

Topics for Today

- 1.) The Effects of Monetary & Fiscal Policies on the Current Account
- 2.) The J-Curve
- 3.) Pass-Through and Pricing-to-Market
- 4.) DD-AA vs. IS-LM

Summary of the DD-AA Model

	<u>Monetary Expansion</u>	<u>Fiscal Expansion</u>
Temporary	$M \uparrow$, AA shifts out $R \downarrow$, $E \uparrow$ $NX \uparrow$, $Y \uparrow$	$G \uparrow$, $T \downarrow$ DD shifts out $R \uparrow$, $E \downarrow$, $NX \downarrow$, $Y \uparrow$
Permanent	$E^e \uparrow$, AA shifts out more $R \downarrow$, $E \uparrow$, $NX \uparrow$, $Y \uparrow$ <u>Long-Run Adjustment</u> $P \uparrow$, $E \uparrow$ by same percentage amount as M . No change in Y , R , or NX .	$E^e \downarrow$, DD shifts out AA shifts down $E \downarrow$, $NX \downarrow$ more No change in Y <u>Long-Run Adjustment</u> Not needed!

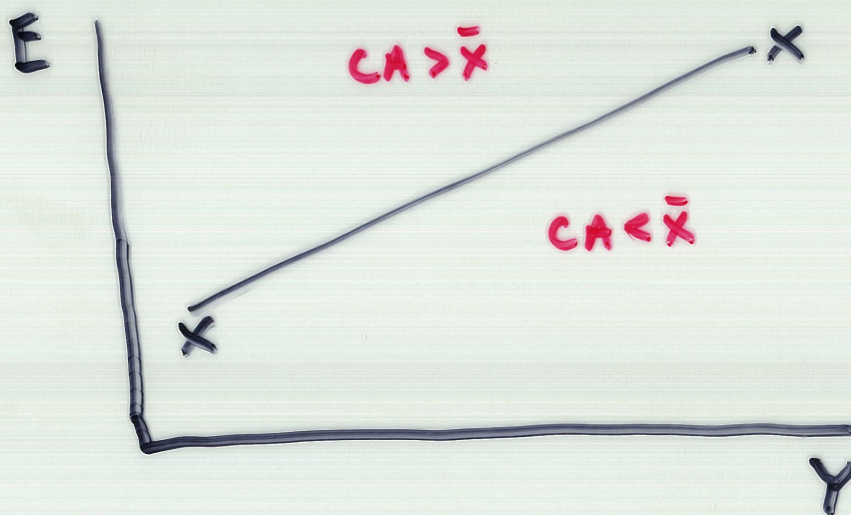
Macroeconomic Policy and the Current Account

Policy makers often care about the level of the current account.

- 1.) CA deficit $\Rightarrow$ Borrowing from foreigners
May not be able to pay back
- 2.) CA surplus $\Rightarrow$ Lending to foreigners
May not get paid back!

How do monetary + fiscal policies affect the Current Account?

$$\bar{X} = CA(\bar{Y}, \frac{EP^*}{P})$$

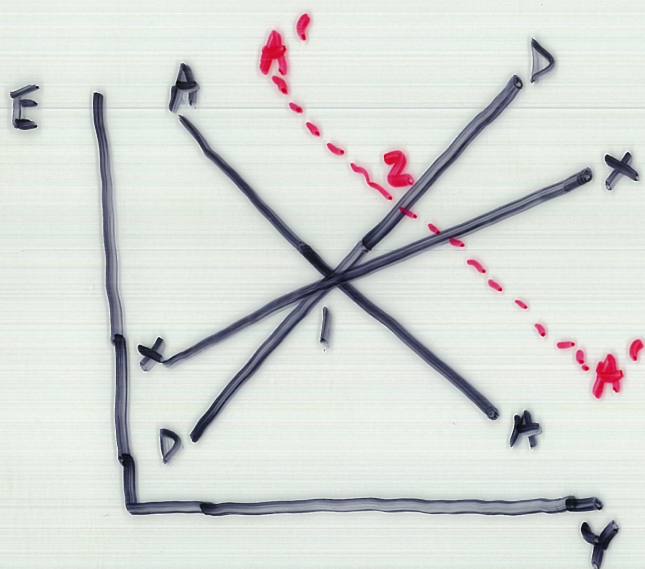


Combos of (E, Y) consistent with a constant CA

Key Point : XX must be flatter than DD
Why?

