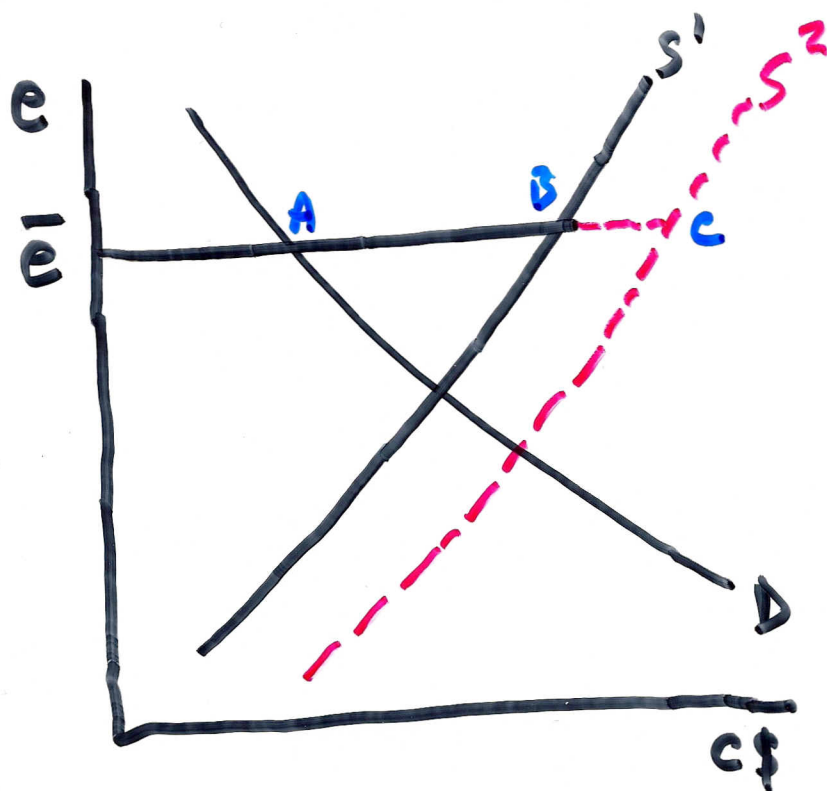


Currency Crises

- In practice, most fixed exchange rate regimes eventually collapse.
- This happens when market participants lose confidence in the govt's. ability to sustain the peg.
- Loss of confidence can be self-fulfilling.



support for the overvalued ex. rate, $\bar{e}$, requires the govt. to buy its own currency using fx reserves.

If investors suspect the ex. rate will be devalued, they will sell the domestic currency. This shifts the S curve further to the right, to S^2 .

This accelerates the loss of reserves, and makes a devaluation more likely!

