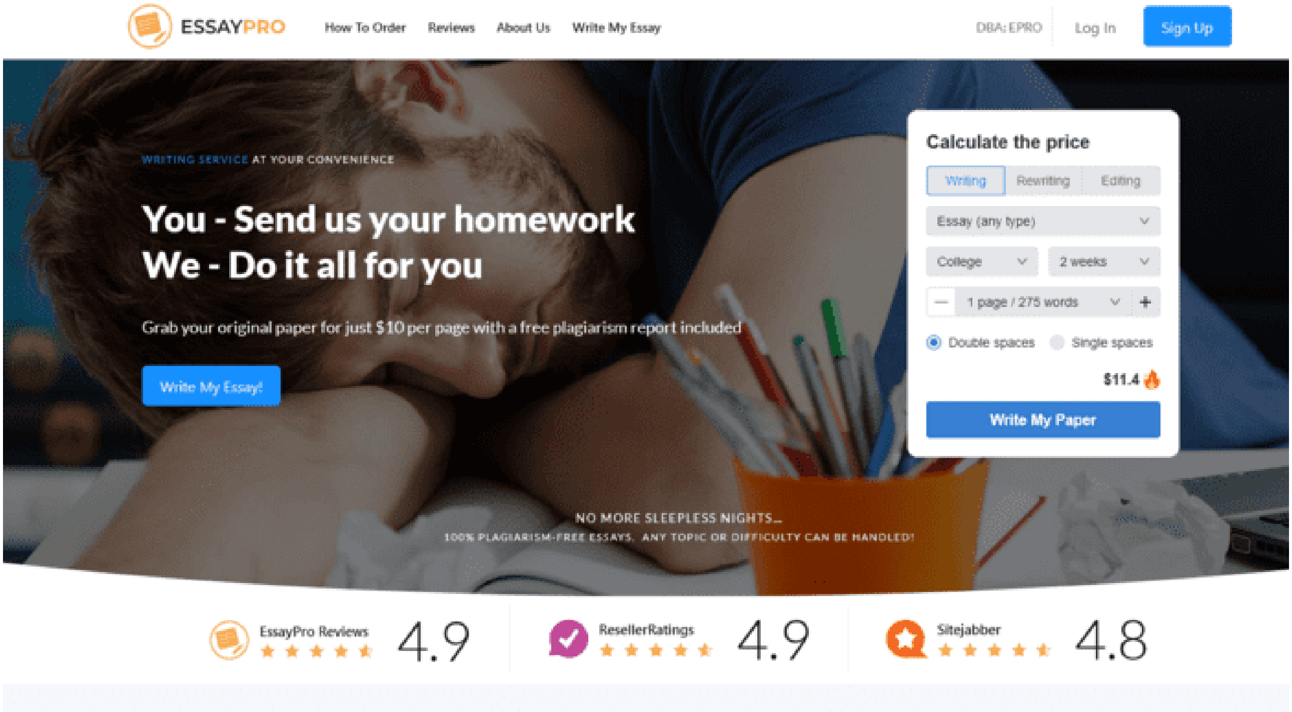
Macroeconomics



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“Many economic forecasters are suggesting that the US economy is about to enter into recession. Using IS/LM/BP analysis and assuming perfect capital mobility, suggest how the US could use its exchange rate policy to counter this movement but also highlight the potential problems of using such a policy to the US government”.

History Background: The US Economy.

There are increasing signs that the US economy is heading towards a recession as major corporations (from the auto industry, to banking, to technology, to consumer goods) have announced far weaker than expected sales and earnings and a new round of mass layoffs and plant closings. While most pundits still maintain that the US will sustain a decline in growth without a recession, the Financial Times noted that “a growing number of economists now believe that the US is well on the way to recession in 2001” with some arguing that it has already arrived. While that assessment may be “too pessimistic”, it continued, the “threat of a serious downturn for the US is as great as it has been at any time in the past decade.”

The IS, LM, BP Model

When we open the economy to international transactions we have to take into account the effects of trade in goods and services (i.e. items in the current account) as well as trade in assets (i.e. items in the capital account). Opening the economy to international trade in goods and services means that we have to take into account the increased demand for our goods by foreigners (our exports), as well as the decreased demand for our goods that occurs because we purchase foreign goods (i.e. our imports).

The effect of opening the economy to trade in goods and services, is that the IS curve needs to be specified for a given exchange rate. The IS curve still depicts the combinations of I and Y for which the level of total expenditures equals the level of production, but now, in addition to being determined by the interest rate, total expenditures are also determined by the exchange rate. Under a fixed exchange rate regime, the IS curve is fixed (unless there is a change in government spending or tax rates, or the government devalues or revalues the currency). Under a flexible exchange rate regime, the price of foreign exchange fluctuates to equate the demand and supply of foreign exchange.