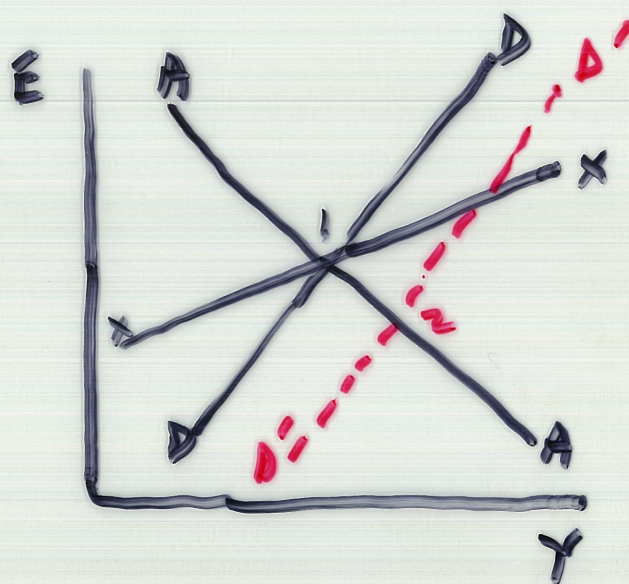
Because NXT as you move up along
the DD curve

Monetary



Expansionary Monetary
Policy "~~improves~~"
the Current Account

Fiscal



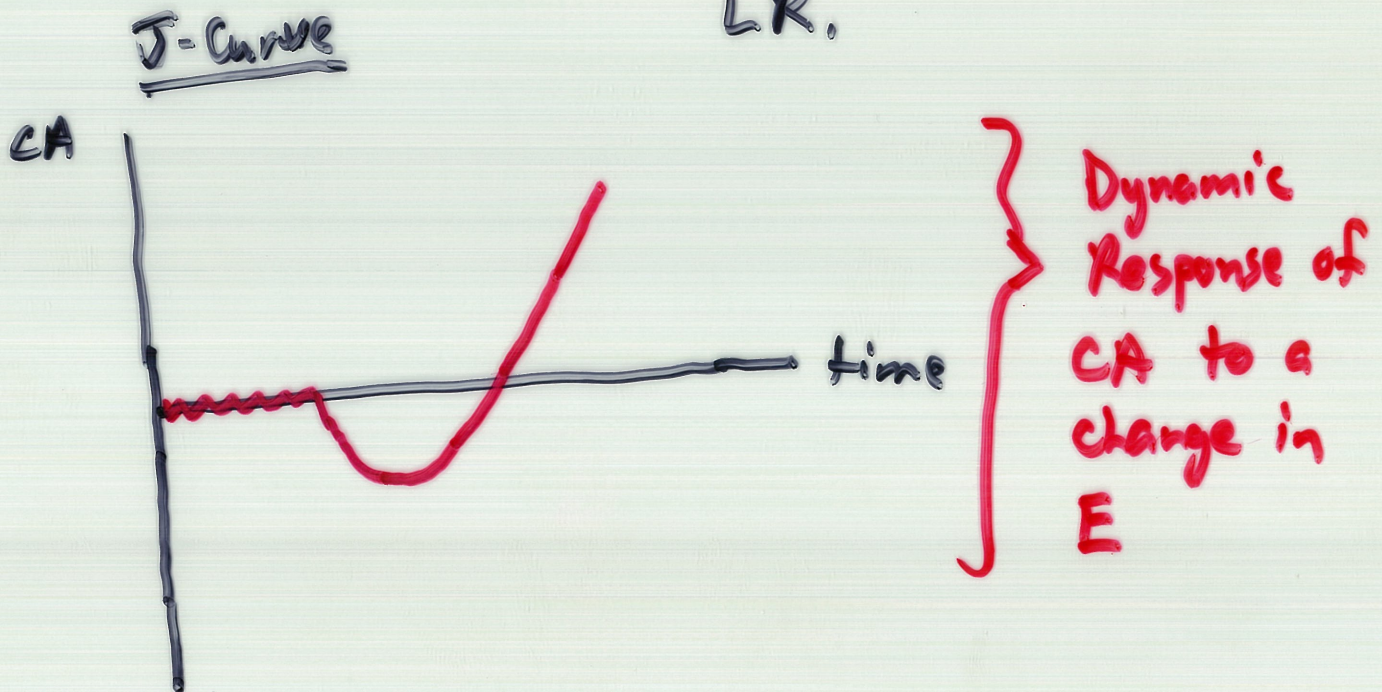
(Temporary) Fiscal
Expansion "worsens"
the Current Account

J-Curve

The values of η^* and η depend on the time horizon.