Recent Currency Crises

1.) Europe 1992-93

2.) Mexico 1994

3.) Asia 1997

- Thailand, Indonesia, Malaysia, Korea, Phillipines

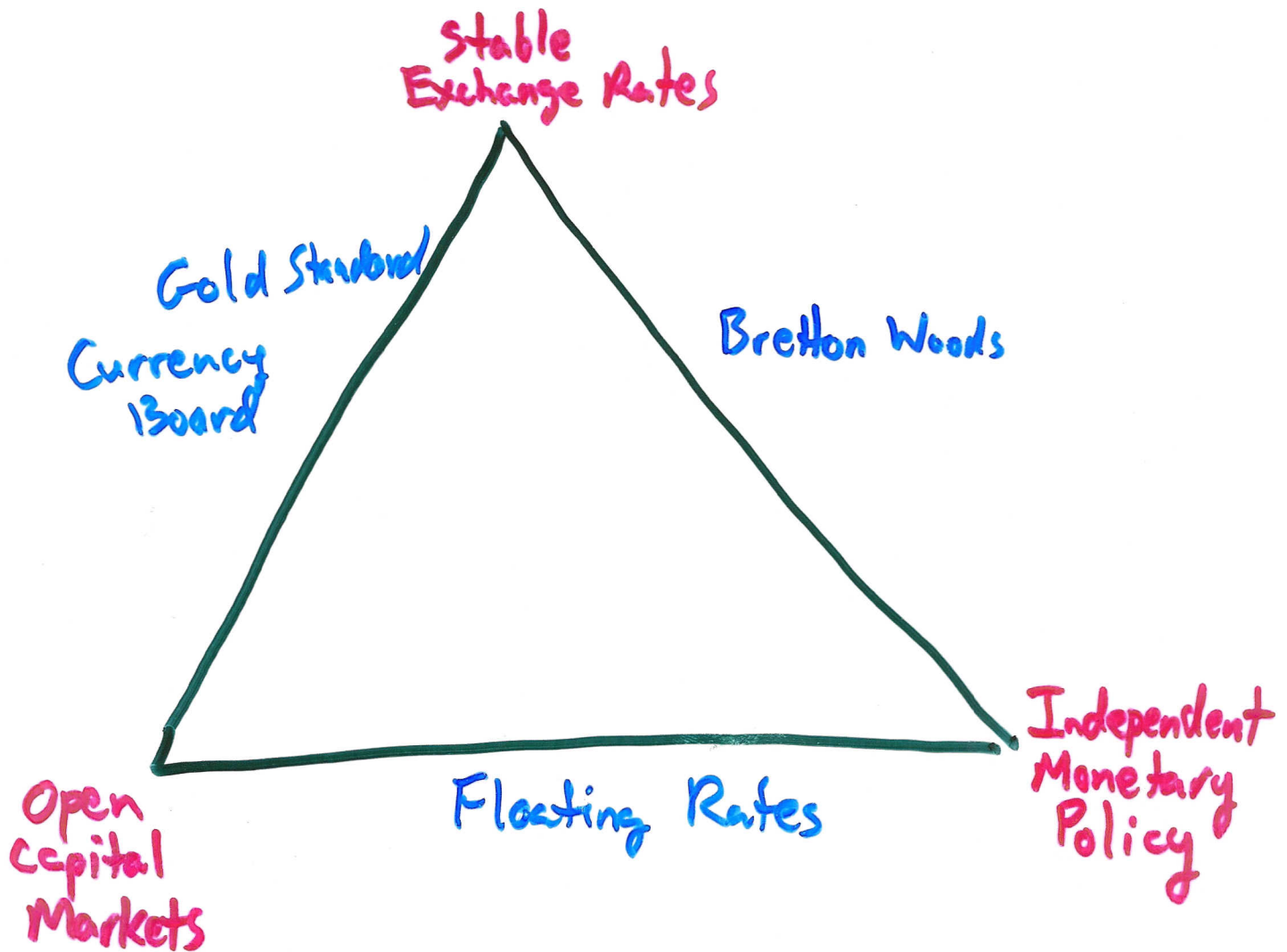
4.) Brazil 1999

5.) Turkey 2000

6.) Argentina 2001

Open-Economy "Trilemma"

or, the "Impossible Trinity"



Examples

Independent Monetary Policy
Open Capital Markets > USA
Canada
Japan
Europe

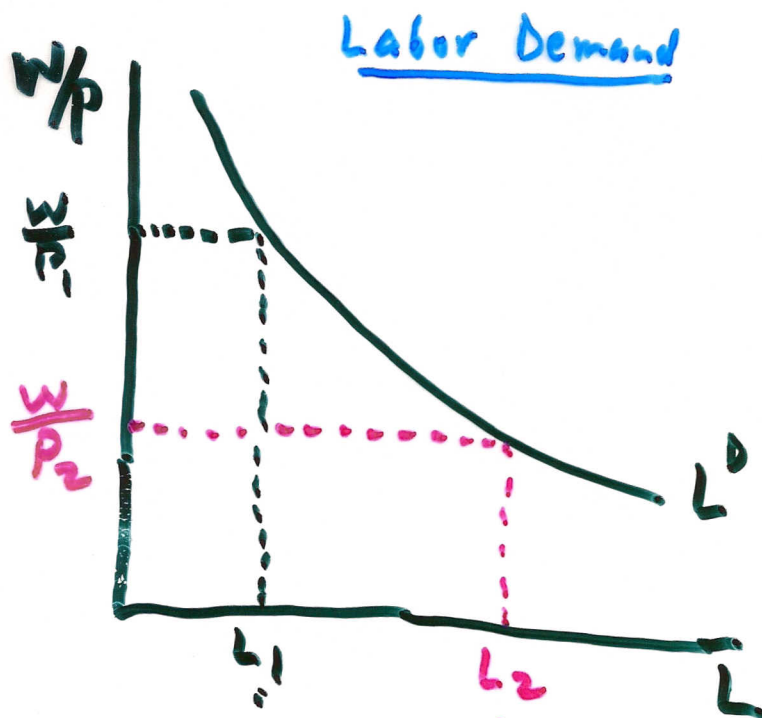
Independent Monetary Policy > China
Stable Exchange Rate

