Contents

List of Figures	vi
List of Tables	
Preface and Acknowledgements	
1 Introduction	1
2 A Theoretical Framework for Modeling the Open Econony	13
3 The Theory of Policy Coordination under Uncertainty	38
4 An Example: the Stock Market Crash of October 1987	76
5 Alternative Empirical Models of the Open Economy	95
6 Model Uncertainty and the Gains from Coordination: an	
Empirical Analysis	127
7 Cooperation versus Coordination	169
8 On the Sustainability of Cooperative Agreements	190
9 Issues in Bargaining	221
10 Conclusions	238
Appendix: Cooperation and Coordination in Historical	
Perspective	242
Bibliography	261
Index	276

List of Figures

2.1	Averages and standard deviations across models for	
	simulated effects of a U.S. monetary expansion	27
3.1	Welfare under an inflationary shock	47
3.2	Nash Equilibrium under an inflationary shock	49
3.3	Optimal unemployment/inflation trade-off for different	• • •
	(α/ϕ)	50
3.4	Coordinated and uncoordinated equilibrium (transmission	
2.5	uncertainty)	62
3.5	Mean and variance of inflation under optimal policy	63
3.6	Uncertainty about transmission multipliers	66
3.7	Uncertainty about domestic multipliers (positive	
	transmission effect)	67
4.1	Stock market prices, January 1985 to September 1990	
4.0	(indices, 1985 = 100)	79
4.2	U.S. Dollar exchange rates, January 1985 to December 1990	
4.0	(indices, 1985 = 100)	81
4.3	Implied volatility of S&P 500, 1 January 1987 to 12 October 1990	
4.4		82
4.4	Short-term interest rates, January 1985 to December 1990	
5.1	(in percent per annum)	83
5.2	Model residuals: U.S. aggregate demand	112
5.3	Model residuals: U.S. money demand	112
5.4	Model residuals: U.S. output price	113
5.5	Model residuals: U.S. consumer price level (all models)	113
5.6	Model residuals: ROW aggregate demand	114
	Model residuals: ROW money demand	114
5.7	Model residuals: ROW output price	115
5.8	Model residuals: ROW consumer price index (all models)	115
5.9	Model residuals: exchange rate (all models; increase is a	
5 10	depreciation of the U.S. dollar)	116
5.10	Effect on U.S. output of a one percent increase in the U.S.	
	money supply	120

5.11	Effect on U.S. output of a one percent increase in the	
	ROW money supply	120
5.12	Effect on the U.S. CPI of a one percent increase in the	
	U.S. money supply	121
5.13	Effect on the U.S. CPI of a one percent increase in the	
	ROW money supply	121
5.14	Effect on ROW output of a one percent increase in the	
	ROW money supply	122
5.15	Effect on ROW output of a one percent increase in the	
5 1 C	U.S. money supply	122
5.16	Effect on the ROW CPI of a one percent increase in the	100
5 17	ROW money supply	123
3.17	Effect on the ROW CPI of a one percent increase in the U.S. money supply	100
5 1 2	Effect on the U.S. exchange rate of a one percent increase	123
5.10	in the U.S. money supply	124
5 19	Effect on the U.S. exchange rate of a one percent increase	124
5.17	in the ROW money supply	124
6.1	Coordinated and uncoordinated regimes: output levels –	121
	Model A	140
6.2	Coordinated and uncoordinated regimes: output levels -	
	Model B	140
6.3	Coordinated and uncoordinated regimes: output levels -	
	Model D	141
6.4	Coordinated and uncoordinated regimes: inflation rates –	
	Model A	141
6.5	Coordinated and uncoordinated regimes: inflation rates –	
	Model B	142
6.6	Coordinated and uncoordinated regimes: inflation rates –	
67	Model D	142
6.7	Coordinated and uncoordinated regimes: money supplies – Model A	143
6.8	Coordinated and uncoordinated regimes: money supplies –	143
0.0	Model B	143
6.9	Coordinated and uncoordinated regimes: money supplies –	173
0.5	Model D	144
6.10	Money target – Model A	144
	Money target – Model B	145
	Money target – Model D	145
	Nominal income target – Model A	146
	Nominal income target – Model B	146
6.15	Nominal income target – Model D	147
6.16	Nominal exchange rate target - Model A	147

viii List of Figures

6.17	Nominal exchange rate target - Model B	148
6.18	Nominal exchange rate target – Model D	148
	Real exchange rate target – Model A	149
	Real exchange rate target – Model B	149
	Real exchange rate target – Model D	150
6.22	Synthetic rule – Model A	150
6.23	Synthetic rule – Model B	151
	Synthetic rule – Model D	151
	Model A is the true model – initial priors (0.4,0.2,0.2,0.2)	161
6.26	Model B is the true model – initial priors (0.2,0.4,0.2,0.2)	161
6.27	Model C is the true model – initial priors (0.2,0.2,0.4,0.2)	162
6.28	Model D is the true model – initial priors (0.2,0.2,0.2,0.4)	162
6.29	VAR Model is the true model – initial priors	
	(0.3,0.3,0.2,0.2)	165
7.1	Coordinated vs. uncoordinated equilibrium: bias of omission	
	$(z-z^*)>0$	176
7.2	Coordinated vs. uncoordinated equilibrium: bias of	
	commission	183
8.1	Tight vs. loose trigger	197
8.2	Tight vs. loose trigger	205
8.3	Trigger probability: effect of variance of ε	207
8.4	Effect of multiplier uncertainty	215
8.5	Effect of multiplier uncertainty on maximum trigger	
	probability	216
9.1	Welfare gains from coordination – when foreign	
	government is of type 1	233
9.2	Welfare gains from coordination – when foreign	
	government is of type 2	234

List of Tables

2.1	Toncy multipliers of some ground economic models: effect	
	in the second year of a one percent increase in the global	
	supply	29
5.1	Estimated models	99
5.2	Equations of alternative models	100
5.3	Tests of random walk with drift against a deterministic	
	trand in the regression $\Delta x = \alpha + \beta x_{-1} + \mu T + \beta \Delta x_{-1}$ over	
	the period 1964-88	104
5.4	Tests for cointegration using augmented Dickey-Fuller and	
	Johansen Tests, 1965–89	105
5.5	Coefficients estimated by three-stage least squares and	
	associated fit statistics (coefficient values: standard errors in	
	paranthesis)	108
5.6	VAR estimates (1966–88)	118
5.7	Eigenvalues of alternative models	119
6.1	Coefficients of model independent rules	138
6.2	Level of dusutility for 10% inflation shock	138
6.3	Welfare with and without model uncertainty	152
6.4	A measure of multiplier uncertainty for the effects of a	
	money supply change on domestic and foreign variables	153
6.5	Welfare levels under Model A (fixed probability priors)	155
6.6	Welfare levels under Model B (fixed probability priors)	156
6.7	Welfare levels under Model C (fixed probability priors)	156
6.8	Welfare levels under Model D (fixed probability priors)	157
6.9	Welfare levels under Model A (Bayesian updating)	159
6.10	Welfare levels under Model B (Bayesian updating)	159
6.11	Welfare levels under Model C (Bayesian updating)	160
6.12	Welfare levels under Model D (Bayesian updating)	160
6.13	Welfare levels under VAR model (fixed priors)	164
6.14	Welfare levels under VAR model (Bayesian updating)	164
8.1	Degree of compliance with summit targets	192