

# Contents

<i>List of figures</i>	xi
<i>Foreword</i>	xvi
<i>Introduction</i>	xvii
<i>Notation</i>	xxii
<b>PART I</b>	
<b>Real–financial market interaction: Baseline approaches</b>	<b>1</b>
1 Price dynamics and the macroeconomy	3
1.1 <i>Introduction</i>	3
1.2 <i>Keynesian AD–AS analysis</i>	3
1.3 <i>Conclusions</i>	11
1.4 <i>References</i>	11
2 Stock market and the macroeconomy	13
2.1 <i>Introduction</i>	13
2.2 <i>The Blanchard model</i>	18
2.3 <i>Analysis of the Blanchard model</i>	20
2.4 <i>The jump variable technique</i>	28
2.5 <i>Conclusions</i>	37
2.6 <i>References</i>	39
2.7 <i>Appendix: Some observations</i>	39
3 Bond market, term structure and the macroeconomy	42
3.1 <i>Introduction</i>	42
3.2 <i>The model</i>	48
3.3 <i>Instability and the jump variable technique</i>	51
3.4 <i>Alternatives to the jump variable technique</i>	62
3.5 <i>Conclusions</i>	82
3.6 <i>References</i>	84
3.7 <i>Appendix: Budget equations</i>	85
4 Exchange rate and the macroeconomy	87
4.1 <i>Introduction</i>	87
4.2 <i>Exchange rate dynamics in the IS–LM–PC model: Level-form formulation</i>	87
4.3 <i>Exchange rate dynamics in the IS–LM–PC model: Loglinear analysis</i>	90

viii *Contents*

4.4	<i>Rational expectations in open economy IS–LM–PC dynamics</i>	102
4.5	<i>References</i>	117
4.6	<i>Notation</i>	118
5	Exchange rate, the stock market and the macroeconomy: A baseline two-country model	120
5.1	<i>Introduction</i>	120
5.2	<i>Overshooting exchange rate dynamics</i>	122
5.3	<i>Symmetric two-country macrodynamics: A baseline model</i>	124
5.4	<i>Blanchard-type stock-market–goods-market interactions</i>	134
5.5	<i>Synthesizing Blanchard stock-market with Dornbusch exchange rate dynamics in a two-country framework</i>	135
5.6	<i>A model-adequate reformulation of the Taylor interest rate rule</i>	138
5.7	<i>Symmetric countries: Stability analysis</i>	141
5.8	<i>Adding inflation dynamics</i>	143
5.9	<i>Outlook: imperfect capital markets</i>	146
5.10	<i>References</i>	147
 <b>PART II</b>		
<b>Stock market dynamics and the macroeconomy: Some extensions</b>		<b>149</b>
6	Output and stock market dynamics with state-dependent financial market reactions	151
6.1	<i>Introduction</i>	151
6.2	<i>The model</i>	152
6.3	<i>Analysis of the model</i>	156
6.4	<i>State-of-market dependent reaction speed – an alternative to the JVT</i>	162
6.5	<i>Relaxing perfection</i>	173
6.6	<i>Conclusion</i>	185
6.7	<i>References</i>	187
7	Real–financial market interaction: Implications of budget equations and capital accumulation	190
7.1	<i>Introduction</i>	190
7.2	<i>The Blanchard model with intrinsic stock-flow dynamics</i>	192
7.3	<i>Intensive form of the model</i>	194
7.4	<i>Analysis</i>	196
7.5	<i>Jump variable conundrums</i>	205
7.6	<i>Conclusions</i>	210
7.7	<i>References</i>	210
7.8	<i>Appendix: Adding the dynamics of the government budget constraint</i>	211
8	Bounded rationality and the real–financial interaction: A stochastic analysis	215
8.1	<i>Introduction</i>	215
8.2	<i>Notation</i>	217
8.3	<i>The model</i>	218
8.4	<i>Heterogenous expectations</i>	221
8.5	<i>Analysis of the deterministic skeleton</i>	223
8.6	<i>Analysis of the nonlinear stochastic model</i>	233

