Lecture 13

- International interdependency and the IS-LM-BP model
- Apply the IS-LM-BP model to the policy choices of the EMU
- Apply the IS-LM-BP model to the Asian crisis
- Summary
The European Monetary Union

- Criteria:
  - Price stability (inflation rate)
  - Government budgetary position (deficit and debt)
  - Exchange rates (exchange rate mechanism)
  - Long-term interest rates

- Each member country in the EMU loses control over its own domestic monetary policy (monetary policy is ineffective under fixed e)
  - different reaction time across countries to a common monetary policy made by the European Central Bank

- Each member country has to rely only on fiscal policies to smooth out idiosyncratic shocks
  - fiscal policy is also restricted to a certain degree
  - imperfect labor markets
The Asian Crisis

- **Cause:** (IS-LM-BP diagram)
  - ¥ depreciated against $ and $\text{e}_{\text{Asian}}$ fixed to $\rightarrow$ ¥ depreciated against $\text{e}_{\text{Asian}} \rightarrow \text{NX}_\downarrow$ in Asia (trade with Japan large) $\rightarrow$ IS left
  - IS left $\rightarrow$ BOP$_2$ deficit $\rightarrow$ R$_\downarrow$ due to fixed $\text{e} \rightarrow$ LM left
  - R$_\downarrow$ $\rightarrow$ speculation of $\text{e}_{\text{Asian}}$ devaluation $\rightarrow$ BP left
  - BP left $\rightarrow$ BOP$_2$ deficit $\rightarrow$ R$_\downarrow$ and LM has to shift to the left further to maintain $\text{e}_{\text{Asian}} \rightarrow$ $\uparrow$speculation of $\text{e}_{\text{Asian}}$ devaluation $\rightarrow$ a vicious cycle
  - When e devalued in Thailand, X in other Asian countries became less competitive and thus the other Asian countries were forced to devalue (a spiral of currency devaluation)
  - Foreign funds raced out of Asia due to the inability to distinguish profitable investment from non-profitable ones

- **Cure:**
  - Money from the IMF to stop speculation
  - Rise in r (attract foreign capital and stop speculation)
    - IS left if asset market crashes and C$_\downarrow$ $\rightarrow$ BOP$_2$ deficit $\rightarrow$ devalue
  - Micro-reform in the banking sector
Summary

- Apply the IS-LM-BP model to policy issues:
  - Monetary policy under different exchange rate regimes and capital mobility
  - Fiscal policy under different exchange rate regimes and capital mobility
  - Other external shocks and policies to smooth out shocks

- Apply the IS-LM-BP model to current issues:
  - The European Monetary Union
  - The Asian Crisis