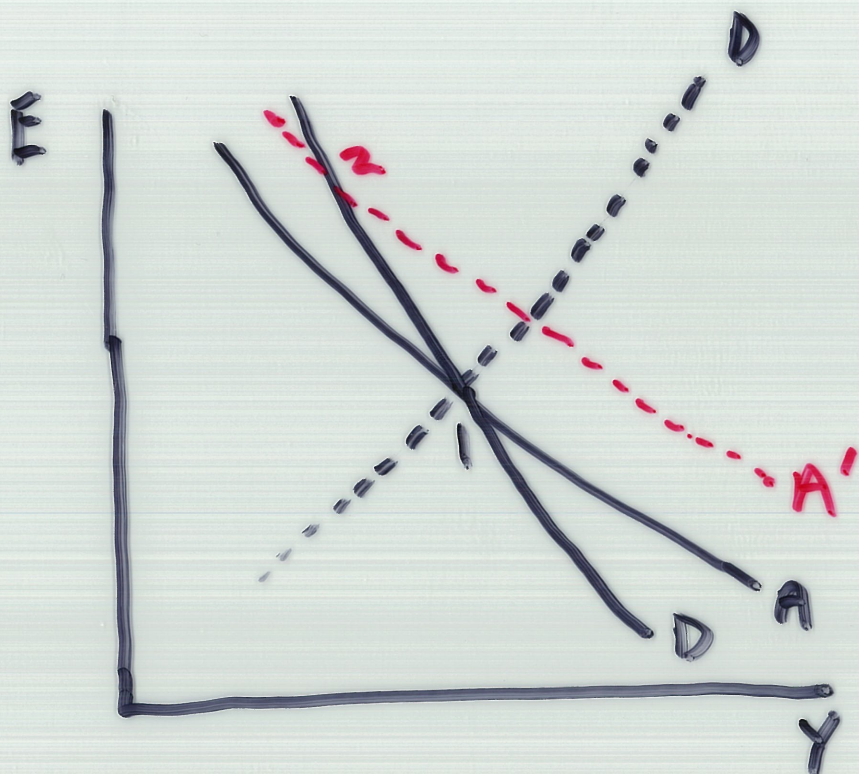
Elasticities tend to increase over time. It takes awhile to find substitutes and to switch expenditure patterns.

Empirical Observation: In the SR (less than a year) Marshall-Lerner not satisfied, but it is satisfied in the LR.



DD-AA Model with J-Curve

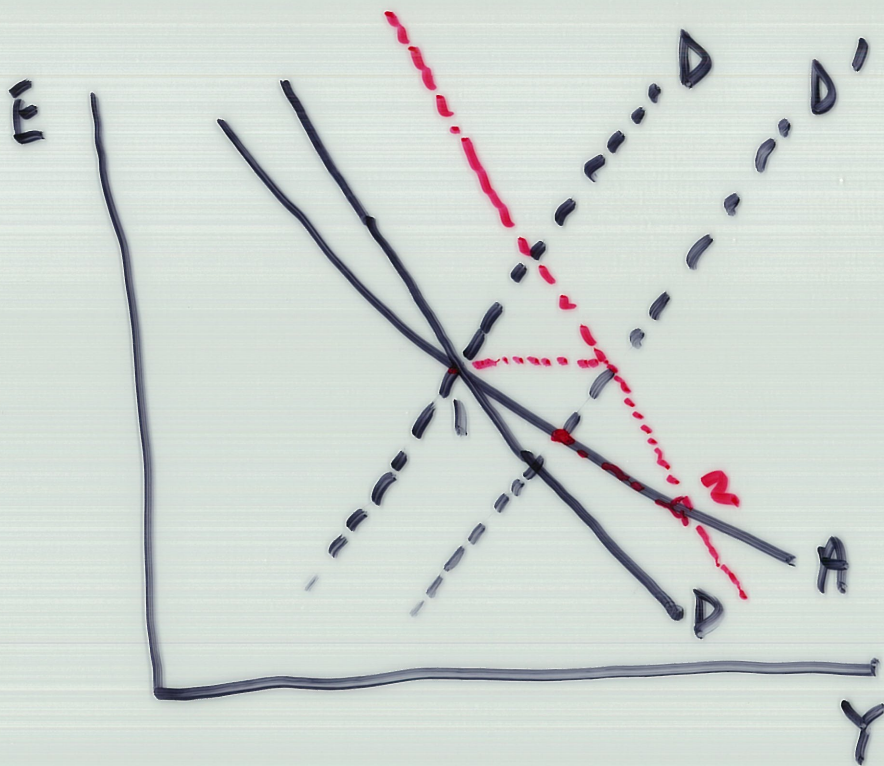
Monetary Expansion



With J-Curve, $M \uparrow \Rightarrow Y \downarrow$ (since $NX \downarrow$)

Note, $Y \downarrow \Rightarrow M^d \downarrow$, which further lowers interest rate and further depreciates the domestic currency

Fiscal Expansion



With J-Curve, $G \uparrow \Rightarrow Y \uparrow$ (same as before,

However, $Y \uparrow$ more since the currency appreciation now increases NX.

