Recap Information 9:
Open-economy aspects and monetary policy coordination

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The lecture slides associated with this part of the course provide the most comprehensive information about what I find of relevance. Nevertheless, this note briefly lists the key concepts that you are supposed to know and be able to explain.

Key concepts you should know

The Obstfeld-Rogoff model under flexible prices

- The representative agents’ utility functions and budget constraints
- The law of one price
- Optimal consumption decisions
  - Intertemporally and intratemporally
- Optimal production (=pricing) decisions
- Optimal money demand decisions
- Neutrality of money:
  - Increase in, e.g., domestic money supply raises domestic prices and nominal exchange rate (depreciation) proportionally
- Superneutrality of money
  - Follows from separability of utility function

- The log-linearized version
  - Money neutrality readily established
- Nominal exchange rate determination
  - Present values of money and consumption differentials
- Uncovered interest parity condition

The Obstfeld-Rogoff model with one-period fixed producer prices

- Sticky producer prices and flexible consumer prices
- Money shocks influence nominal exchange rate and consumer prices and demand and production
- Unanticipated, permanent increase in domestic money supply
  - Short-run effects (one period); the role of the nominal exchange rate depreciation; higher domestic consumption and production; current account surplus
  - Long-run effects (steady state); the role of wealth redistribution; higher consumption
- Welfare implications of shock:
  - The short run gains from higher production; the welfare irrelevance of long-run effects
- Spill-overs of unilateral monetary policy
- Scope for coordination?

Policy coordination

- Simple two-country AS/AD style model
- The spill over of foreign surprise inflation: Higher domestic output as the real exchange rate is appreciated (reducing production costs)
- Coordinated policies takes both countries' welfare into account
- "Leaning against the wind" policies in face of supply shocks

- Uncoordinated policies ignores other country's welfare => Nash equilibrium in policies
  - To little stabilization of the supply shock (each country ignores the positive international externality of their policies)
- The general possibility of counterproductive policy coordination

Small open economy under flexible and fixed nominal exchange rates

- Simple *ad hoc* model for small open economy
- Flexible nominal exchange rates
  - Home prices are insulated from foreign price shocks
  - Home money shocks affect both real output and real exchange rate
  - Dornbusch "overshooting"
- Fixed nominal exchange rates
  - Home prices now proportional to foreign
  - No role for money market shocks
  - With real demand shocks more volatile output
- Optimal regime? Poole (1970) revisited.....