

# Core Macroeconomics

Hillary Term 2008

## Week 7: The Open Economy

### Reading

When considering the exchange rate, governments must choose which two of the following trinity they prefer: independence of monetary policy; freedom from exchange controls; a stable exchange rate. This issue is of great policy relevance given the recent arrival of Euro notes and coins across Euroland. Chapter 9 of Carlin & Soskice (2006) and Krugman (1989)\*\* provide an enjoyable introduction to this issue, with Burda & Wyplosz (2005) chapters 7, 19 and 20 and Mankiw (2005) chapters 5 and 12 providing the basic material. Krugman & Obstfeld (2006) chapters 12-17 cover the topic thoroughly. Pierce & Tysome (1985) chapter 10 gives a nice overview of older material. Taylor (1995)\*\* and chapter 2 of Sarno & Taylor (2003) provide a good review of exchange rate theory, which may be of interest as further reading. The Autumn 1998 issue of OXREP contains a number of articles on EMU, including a good piece on institutions by Maclennan, Muellbauer & Stephens (1998)\*\*. Crafts & Woodward (1991) chapter 5 provides a UK historical perspective.

Take notes on:

1. The nominal and real exchange rate, the terms of trade
2. Domestic Absorbtion and the Balance of Payments
3. Devaluation, the Marshall-Lerner Condition, and the J-Curve
4. Purchasing Power Parity and Interest Parity
5. The Overshooting Model
6. Speculative attacks and exchange rate crises
7. The case for, and against, EMU.

### Essay

**A:** "Tighter fiscal policy weakens the exchange rate, tighter monetary policy strengthens it." Is this a reliable guide for policy makers? (2005)

**B:** How do varying degrees of capital mobility affect the choice between monetary and fiscal policy under floating exchange rates? (2003)

### References

- Burda, M. & Wyplosz, C. (2005), *Macroeconomics: A European Text*, Oxford Univeristy Press.
- Carlin, W. & Soskice, D. (2006), *Macroeconomics: Imperfections, Institutions and Policies*, Oxford University Press.
- Crafts, N. & Woodward, N. (1991), *The British Economy since 1945*, Clarendon Press, Oxford.
- Krugman, P. (1989), 'The case for stabilizing exchange rates', *Oxford Review of Economic Policy* 5(3), 61–72.
- Krugman, P. R. & Obstfeld, M. (2006), *International Economics : Theory and Policy*, 7th edn, Pearson Addison-Wesley, Boston, Mass. ; London.
- Maclennan, D., Muellbauer, J. & Stephens, M. (1998), 'Asymmetries in housing and financial market institurions and emu', *Oxford Review of Economic Policy* 14(3), 54–80.
- Mankiw, N. G. (2005), *Macroeconomics*, Worth Publishers.
- Pierce, D. & Tysome, P. (1985), *Monetary Economics, 2nd edition*, Butterworths.
- Sarno, L. & Taylor, M. P. (2003), *The Economics of Exchange Rates*, Cambridge University Press.
- Taylor, M. P. (1995), 'The economics of exchange rates', *Journal of Economic Literature* 33(1), 13–47.