Pass-Through and Pricing-to-Market

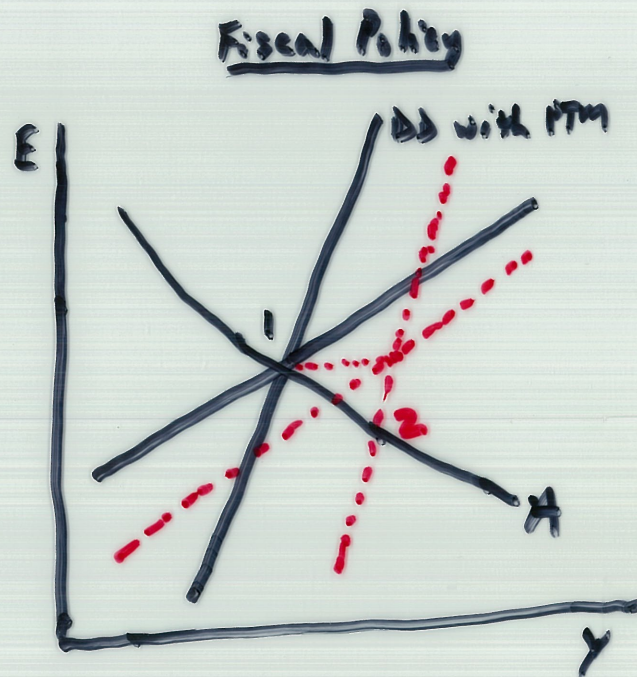
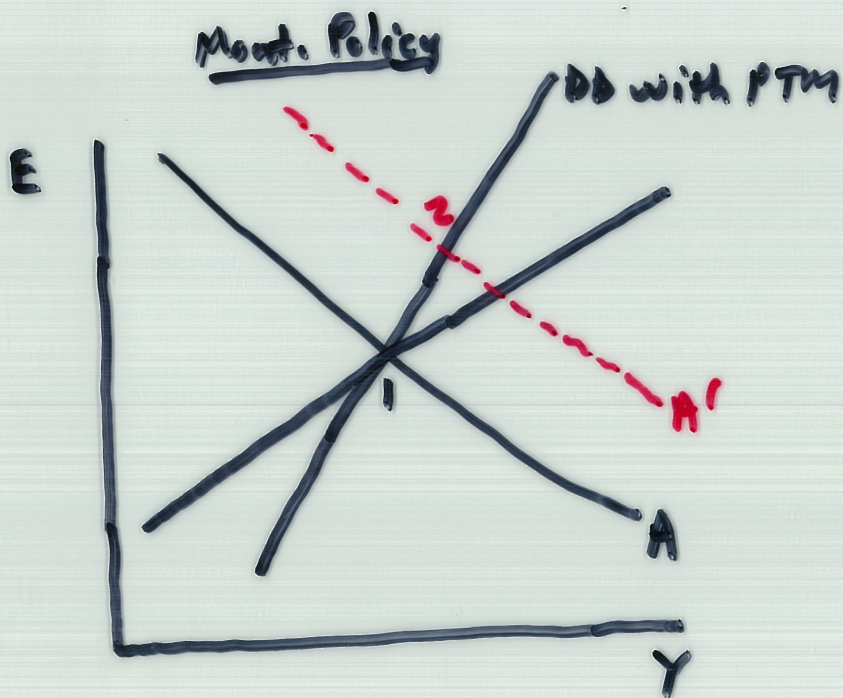
So far, we have assumed prices of foreign goods change one-for-one with the ex. rate, i.e., the pass-through is 100%. This will be the case if producers keep prices fixed in local currency terms.

In practice, however, firms may want to use their profit margins to smooth out temporary changes in the ex. rate.

For example, suppose the \$ depreciates by 10%. If P^* and P are constant, then this leads to a 10% real \$ depreciation, which then switches expenditure towards U.S. goods. However, if the depreciation is perceived to be temporary, foreign firms may respond by protecting their market shares and cutting their profit margins (i.e., lowering P^* on their exports). This practice is called Pricing-to-Market. It is one reason why pass-through is less than 100%. Empirical estimates suggest pass-through is only about 50% on average in the short-run.

PTM in the DD-AA Model

PTM will make the DD curve steeper, since the nominal ex. rate will need to change more to produce a given change in the real ex. rate.



Notice that PTM will increase ex. rate volatility. (Interestingly, most models of PTM will predict that ex. rate volatility will in turn increase PTM!).

Also notice that monetary policy becomes less effective, while fiscal policy becomes more effective. (in terms of influencing output).