Stable Exchange Rate > Hong Kong
Open Capital Markets Argentina

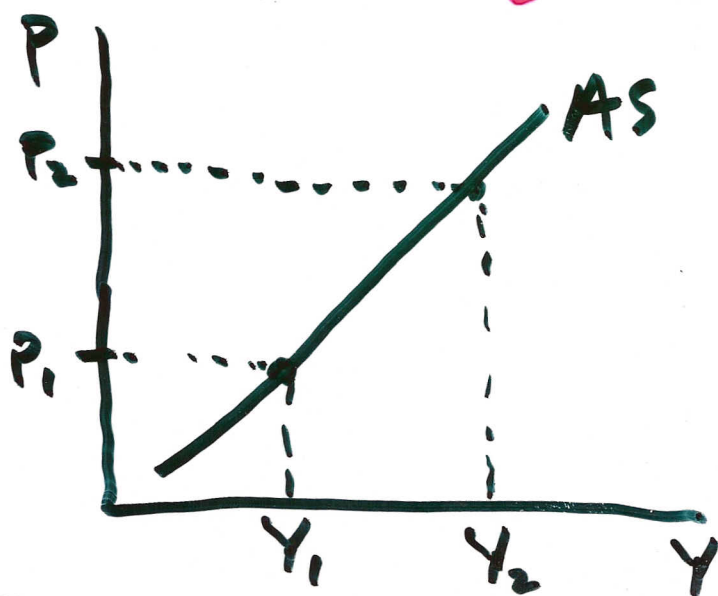
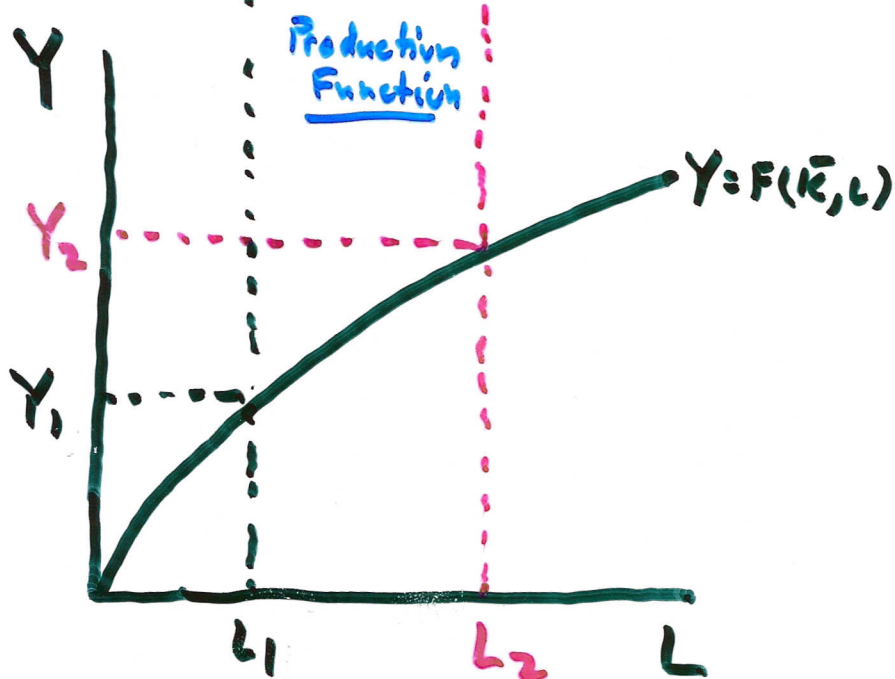
The Keynesian Aggregate Supply Curve

What are the implications of sticky nominal wages for Aggregate Supply?

- 1.) When the nominal wage is fixed, an increase in the price level lowers the real wage.
- 2.) The lower real wage induces firms to hire more labor
- 3.) The additional labor produces more output.



