## Contents

	Preface		xiii
CHAPTER 1	Global	mbalances	1
OTIAL TERT		Balance of Payments	3
		e Trade Balance and the Current Account	6
		e Trade Balance and the Current Account	
		oss Countries	8
	1.4 lm	palances in U.S. Trade with China	10
	1.5 The	Current Account and the Net International	
	Inv	estment Position	12
	1.6 Val	uation Changes and the Net International	
	Inv	estment Position	13
	1.6.	1 Examples of Valuation Changes	14
	1.6.	2 Valuation Changes in the United States	14
	1.6.	3 A Hypothetical NIIP That Excludes	
		Valuation Changes	17
	1.7 The	NIIP—NII Paradox	19
	1.7.	1 Dark Matter	19
	1.7.		21
	1.7.		22
		nming Up	23
	1.9 Exe	ercises	24
PART I	DETER	MINANTS OF THE CURRENT ACCOUNT	31
.,			•
CHAPTER 2	Current Account Sustainability		33
	2.1 Car	a Country Run a Perpetual Trade Balance Deficit?	33
	2.2 Car	a Country Run a Perpetual Current Account Deficit?	35
	2.3 Sav	ring, Investment, and the Current Account	36
	2.3	1 The Current Account as the Gap between	
		Saving and Investment	36
	2.3	2 The Current Account as the Gap between National	
		Income and Domestic Absorption	38

	2.4 Appen	dix: Perpetual Trade Balance and Current Account	
	Deficit	s in Infinite Horizon Economies	38
	2.5 Summ	ing Up	41
	2.6 Exercis	ses	42
CHAPTER 3	An Intertemporal Theory of the Current Account		44
	3.1 The Int	tertemporal Budget Constraint	45
		fetime Utility Function	47
	3.3 The Op	ptimal Intertemporal Allocation of Consumption	50
	3.4 The Int	terest Rate Parity Condition	52
		rium in the Small Open Economy	53
	3.6 The Tra	ade Balance and the Current Account	55
	3.7 Adjust	ment to Temporary and Permanent Output Shocks	56
	3.7.1	Adjustment to Temporary Output Shocks	56
	3.7.2	Adjustment to Permanent Output Shocks	58
		pated Income Shocks	59
	3.9 An Eco	onomy with Logarithmic Preferences	61
	3.10 Summ	ning Up	62
	3.11 Exercis	ses	63
CHAPTER 4	Terms of Trade, the World Interest Rate, Tariffs, and		
	the Curren	t Account	68
	4.1 Terms	of Trade Shocks	69
	4.2 Terms	of Trade Shocks and Imperfect Information	70
	4.3 Imperf	fect Information, the Price of Copper, and the	
	Chilea	n Current Account	71
	4.4 World	Interest Rate Shocks	72
	4.5 Import	t Tariffs	75
	4.5.1	A Temporary Increase in Import Tariffs	77
	4.5.2	A Permanent Increase in Import Tariffs	79
	4.5.3	An Anticipated Future Increase in Import Tariffs	80
	4.6 Summ	ning Up	80
	4.7 Exercis	ses	81
CHAPTER 5	Current Account Determination in a Production		
	Economy		87
	5.1 The In	vestment Decision of Firms	87
	5.2 The In	vestment Schedule	93
	5.2.1	The Profit Function	93
	5.3 The Co	onsumption-Saving Decision of Households	96
	5.3.1	Effect of a Temporary Increase in	
		Productivity on Consumption	98
	5.3.2	Effect of an Anticipated Future Productivity	
		Increase on Consumption	99
	5.3.3	Effect of an Increase in the Interest Rate	
		on Consumption	101

			Contents
	5.4	The Saving Schedule	102
	5.5	The Current Account Schedule	104
	5.6	Equilibrium in the Production Economy	106
		5.6.1 Adjustment of the Current Account to Changes	
		in the World Interest Rate	107
		5.6.2 Adjustment of the Current Account to a	
		Temporary Increase in Productivity	108
		5.6.3 Adjustment of the Current Account to an	
		Anticipated Future Productivity Increase	109
	5.7	Equilibrium in the Production Economy: An Algebraic	
		Approach	110
		5.7.1 Adjustment to an Increase in the World	
		Interest Rate	114
		5.7.2 Adjustment to a Temporary Increase in	
		Productivity	114
		5.7.3 Adjustment to an Anticipated Future Increase	
		in Productivity	115
	5.8	The Terms of Trade in the Production Economy	115
	5.9	An Application: Giant Oil Discoveries	117
	5.10	Summing Up	119
	5.11	Exercises	120
CHAPTER 6	Unc	ertainty and the Current Account	124
	6.1	The Great Moderation	124
	6.2	Causes of the Great Moderation	125
	6.3	The Great Moderation and the Emergence of	
		Current Account Imbalances	126
	6.4	An Open Economy with Uncertainty	126
	6.5	Complete Asset Markets and the Current Account	131
		6.5.1 State Contingent Claims	131
		6.5.2 The Household's Problem	132
		6.5.3 Free Capital Mobility	133
		6.5.4 Equilibrium in the Complete Asset Market	
		Economy	134
	6.6	Summing Up	135
	6.7	Exercises	136
CHAPTER 7	Larc	ge Open Economies	141
	7.1	A Two-Country Economy	141
	7.2	An Investment Surge in the United States	143
	7.3	Microfoundations of the Two-Country Model	145
	7.4	International Transmission of Country-Specific Shocks	148
	7.5	Country Size and the International	1-10
		Transmission Mechanism	149
	7.6	Explaining the U.S. Current Account Deficit: The Global	1 10
	-	Saving Glut Hypothesis	151

