Wage setting curve in an economy

In the absence of any imported materials, price setting in the open economy is same as in closed economy, ie prices are set as a mark-up on unit labour costs

When $\theta = 1$, wage setting curve is same as in closed economy.

A rise in θ raises the real cost of imported goods and therefore reduces the price-setting real wage

Source: Carlin & Soskice, p353

The ERU curve is defined as the combinations of the real exchange rate and output at which the wage-setting real wage is equal to the price-setting real wage. At any point on the ERU curve, the real exchange rate, θ, is constant and inflation is constant.

On ERU curve, inflation constant; real exchange rate constant

At points above ERU curve, real wage below WS curve so upward pressure on inflation. Wages too low to satisfy wage setters at this level of employment. Home inflation above world inflation. Hence θ falling, real wages rising

At points below ERU curve, real wage above WS curve so downward pressure on inflation. Wages too high for wage-setting equilibrium given low level of employment. Home inflation below world inflation. Hence θ rising, real wages falling

AD curve shows combination of real exchange rate, Î¸, and level of output, y, at which goods market is in equilibrium with domestic real interest rate equal to world real interest rate

AD curve is positively sloped to the right on assumption that a more competitive exchange rate (high Î¸) raises aggregate demand and output

BT curve shows combination of real exchange rate (Î¸) and output (y) at which trade is balanced, ie x = m

BT curve positively sloped to the right. A more competitive exchange rate (high Î¸) raises exports and requires a higher level of output to drive up demand for imports to deliver trade balance

To left of the BT curve is a trade surplus; to right is a trade deficit

BT curve flatter than AD curve.

Suppose economy initially in equilibrium at A and then exchange rate depreciates.

Aggregate demand boosted by higher exports and economy moves to B on AD curve. There is now a trade surplus because output has not risen enough to boost imports by same amount as exports.

For a small open economy:

demand side is given by AD curve. On AD curve, goods market in equilibrium and $r = r^*$ (world real interest rate)

supply side given by ERU curve. On ERU curve, inflation is constant

balance of trade equilibrium represented by BT curve

In short run, economy in goods market equilibrium on AD curve. That is, for a given nominal exchange rate and a given price level, level of output is fixed by the AD curve

In medium run, economy must also be on ERU curve. Only then is labour market in equilibrium. So in medium run, AD and ERU curves intersect

In long run, trade balance must also be in equilibrium

Source: Carlin & Soskice, p362

A is short-run equilibrium (on AD curve but not ERU curve). Economy loses competitiveness and moves along AD curve to B.

B (and B') is medium-run equilibrium in that there is stable inflation. But at B there is a trade surplus.

Z is long-run equilibrium. At Z, labour market equilibrium coincides with the balanced trade level of output.

What might shift the AD curve to intersect ERU and BT curves at Z?

Mechanisms to achieve long-run equilibrium

Wealth effects: At A, country is accumulating wealth. May raise permanent income and shift AD curve to right

Market pressure: Persistent trade surplus of trade deficit may lead to a change in credit conditions

Political pressure: Surplus countries may come under political pressure at home to boost activity and operate at a lower unemployment rate. Also may be political pressure from abroad to adjust policies

What are the key differences between an open and closed economy?

Trade in Goods

Output can now differ from domestic demand because of net exports

Net exports depends on the real exchange rate = national competitiveness C&S 9. 1

Trade in Assets

Uncovered Interest Parity

Common Link is the Exchange Rate

Two alternative policy regimes

Flexible exchange rate

Fixed exchange rates or Monetary Union

Uncovered Interest Parity (C&S 9. 2. 2)

e= log real exchange rate

Rise implies real depreciation, or gain in competitiveness, due to

Nominal depreciation

Lower home prices

Higher overseas prices

Extends IS/LM to open economy

Implies under flex rates, monetary policy effective, fiscal policy ineffective

Money demand: M/p= f(Y, r). If M and p are fixed, and r is fixed in steady state by UIP, then Y is also fixed in steady state – QED

If IS curve shifts in short run, higher interest rates imply real appreciation, crowding out next exports, returning IS curve to its original position in long run

Assumes fixed M – unrealistic today

Under fixed exchange rates, monetary policy ineffective, fiscal policy effective

Obvious – there is no independent monetary policy under fixed exchange rates

Equilibrium given by IS curve and overseas interest rates, LM curve endogenous

Monetary policy in an open economy under flexible exchange rates

UIP implies that there are now two transmission mechanisms through which interest rates influence demand

Through direct effects on investment and consumption

Through UIP, which changes the real exchange rate, which in turn influences net exports i. e. the demand for domestic production

Under UIP, the impact of an increase in interest rates on demand will depend on expectations about how long interest rates will remain high.

This gives policy extra leverage, but it also creates problems of ' managing expectations'

However, if consumption is forward looking, then we have similar problems with direct interest rate effects.