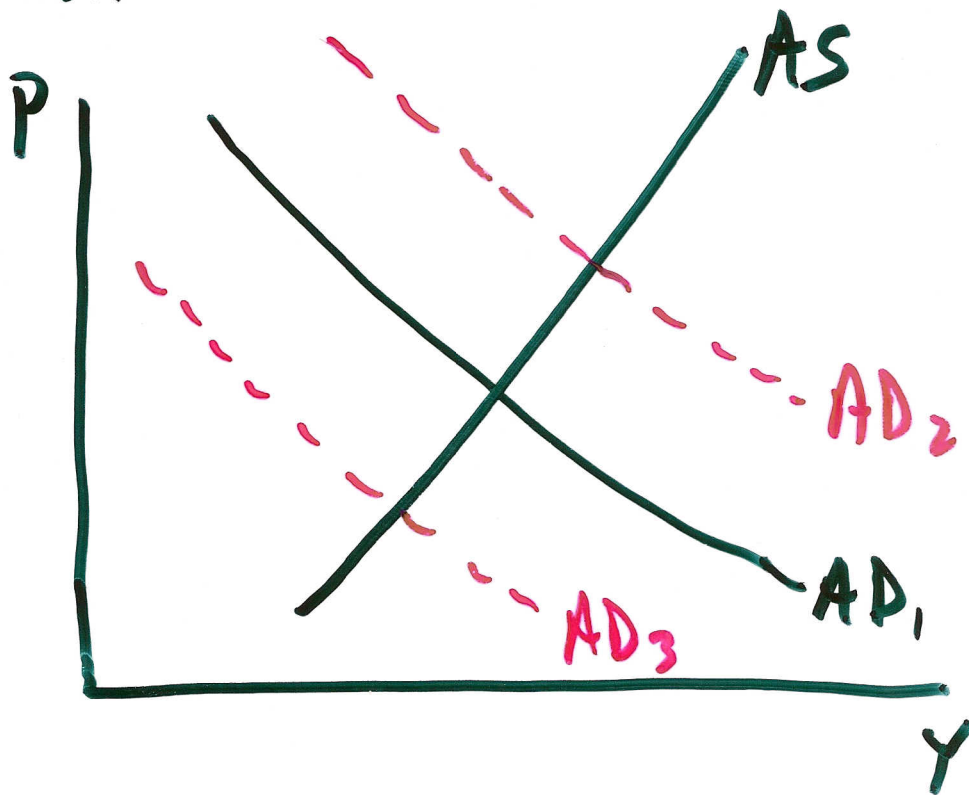
$$P_2 > P_1$$



Aggregate
Supply Curve

Keynesian Business Cycles

According to Keynes, business cycles are caused by fluctuations in Aggregate Demand.



Prediction : There should be a positive correlation between output and the price level

