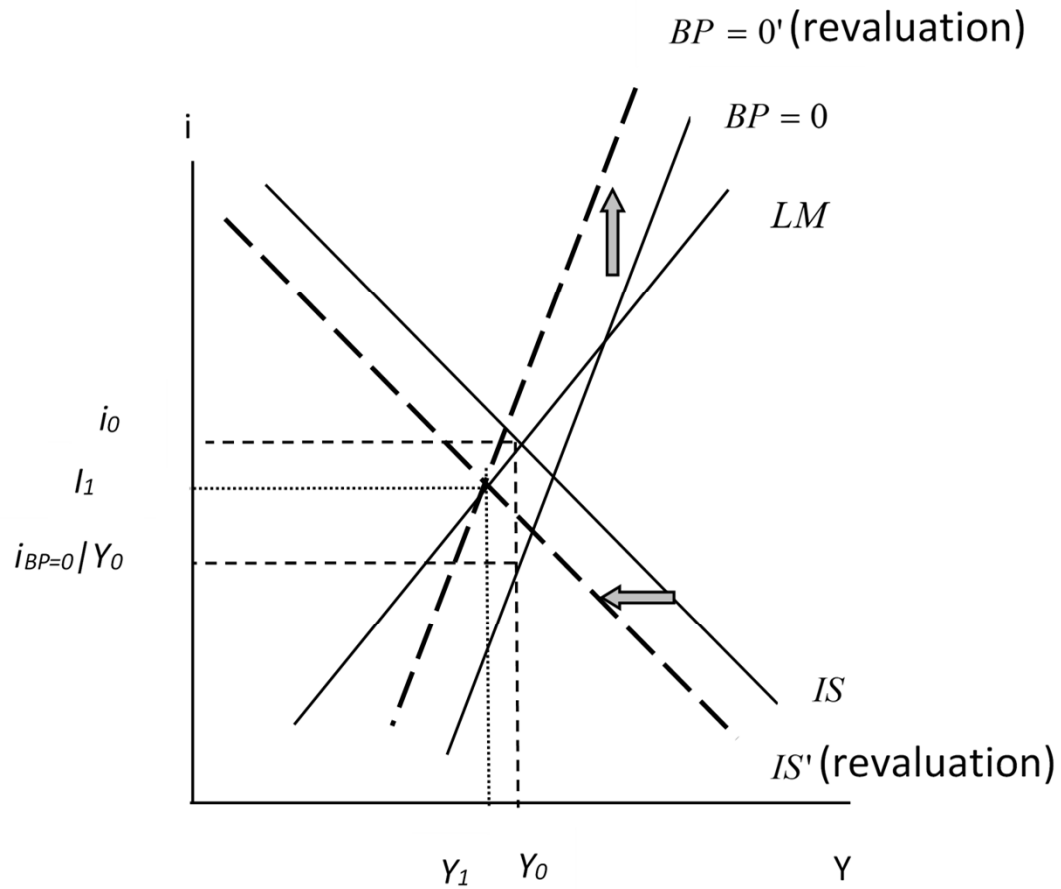
Too Much of a Good Thing?



