

Contents

1	Introduction	1
----------	---------------------	----------

Part I A Theoretical Framework

2	Specifications and Assumptions	11
3	Underlying Equilibrium Growth Paths	15
3.1	Aggregate Production and Income	15
3.2	Intertemporal Optimization: The Equilibrium Growth Rate	17
3.3	A Digression on Population Growth	22
3.4	Money and Output	24
3.5	Two Countries	30
3.5.1	The Real Exchange Rate	36
4	Variations in Employment	41
4.1	Equilibrium in Asset and Output-Flow Markets: Closed Economy	42
4.1.1	Monetary and Real Shocks	45
4.1.2	Monetary and Fiscal Policy	50
4.2	Small Open Economy Equilibrium	53
4.3	World Equilibrium With Two Big Countries	58
4.4	Equilibrium in Common Currency Areas	67
4.5	More on the Determination of Risk Premiums	68
5	Some Important Implications	71
5.1	The Real Exchange Rate and the Current and Capital Accounts	71

X Contents

5.2	Balance of Payments Disequilibria and the Current Account	76
5.3	Monetary Policy and Interest Rates	79
6	Exchange Rate Overshooting	87
6.1	The Basis for Overshooting	87
6.2	Two Avenues to Equilibrium	89
6.3	Will Overshooting in Fact Occur?	93

Part II Exchange Rate Determination

7	Issues Regarding Exchange Rate Determination	99
7.1	General Equilibrium Issues	99
7.2	Exchange Rate Determination under Less-Than-Full-Employment Conditions	106
7.3	Exchange Rates as Asset Prices	108
8	Time Series Properties of Observed Exchange Rate Movements	113
8.1	Stationarity vs. Non-Stationarity of Time Series	117
8.2	Testing for Stationarity	121
8.3	Some Stationarity Tests	123
9	Efficient Markets and Exchange Rate Forecasts	131
9.1	Covered Interest Parity	133
9.2	Uncovered Interest Parity	137
10	The Role of Real Shocks in Determining Real Exchange Rates: The Evidence	157
10.1	Canada vs. United States	158
10.2	United Kingdom vs. United States	171
10.3	Japan vs. United States	179
10.4	France vs. United States	188
10.5	Germany vs. United States	197
10.6	Conclusions	208
11	The Role of Money Supply Shocks in Determining Real Exchange Rates: The Evidence	209
11.1	Canada vs. the United States	211
11.2	United Kingdom vs. United States	222
11.3	Japan vs. United States	228

11.4 France vs. United States	235
11.5 Germany vs. United States	241
11.6 Conclusions	245
12 Further Evidence from a Blanchard-Quah VAR	
Analysis	251
12.1 Vector Autoregression Analysis	251
12.2 The Blanchard-Quah Decomposition	255
12.3 The Results	256
<hr/>	
Part III Implications for Monetary Policy	
<hr/>	
13 The Model	269
13.1 Basic Equations and Diagrams	269
13.2 Consolidated Four-Equation System	278
13.2.1 Flexible Price Levels: Full-Employment	278
13.2.2 Fixed Price Levels	279
13.3 Formal Equilibrium Conditions	281
13.3.1 Rest-of-World Equilibrium	281
13.3.2 Domestic Equilibrium With a Flexible Exchange Rate	282
13.3.3 Domestic Equilibrium With a Fixed Exchange Rate	283
13.4 Response of the Domestic Economy to Domestic and Foreign Shocks	284
14 Monetary Policy and Exchange Rates	289
14.1 Large vs. Small Open Economies	289
14.2 Fixed vs. Flexible Exchange Rates	291
14.3 Implications for the World Monetary System	299
14.3.1 Foreign Exchange Crises	300
14.3.2 Exchange Rate Target Zones	301
14.3.3 Currency Unions	305
15 Corroborating and Other Evidence	307
15.1 The Historical Evidence Regarding Real Exchange Rates	308
15.2 International Transmission of Business Cycles and Inflation Episodes	327
15.3 The European Monetary Union	341

XII Contents

16 Conclusions and Suggestions for Future Work	359
16.1 Conclusions	359
16.2 Suggestions for Future Work	363
A Optimal Allocation of the Capital Stock Among its Alternative Forms	365
B Derivation of the Real Exchange Rate	367
C Analysis of the GG and AA Curves	369
D The Determination of Risk Premiums	377
E Analysis of the Forward Rate Equation	381
F Data Sources	383
F.1 Annual Data	383
F.2 Quarterly Data	384
F.3 Monthly Data	385
References	387
Index	393