

Questions for:

Some Monetary History

Obstfeld: Beyond Mundell-Fleming model

Q1: Provide description of classical view on international economy and give examples of shortcomings of the classical view of the world

A1: a) stable dynamic system, adjustment of price levels, free flow of capital and goods that restore full employment and national balances equilibrium.

b) direct state trading, default on foreign debts, exchange controls, barriers to trade, rigid prices

Q2: Describe limitation of monetary policy under fixed exchange rate regime and perfect capital mobility.(Mundell-Fleming model)

A2: increase in money supply (buying bond from public) -> depreciation pressure on the exchange rate-> to maintain fixed exchange rate LM curve must return to initial position no effect on output

monetary policy is ineffectual. Monetary policy is effective only when changing the exchange rate level.

Q3: Explain the role of the exchange rate devaluation in the Great depression recovery process.

A3: devaluation-> raised money supply, stimulated exports -> expanded production.

Countries without devaluation suffered longer.

Devaluation: Denmark, UK, Sweden

Maintained fixed exchange rate: France, Germany

Q4: Why Mundell-Fleming model does not account for high exchange rate volatility?

A4: Exchange rate is determined by conditions of zero balance of payments, it omits role of exchange rate change in establishing the balance of demand and supply for stocks.

Q5: Provide examples of international economy phenomena that oppose McKinnon's (1981) opinion that the age of international trade insularity is over.

A5: high transportation costs make some goods non-tradable, home biases in consumption and trade, Feldestein-Horioka puzzle, sustainable price differences, deviations from law of one price

Q6: Describe consequences of performance incapability of the arbitrage process for international goods prices.

A6: real exchange rates rare not driven in line for long periods, high persistence of real exchange rate movements, long half live of real exchange shocks; test for real exchange rate: unit root

Q7: Discuss limitations of use of the CPI in evaluation of deviations from the law of one prices. Propose solution.

A7:CPI, beside the incorporation of import prices includes high fraction of non-tradable goods – internal shipping costs, service prices (wages), retail price and this makes hard to

draw conclusion about stickiness of prices in evaluation of LOOP deviations.
Solution: use PPI.

Q8: Describe 3 types of price discrimination and explain the assumptions under which these concepts are operational

A8: 1) monopolistic producers exploits the observed heterogeneity of consumers – assumption : prevent resale, 2) based on self selection of consumers, 3) price based on observable signal (location), assumption: international market segmentations, PTM

Q9: What level of pass through from exchange rate to import prices is assumed in Mundell-Fleming model? Why the empirical failures related to level of pass through of Mundell-Fleming model occur?

A9: Complete pass through. Mundell-Fleming model does not capture near-zero pass through of exchange rate to consumer price and partial pass through of exchange rate to exporter price.

Q10: Why is PTM-LCP framework widely accepted in modern models of international economy for description of price behavior?

A10: It allows for zero pass through for import goods prices and complete pass through for export prices

Obstfeld : The Trilemma in History

Q11: Explain the mechanism that makes policy maker's intent to pursue autonomous monetary policy, in environment with open capital markets, conflict with the goal of fixed exchange rate.

A11: Credible exchange rate peg a mobile capital leads to situation when domestic interest rate is pinned to base country interest rate and this makes monetary policy (through affecting liquidity it affect interest rate) in effective.

Q12: What are consequences of expected lower appreciation of domestic currency on interest rate under assumption of interest rate parity.

A12: lower appreciation in future means that the depreciation term in interest parity equation is higher that means that interest rate differential of domestic currency will be increased by amount of expected decrease in appreciation of domestic currency

Q13: Explain, why the higher explanatory power of difference equation for interest rate parity under regime of fixed exchange rate coincides with predictions of trilemma.

A13: Changes in domestic interest rate are driven by changes in base country interest rate, so the base country is more important factor for determining the interest rate for countries with pegged currency.

Q14: Discuss problem that researchers should be aware, when testing for validity of trilemma by use of interest rate parity tests. Mention also, problems that are specific for interwar period.

A14: presence of unit roots, countries often change the exchange rate policy for short time and because of outside lag the policy results are lagged. Long response halftime 3 months. Many countries state free float regime, but they pursue managed float regime.

Test is usually done only on one type of interest rate (3 months) and no time controls are included.

Q15: What are implications of trilemma for reaction of domestic monetary policy on shocks in base country?

A15: Ineffective monetary policy when smoothing interest rate fluctuations that comes from base country.

Q16: Describe the conflict of policy maker's credibility under fixed exchange rate when smoothing the impact of RBC fluctuations in base country. Describe interest rate smoothing implications for testing of trilemma.

A16: under hard rules of exchange rate peg there is little independence of domestic monetary policy maker, interest rate parity is very strong and only move to float of imposition of capital controls can free monetary policy to pursue the domestic aims. Lower value of parameter of autocorrelation in estimation of interest rate parity equation.