The Phillips Curve

$$P = \alpha Y$$

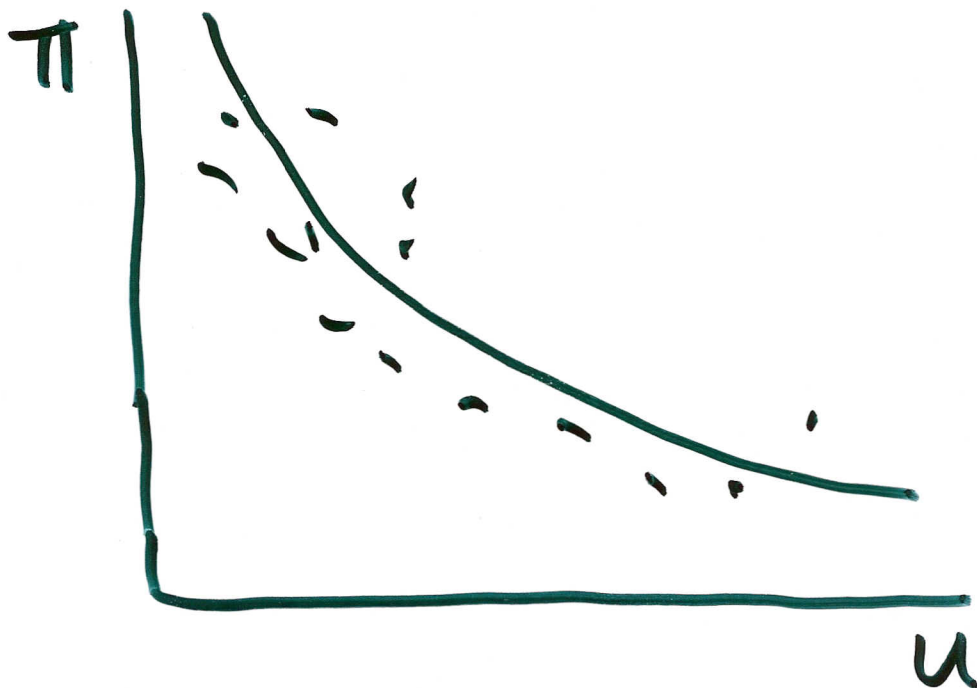
} AS Curve

$$\Delta P = \alpha \Delta Y$$

$$\Delta P = \pi = \text{inflation}$$

$$\Delta Y \approx -2 \Delta u \quad \text{ } \} \text{ Okun's Law}$$

$$\pi = \text{Constant} - 2\alpha \Delta u \quad \text{ } \} \text{ Phillips Curve}$$



2 Problems with the Keynesian Model

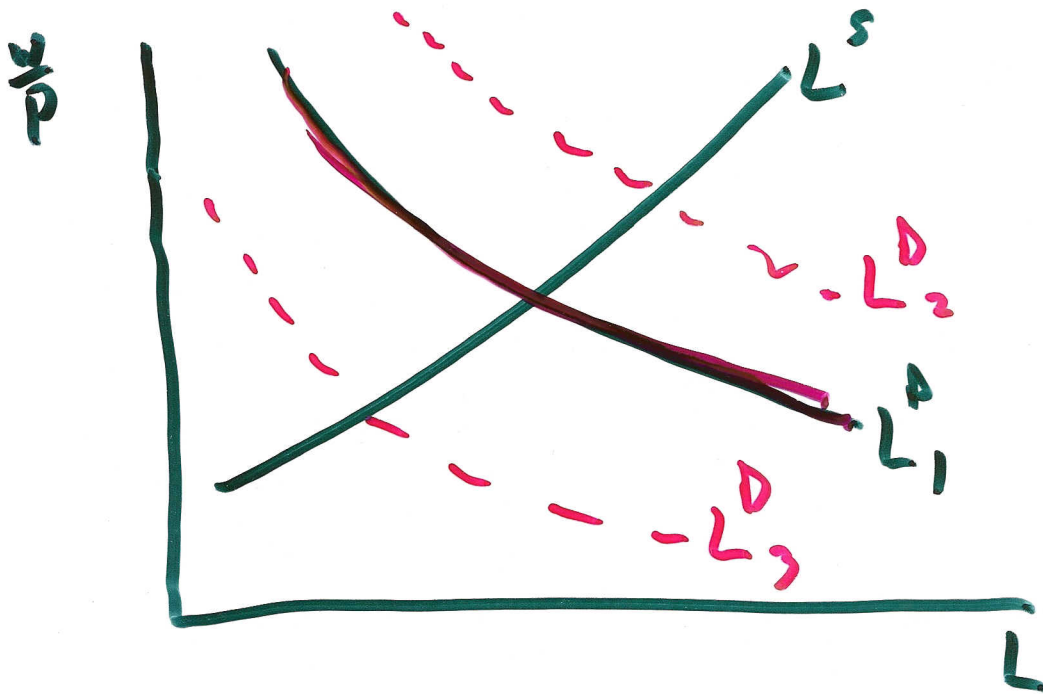
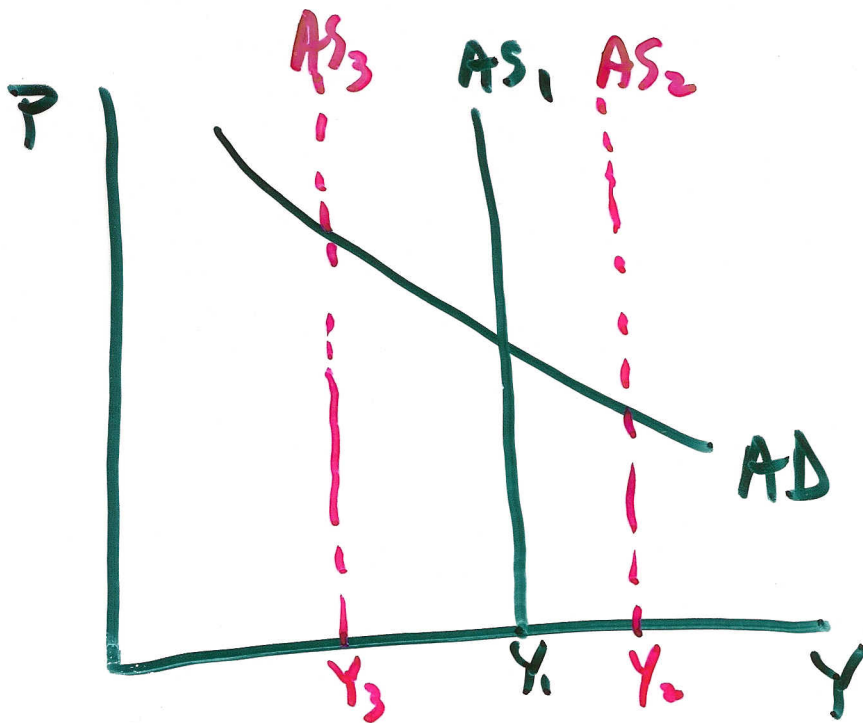
1.) Stagflation (Combination of
↙ high unemployment and high inflation)