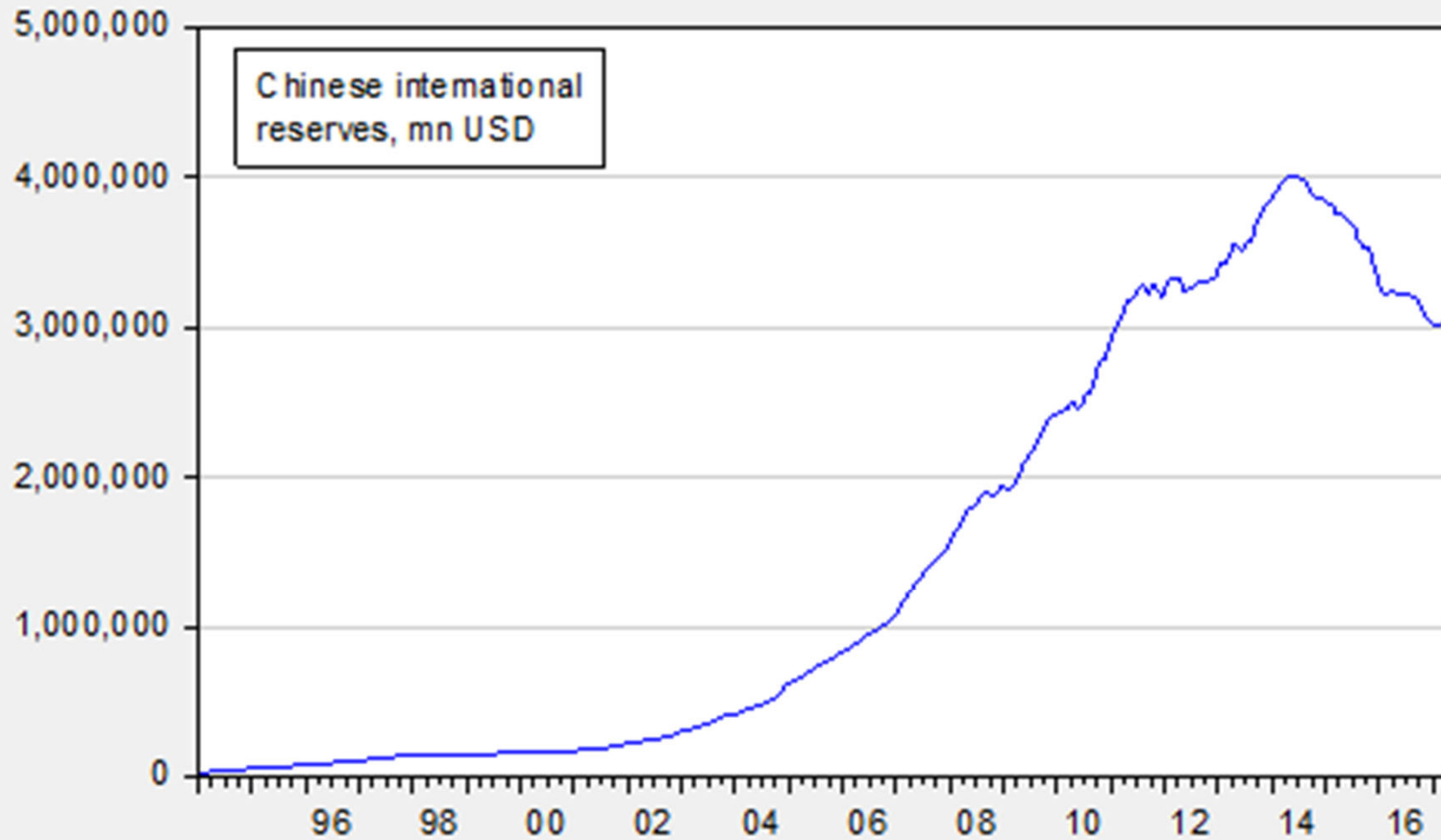
2004-05: Fear of Overheating



China Revalues



Reserves Continue to Accumulate



Mundell-Fleming under Floating Exchange Rates

Derivation

$$(14.9) \quad CA + FA + ORT \equiv 0$$


Simplify: no F, V

$$(14.10) \quad TB + FA = 0$$

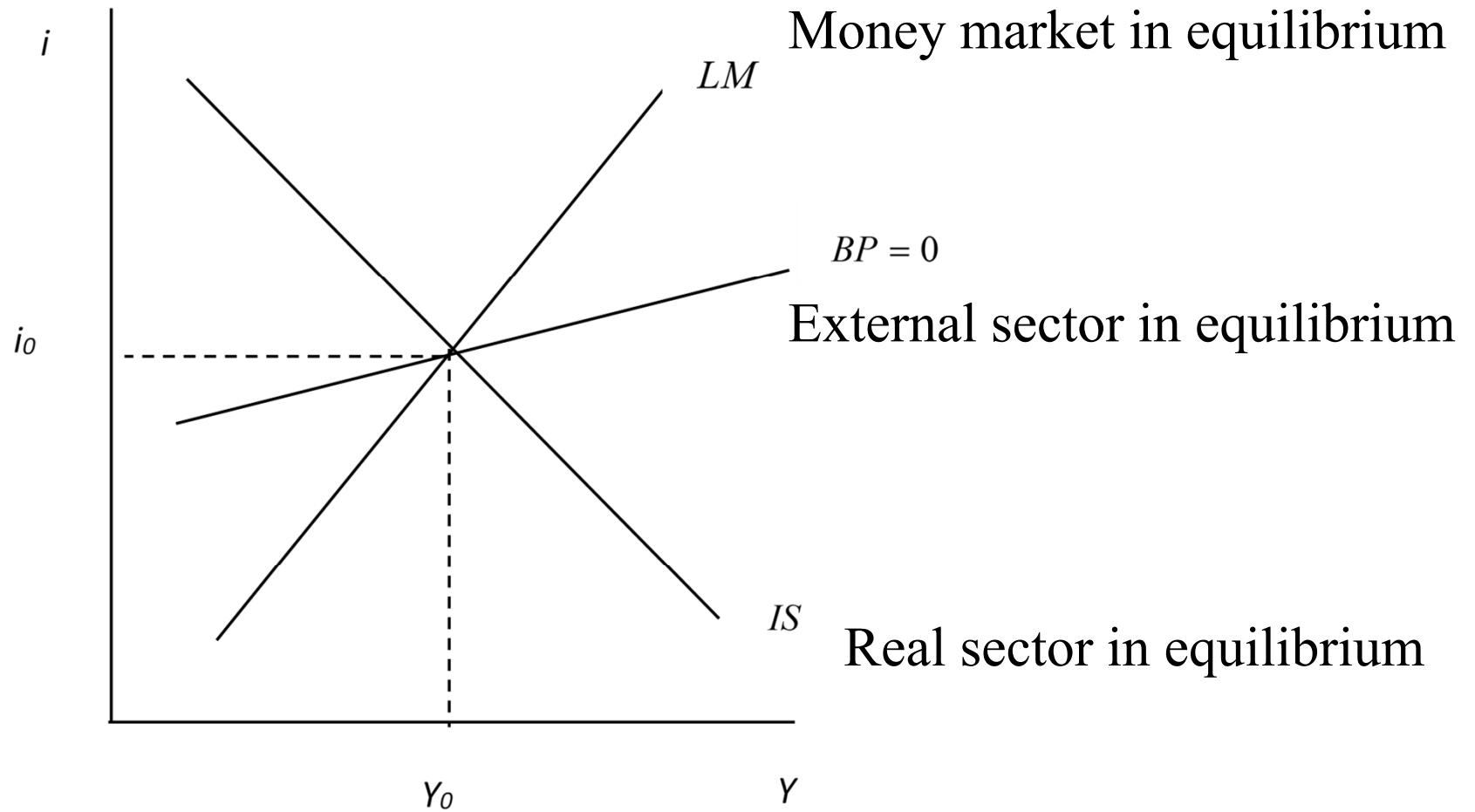
$$(14.11) \quad FA = \overline{FA} + \kappa(i - \bar{i}^*)$$