vii

		7.6.1 Two Competing Hypotheses	151	
		7.6.2 The Made in the U.S.A. Hypothesis Strikes Back	153	
	7.7	Summing Up	154	
	7.8	Exercises	155	
CHAPTER 8	The Twin Deficits: Fiscal Deficits and the Current			
	Ac	count	160	
	8.1	An Open Economy with a Government Sector	160	
		8.1.1 The Government	161	
		8.1.2 Firms	162	
		8.1.3 Households	163	
	8.2	Ricardian Equivalence	165	
	8.3	Government Spending and Twin Deficits	168	
	8.4	Failure of Ricardian Equivalence: Tax Cuts and		
		Twin Deficits	169	
		8.4.1 Borrowing Constraints	170	
		8.4.2 Intergenerational Effects	172	
		8.4.3 Distortionary Taxation	172	
	8.5	The Optimality of Twin Deficits	175	
	8.6	Fiscal Policy in Economies with Imperfect Capital		
		Mobility	178	
	8.7	Fiscal Policy in a Large Open Economy	181	
	8.8	Summing Up	183	
	8.9	Exercises	184	
PART II	TU	E DEAL EVOLUNIOS DATE	404	
PANT II	ın	E REAL EXCHANGE RATE	191	
CHAPTER 9	The	Real Exchange Rate and Purchasing Power Parity	193	
	9.1	The Law of One Price	193	
	9.2	Purchasing Power Parity	198	
	9.3	PPP Exchange Rates	201	
		9.3.1 Big Mac PPP Exchange Rates	201	
		9.3.2 PPP Exchange Rates for Baskets of Goods	202	
		9.3.3 PPP Exchange Rates and Standard of Living		
		Comparisons	202	
		9.3.4 Rich Countries Are More Expensive Than		
	0.4	Poor Countries	205	
	9.4	Relative Purchasing Power Parity	206	
		9.4.1 Does Relative PPP Hold in the Long Run?	207	
	0.5	9.4.2 Does Relative PPP Hold in the Short Run?	210	
	9.5	How Wide Is the Border?	210	
	9.6	Nontradable Goods and Deviations from	616	
	0.7	Purchasing Power Parity	213	
	9.7	Trade Barriers and Real Exchange Rates	215	
	9.8	Home Bias and the Real Exchange Rate	216	

		Contents	ix
	<ul> <li>9.9 Price Indices and Standards of Living</li> <li>9.9.1 Microfoundations of the Price Level</li> <li>9.9.2 The Price Level, Income, and Welfare</li> <li>9.10 Summing Up</li> <li>9.11 Exercises</li> </ul>	217 218 220 221 222	
CHAPTER 10	Determinants of the Real Exchange Rate  10.1 The TNT Model  10.1.1 Households 10.1.2 Equilibrium 10.1.3 Adjustment of the Relative Price of Nontradables to Interest Rate and Endowment Shocks  10.2 From the Relative Price of Nontradables to the Real Exchange Rate  10.3 The Terms of Trade and the Real Exchange Rate  10.4 Sudden Stops 10.4.1 A Sudden Stop through the Lens of the TNT Model 10.4.2 The Argentine Sudden Stop of 2001 10.4.3 The Icelandic Sudden Stop of 2008  10.5 The TNT Model with Sectoral Production 10.5.1 The Production Possibility Frontier 10.5.2 The PPF and the Real Exchange Rate 10.5.3 The Income Expansion Path 10.5.4 Partial Equilibrium 10.5.5 General Equilibrium 10.5.6 Sudden Stops and Sectoral Reallocations  10.6 Productivity Differentials and Real Exchange Rates: The Balassa-Samuelson Model  10.7 Summing Up  10.8 Exercises	227 228 228 231 232 235 236 238 240 242 243 244 247 249 251 255 257 259 263 264	
PART III	INTERNATIONAL CAPITAL MOBILITY	273	
CHAPTER 11	<ul> <li>International Capital Market Integration</li> <li>11.1 Covered Interest Rate Parity</li> <li>11.2 Covered Interest Rate Differentials in China: 1998–2021</li> <li>11.3 Capital Controls and Interest Rate Differentials:</li></ul>	275 276 278 279 281 283 285 285	