Lucas

2.) It predicts real wages and
productivity should be
countercyclical (Contrary
to empirical observations).

→ RBC Model

Real Business Cycles



Solow Residuals as Technology Shocks

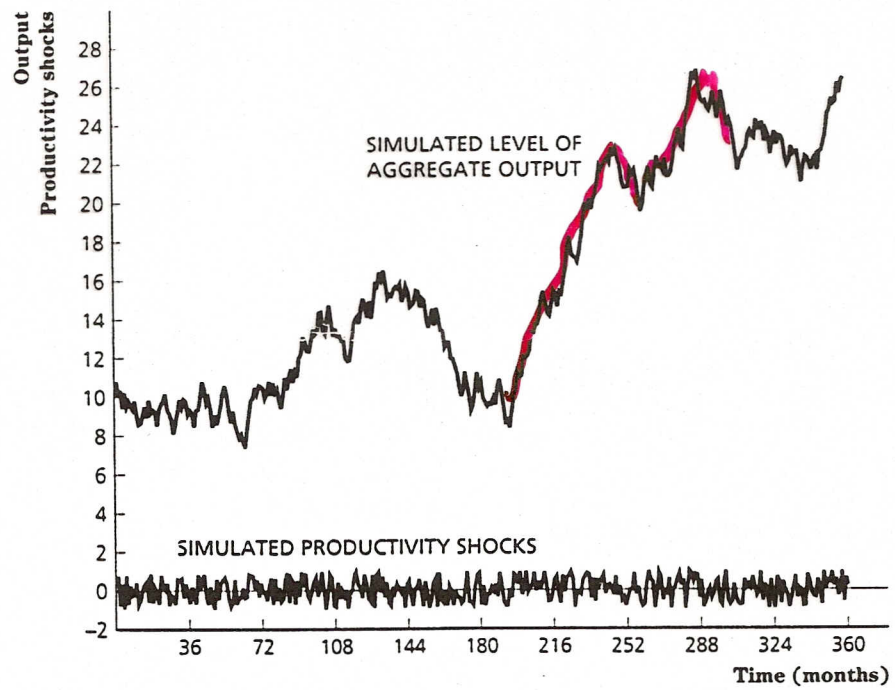
$$Y_t = A_t K_t^\alpha L_t^{1-\alpha}$$

$$\frac{\Delta Y}{Y} = \frac{\Delta A}{A} + \alpha \frac{\Delta K}{K} + (1-\alpha) \frac{\Delta L}{L}$$

$$\frac{\Delta A}{A} = \frac{\Delta Y}{Y} - \alpha \frac{\Delta K}{K} - (1-\alpha) \frac{\Delta L}{L}$$

✓

Measured
Solow
Residual



$$Y_t = .01 + Y_{t-1} + \varepsilon_t$$