We now let q float –
No “bar” implies its
endogenous

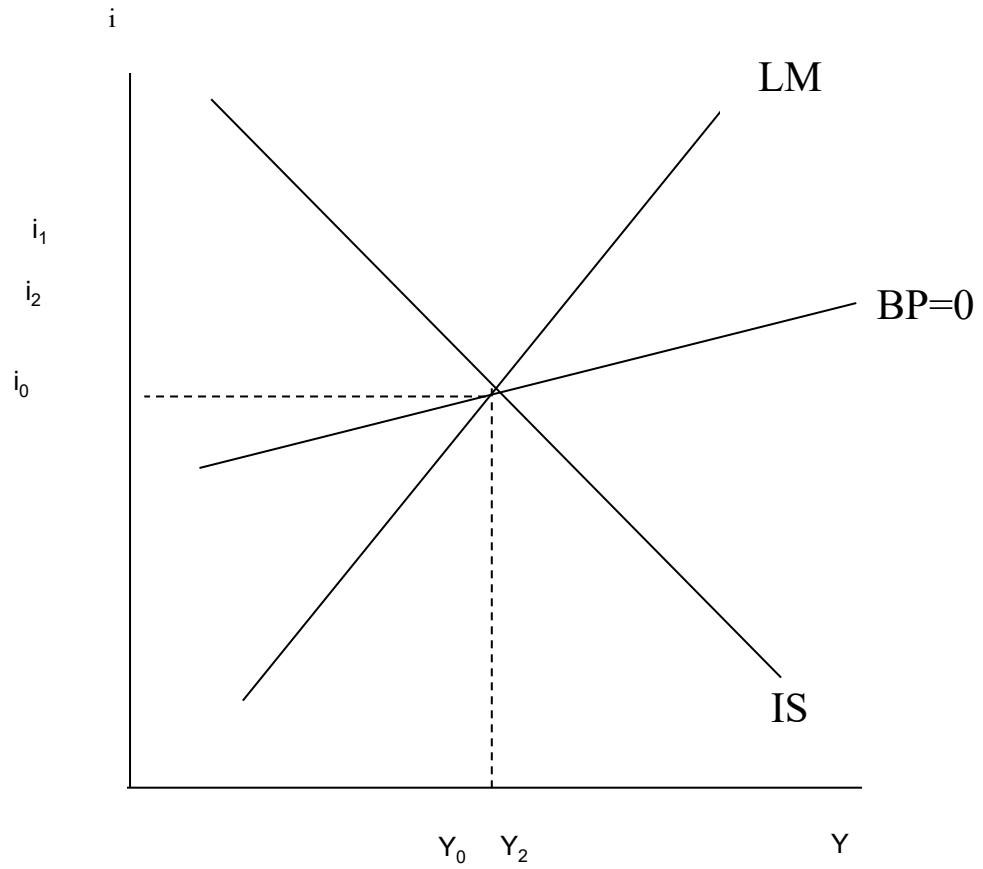
Substitute into 14.10, solve for interest rate

$$(14.12) \quad i = -\left(\frac{1}{\kappa}\right) [(\bar{X} - \overline{IM} + \overline{FA}) + (n + v)q] + \bar{i}^* + \left(\frac{m}{\kappa}\right) Y$$