	<ul> <li>11.6.2 CIP as an Equilibrium Condition</li> <li>11.6.3 Is UIP an Equilibrium Condition?</li> <li>11.6.4 Carry Trade as a Test of UIP</li> <li>11.6.5 The Forward Premium Puzzle</li> <li>11.7 Real Interest Rate Parity</li> <li>11.8 Saving-Investment Correlations</li> <li>11.9 Summing Up</li> <li>11.10 Exercises</li> </ul>	288 288 290 291 292 294 298 299
CHAPTER 12	Capital Controls  12.1 Capital Controls and Interest Rate Differentials  12.2 Macroeconomic Effects of Capital Controls  12.2.1 Effects of Capital Controls on Consumption, Savings, and the Current Account  12.2.2 Effects of Capital Controls on Investment  12.2.3 Welfare Consequences of Capital Controls  12.4 Quantitative Restrictions on Capital Flows  12.4 Borrowing Externalities and Optimal Capital Controls  12.4.1 An Economy with a Debt-Elastic Interest Rate  12.4.2 Competitive Equilibrium without Government Intervention  12.4.3 The Efficient Allocation  12.4.4 Optimal Capital Control Policy  12.5 Capital Mobility in a Large Economy  12.6 Graphical Analysis of Equilibrium under Free Capital Mobility in a Large Economy  12.7 Optimal Capital Controls in a Large Economy  12.8 Graphical Analysis of Optimal Capital Controls in a Large Economy  12.9 Retaliation  12.11 Summing Llp	302 303 304 308 309 311 312 314 316 317 318 323 327 331 332 337
	12.11 Summing Up 12.12 Exercises	342 343
PART IV	MONETARY POLICY AND EXCHANGE RATES	351
CHAPTER 13	Nominal Rigidity, Exchange Rate Policy, and Unemployment  13.1 The TNT-DNWR Model 13.1.1 The Supply Schedule 13.1.2 The Demand Schedule 13.1.3 The Labor Market Slackness Condition 13.1.4 Equilibrium in the TNT-DNWR Model  13.2 Adjustment to Shocks with a Fixed Exchange Rate	353 354 355 356 361 362 363
	13.2.1 An Increase in the World Interest Rate	364

	C	Contents
	13.2.2 Asymmetric Adjustment: A Decrease in the	
	World Interest Rate	366
	<ul><li>13.2.3 Output and Terms of Trade Shocks</li><li>13.2.4 Volatility and Average Unemployment</li></ul>	368 370
	13.3 Adjustment to Shocks with a Floating Exchange Rate	370
	13.3.1 Adjustment to External Shocks	371
	13.3.2 Supply Shocks, the Inflation-Unemployment	072
	Trade-off, and Stagflation	374
	13.4 A Numerical Example: A World Interest Rate Hike	377
	13.4.1 The Pre-Shock Equilibrium	378
	13.4.2 Adjustment with a Fixed Exchange Rate	379
	13.4.3 Adjustment with a Floating Exchange Rate	381
	13.4.4 The Welfare Cost of a Currency Peg	381
	13.5 The Monetary Policy Trilemma	382
	13.6 Exchange Rate Overshooting	384
	13.7 Empirical Evidence on Downward Nominal Wage Rigidity	388
	13.7.1 Evidence from U.S. Micro Data	388
	13.7.2 Evidence from the Great Depression	388
	13.7.3 Evidence from Emerging Countries	390
	13.8 Appendix	393
	13.9 Summing Up 13.10 Exercises	393 394
	13. TO EXERCISES	394
CHAPTER 14	Managing Currency Pegs	399
	14.1 A Boom-Bust Cycle in the TNT-DNWR Model	399
	14.2 The Currency Peg Externality	401
	14.3 Managing a Currency Peg	402
	14.3.1 Macroprudential Capital Control Policy	403
	14.3.2 Fiscal Devaluations	406
	14.3.3 Higher Inflation in a Monetary Union	411
	14.4 The Boom-Bust Cycle in Peripheral Europe, 2000–2011	415
	14.5 Summing Up	417
	14.6 Exercises	419
CHAPTER 15	Inflationary Finance and Balance of Payments Crises	424
	15.1 The Quantity Theory of Money	425
	15.1.1 A Flexible Exchange Rate Regime	427
	15.1.2 A Fixed Exchange Rate Regime	428
	15.2 A Monetary Economy with a Government Sector	428
	15.2.1 An Interest-Elastic Demand for Money	429
	15.2.2 Purchasing Power Parity	429
	15.2.3 The Interest Parity Condition	430
	15.2.4 The Government Budget Constraint	430
	15.3 Fiscal Deficits and the Sustainability of Currency Pegs	431
	15.4 Fiscal Consequences of a Devaluation	432
	15.5 A Constant Money Growth Rate Regime	434

χi

## xii Contents

15.6	Fiscal Consequences of Money Creation	435	
	15.6.1 The Inflation Tax	435	
	15.6.2 The Inflation Tax Laffer Curve	436	
	15.6.3 Inflationary Finance	436	
15.7	Balance of Payments Crises	438	
15.8	Appendix: A Dynamic Optimizing Model of the		
	Demand for Money	442	
15.9	Summing Up	448	
15.10	) Exercises	449	
Inde	ex	457	