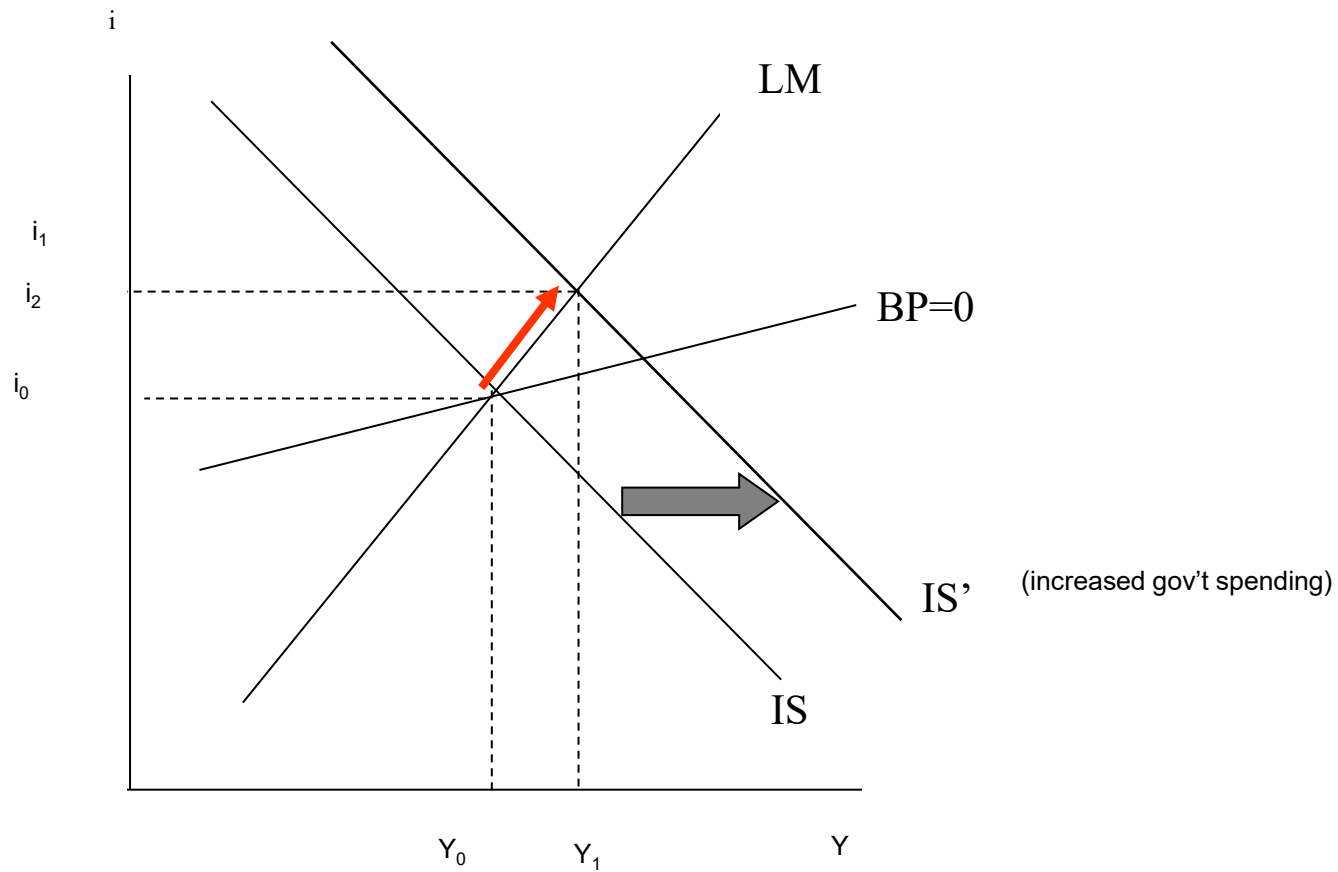
Mundell-Fleming



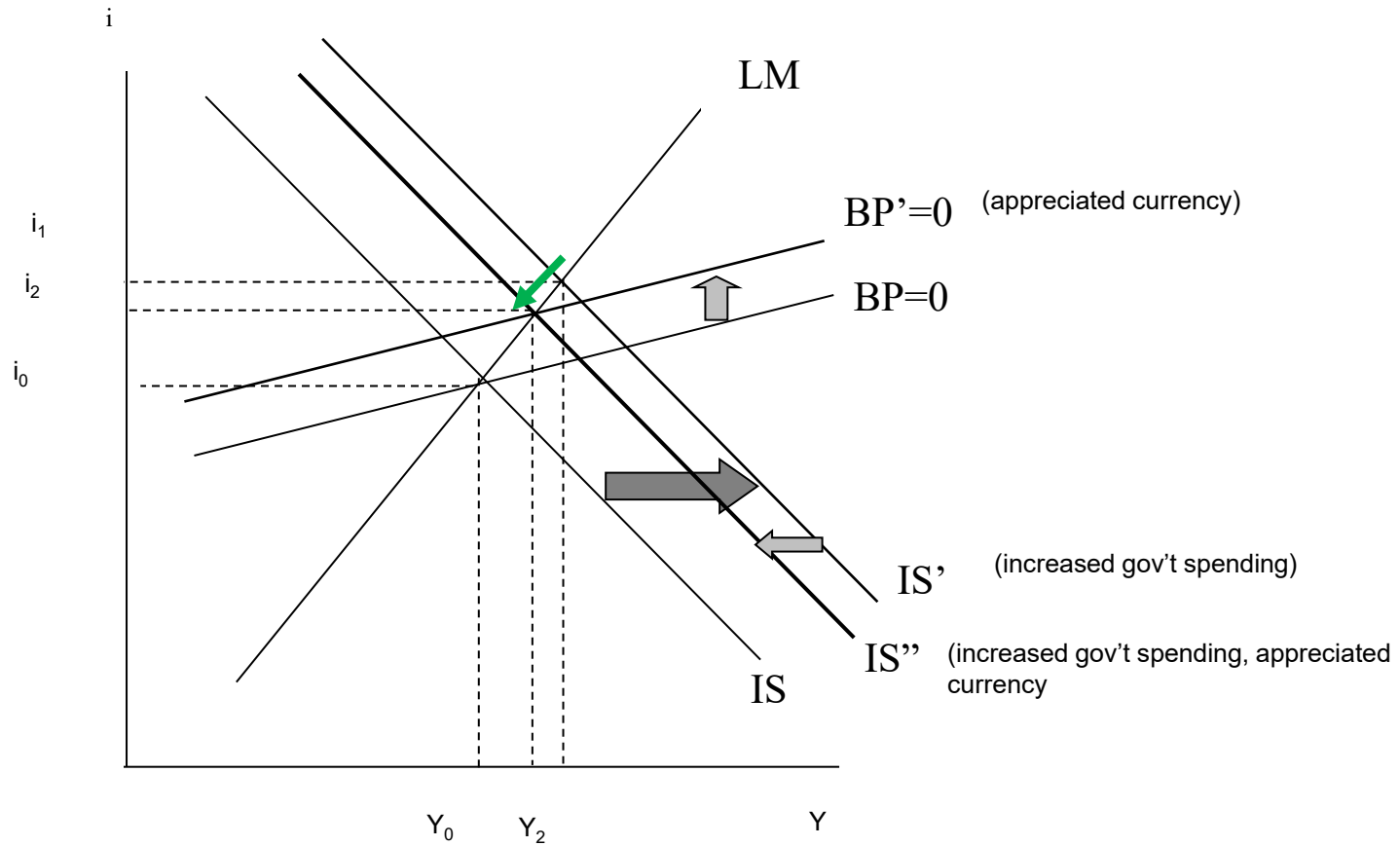
Fiscal Policy under Floating



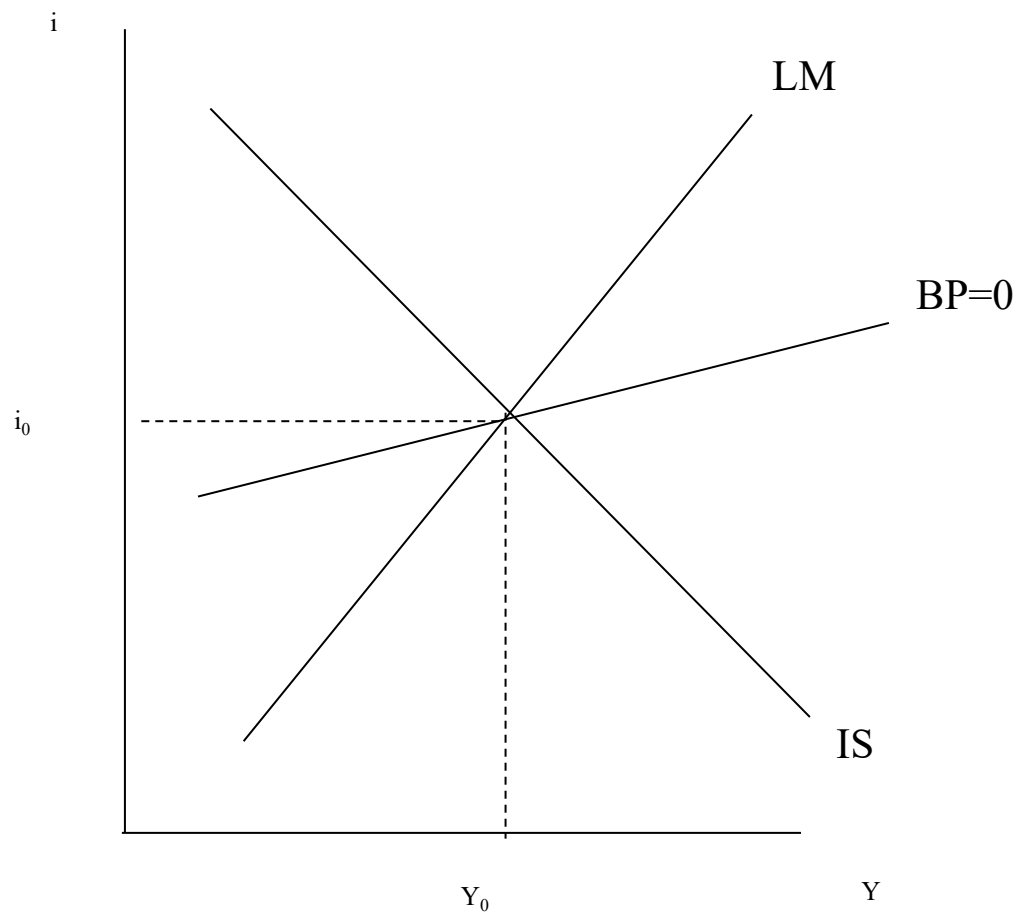
Fiscal Policy under Floating



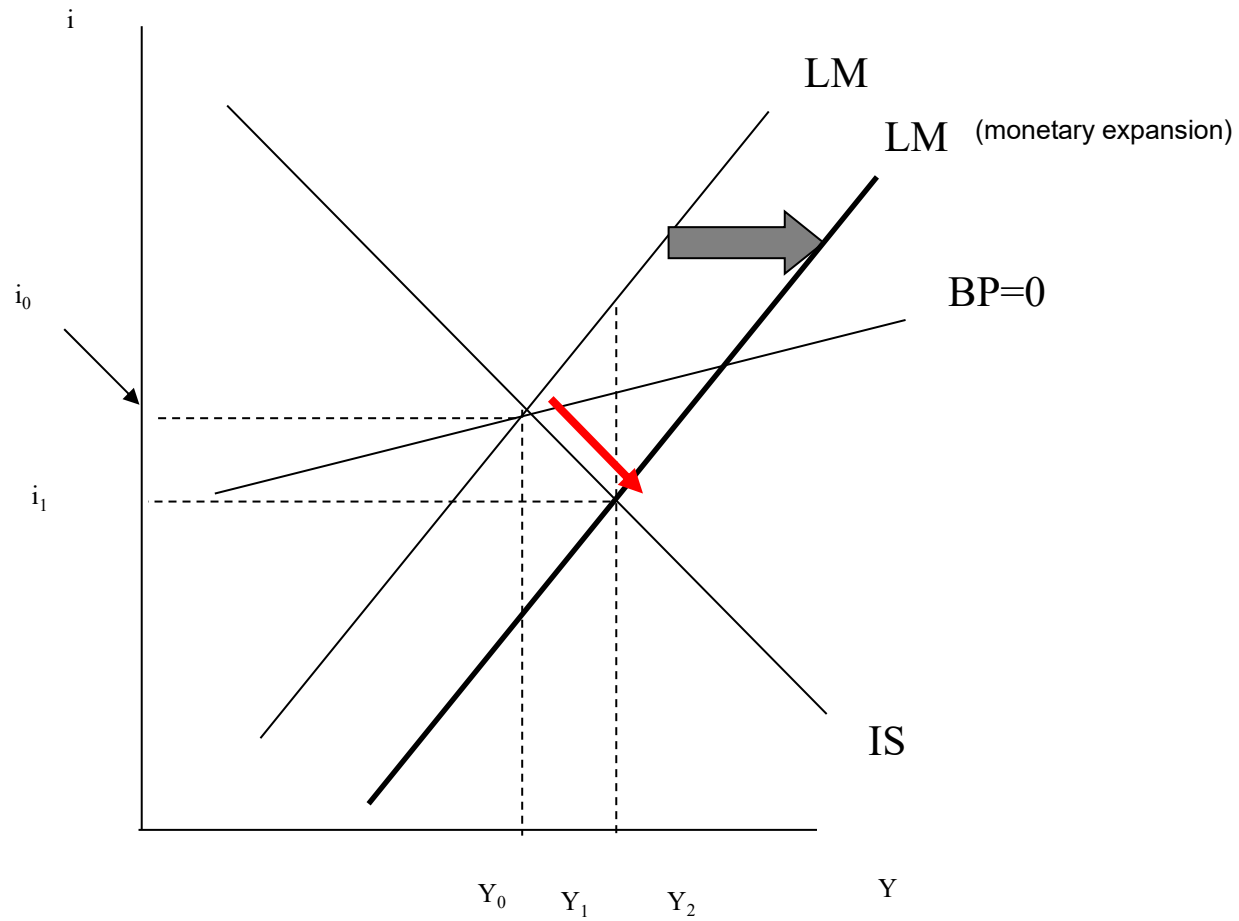
Fiscal Policy under Floating



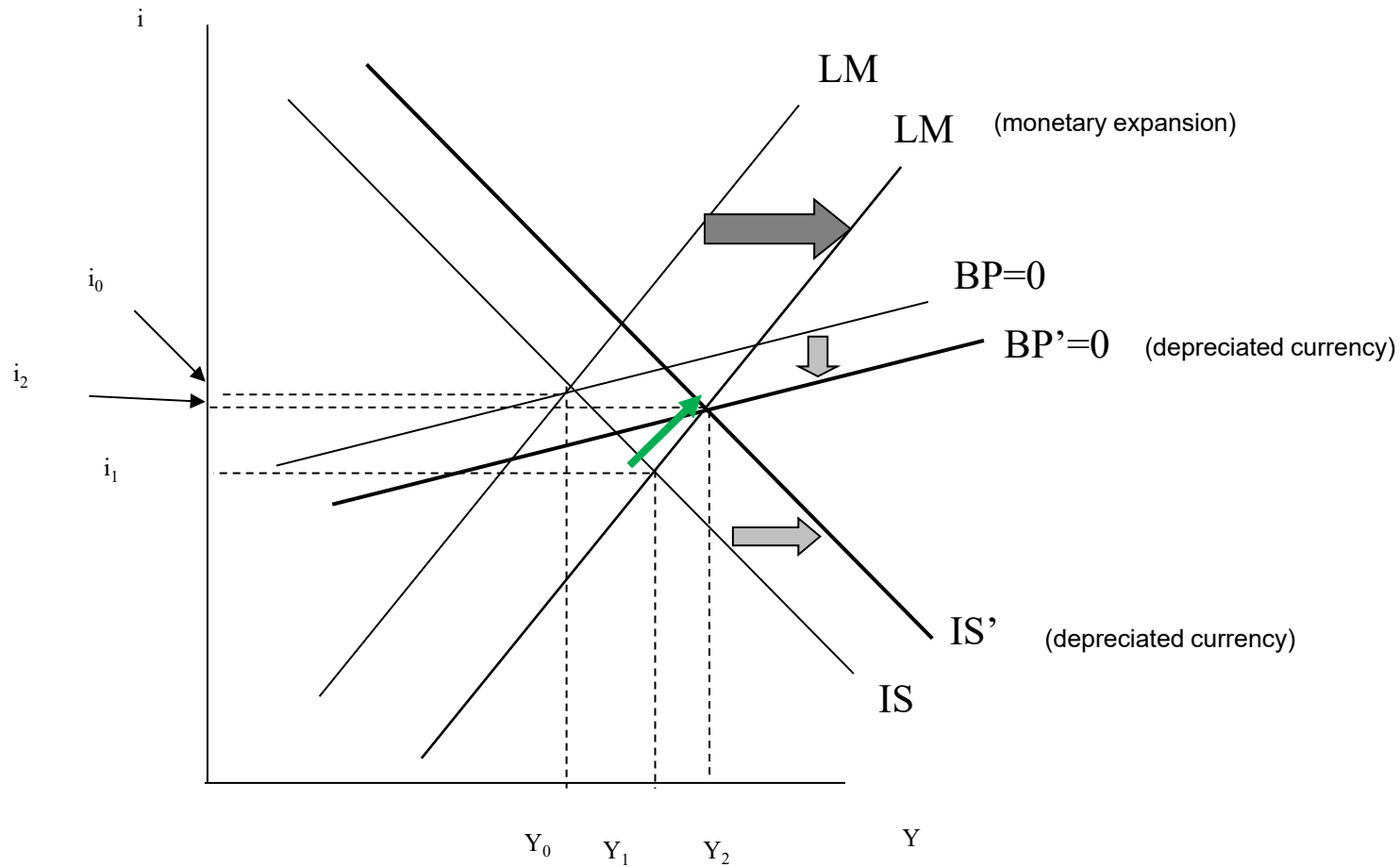
Monetary Policy under Floating



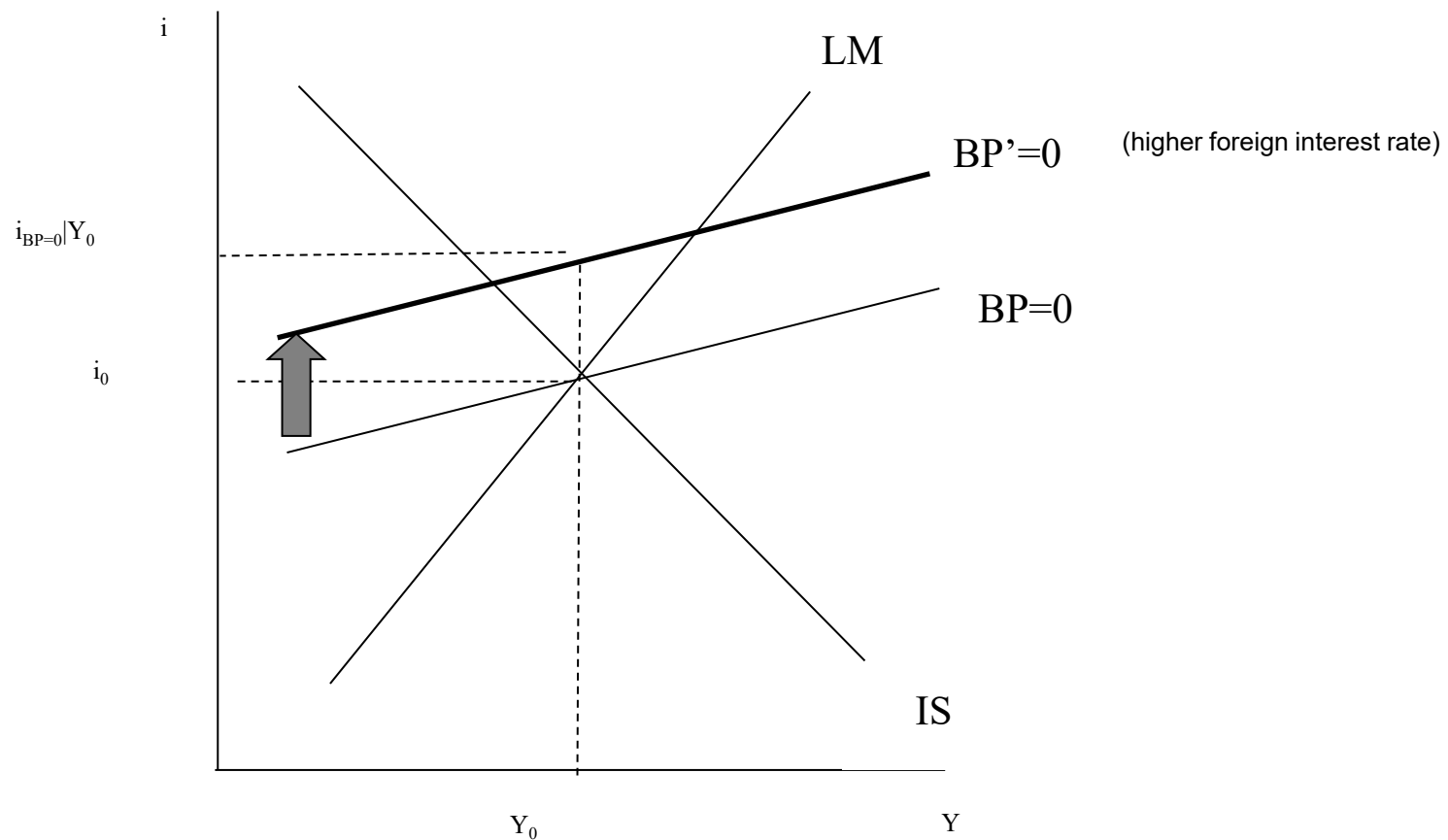
Monetary Policy under Floating



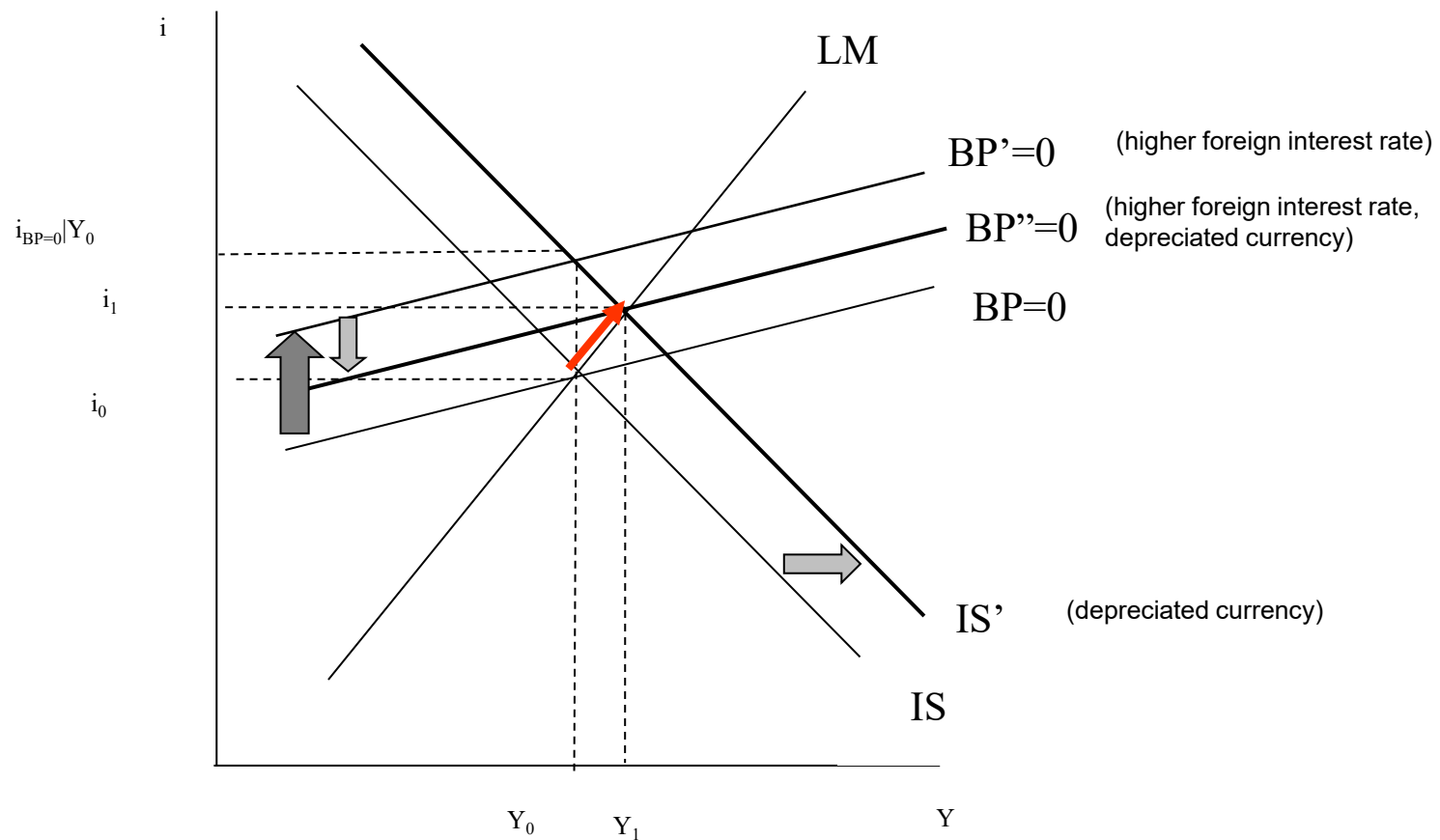
Monetary Policy under Floating



(Foreign) Interest Rate Shocks



(Foreign) Interest Rate Shocks

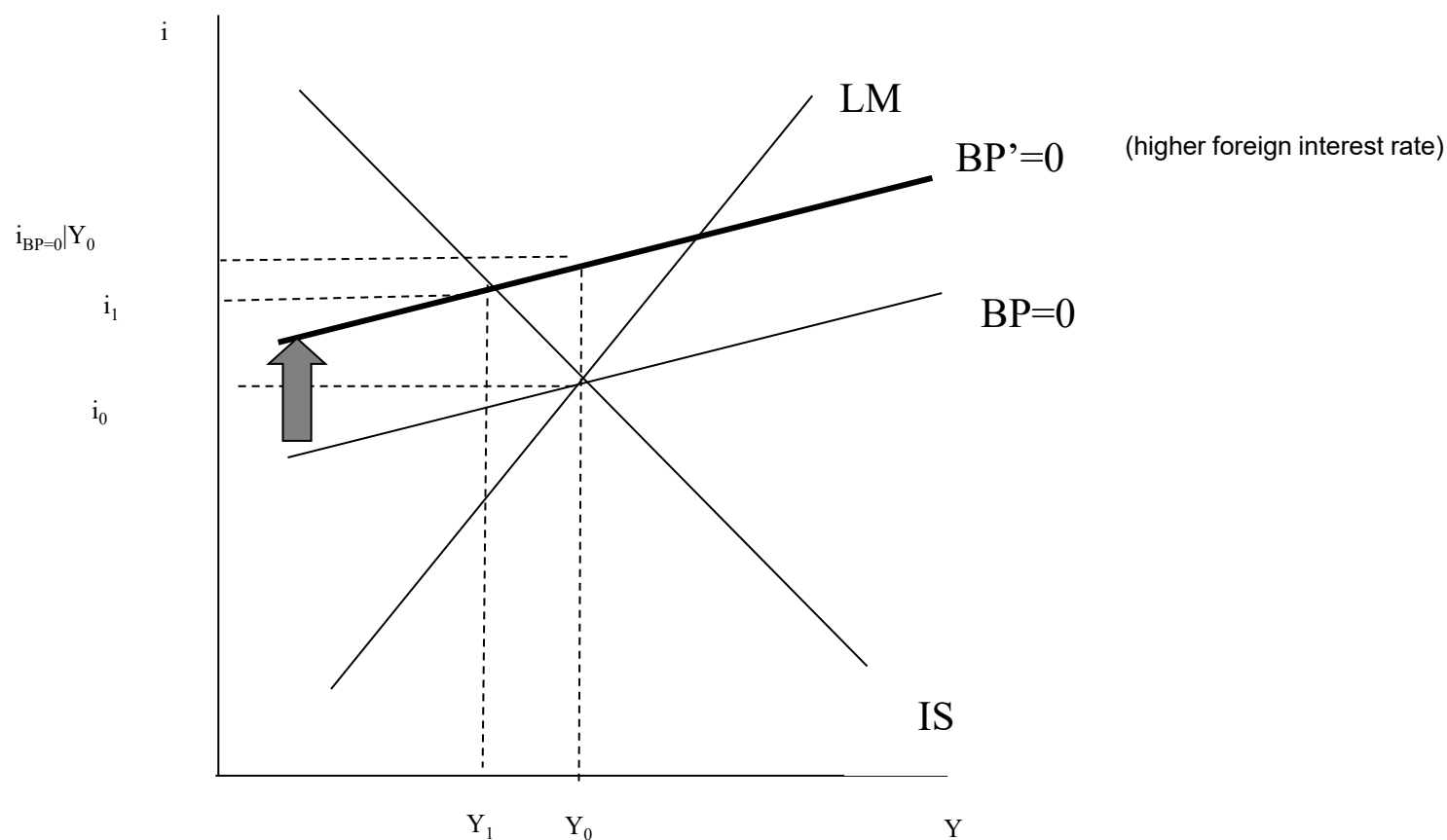


(Foreign) Interest Rate Shock

- Counter-intuitively, induces increases in income
- As the exchange rate depreciates, spurs expenditure switching
- But this assumes floating rates, *and* central bank desire to *not* stabilize the exchange rate
- What if it does want to stabilize the exchange rate

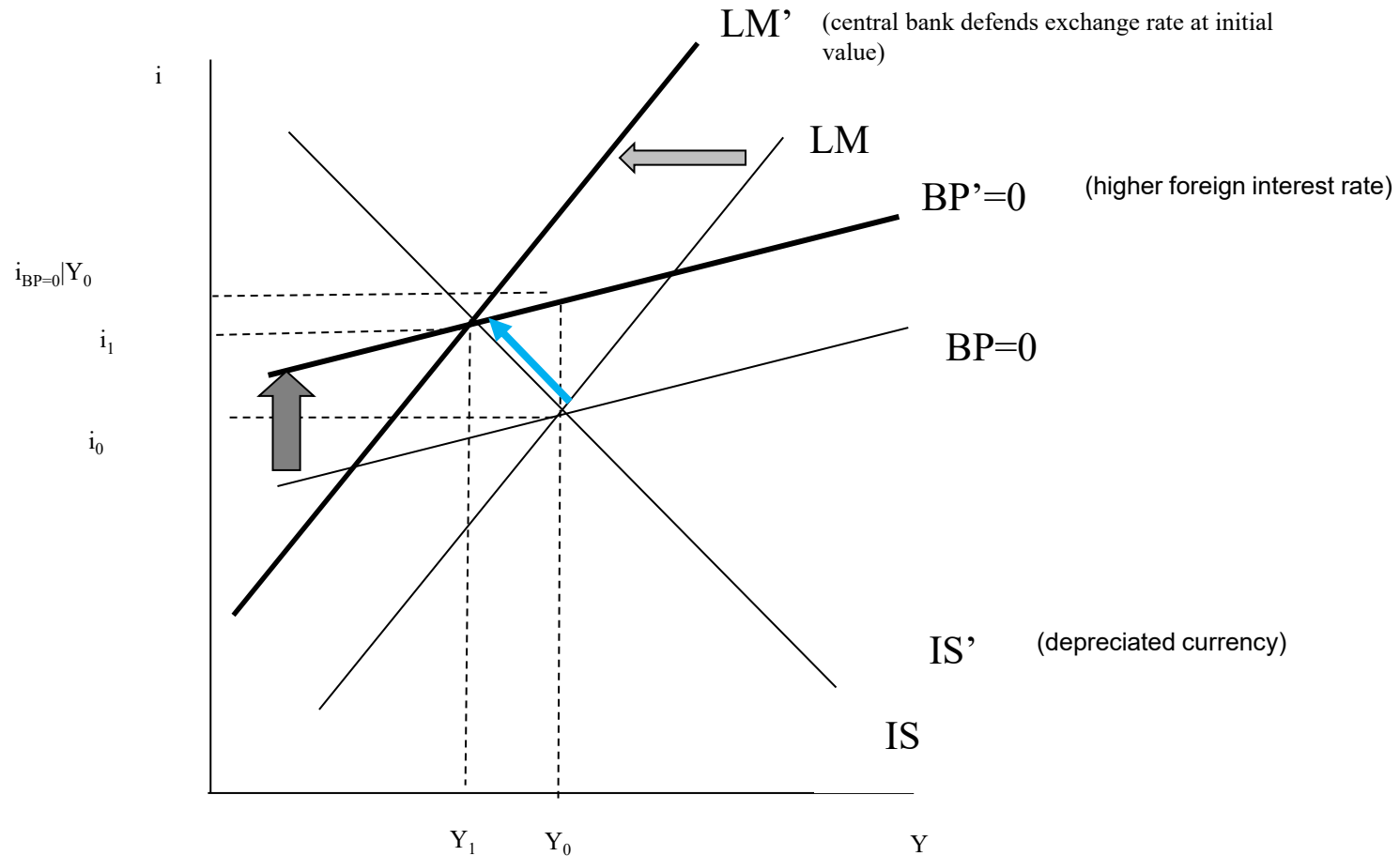
(Foreign) Interest Rate Shocks

(Central Bank wants to stabilize exchange rate)



(Foreign) Interest Rate Shocks

(Central Bank wants to stabilize exchange rate)



Interest Rate Defense

- Maintains the exchange rate at initial value
- But induces a contraction in the economy
- So the interest rate defense is not costless

Conclusions

- Develop model of entire economy for short run
- Real, money, external sectors
- Under *floating* exchange rates
- Fiscal policy is less effective (exchange rate appreciates)
- Monetary policy is more effective (exchange rate depreciates)
- Notice these are inverse of what occurs under fixed rates

Next Lecture

- Summarizing Fixed/Flexible
- The Impossible Trinity/The Trilemma