8.7	<i>Conclusions</i>	236	
8.8	<i>References</i>	239	
9	A high-dimensional model of real–financial market interaction		240
9.1	<i>Introduction</i>	240	
9.2	<i>Formulation of the model</i>	241	
9.3	<i>The model in intensive form</i>	246	
9.4	<i>Subdynamics in the real and financial sector</i>	248	
9.5	<i>Local stability analysis of the full 7D dynamics</i>	252	
9.6	<i>Conclusions</i>	258	
9.7	<i>References</i>	259	
10	Stock market, interest rate and output: A model and estimation for US time series data		261
10.1	<i>Introduction</i>	261	
10.2	<i>Stylized facts and macromodels</i>	262	
10.3	<i>A generalized Blanchard model</i>	266	
10.4	<i>The dynamics of the model</i>	272	
10.5	<i>Discrete time form for observable variables</i>	274	
10.6	<i>Empirical results for US time series data</i>	276	
10.7	<i>Stochastic simulations and impulse response functions</i>	278	
10.8	<i>Conclusions</i>	287	
10.9	<i>References</i>	288	
10.10	<i>Appendix 1: Stability analysis of the Blanchard model</i>	290	
10.11	<i>Appendix 2: The characteristic equation of the generalized Blanchard model</i>	291	
<b>PART III</b>			
<b>Exchange rate dynamics, capital flows and currency crises</b>			<b>293</b>
11	Capital account and government budget dynamics in perfect open economies		295
11.1	<i>Introduction</i>	295	
11.2	<i>Notation</i>	295	
11.3	<i>The basic one-good monetary model of international commodity trade</i>	296	
11.4	<i>The monetary adjustment process</i>	301	
11.5	<i>The two-commodity extension</i>	311	
11.6	<i>The perfectly open economy: Basic and advanced formulations</i>	318	
11.7	<i>Twin deficits and PPP/UIP-driven price dynamics</i>	332	
11.8	<i>Active fiscal and monetary policy in the perfect open economy</i>	336	
11.9	<i>Conclusions</i>	341	
11.10	<i>References</i>	341	
11.11	<i>Appendix: Two-country and other extensions of the model</i>	341	
12	Twin deficits and inflation in the Mundell–Fleming–Tobin model		344
12.1	<i>Introduction</i>	344	
12.2	<i>Temporary equilibrium</i>	345	
12.3	<i>The six economic regimes of the model</i>	352	
12.4	<i>Twin deficits and price level dynamics under fixed and floating exchange rates</i>	360	

12.5	<i>Capital account and inflation with interest and exchange rate pegs</i>	371
12.6	<i>Overshooting exchange rate dynamics</i>	376
12.7	<i>Conclusions</i>	381
12.8	<i>References</i>	381
13	<b>Financial crisis, currency crisis and large output loss</b>	382
13.1	<i>Introduction</i>	382
13.2	<i>Stylized facts</i>	383
13.3	<i>The basic model</i>	385
13.4	<i>Budget restrictions and national accounting</i>	391
13.5	<i>Dynamics under flexible exchange rates</i>	397
13.6	<i>Currency crisis in a fixed exchange rate regime</i>	405
13.7	<i>Conclusions</i>	412
13.8	<i>References</i>	413
14	<b>Emerging market economies, currency crises and macroeconomic adjustment</b>	415
14.1	<i>Introduction</i>	415
14.2	<i>The basic model</i>	416
14.3	<i>Local stability analysis</i>	424
14.4	<i>Currency crises in a pegged exchange rate system</i>	425
14.5	<i>Currency crises and hedging</i>	428
14.6	<i>Adding wage and price dynamics</i>	436
14.7	<i>The dynamics of a currency crisis in our extended model</i>	444
14.8	<i>Conclusions</i>	447
14.9	<i>References</i>	448
15	<b>Outlook: International capital flows in the MFT approach</b>	450
15.1	<i>Introduction</i>	450
15.2	<i>Integrating international capital flows into the MFT approach</i>	451
15.3	<i>Real–financial disequilibrium dynamics: Some basic results</i>	459
15.4	<i>Capital flight, global players and the emergence of currency crises</i>	471
15.5	<i>Conclusions</i>	472
15.6	<i>References</i>	473
	<b>Mathematical appendix: Some useful theorems</b>	474
A1	<i>The concepts of local stability and global stability in a system of differential equations</i>	474
A2	<i>Theorems that are useful for the stability analysis of a system of linear differential equations or the local stability analysis of a system of nonlinear differential equations</i>	474
A3	<i>Theorems that are useful for the global stability analysis of a system of nonlinear differential equations</i>	477
A4	<i>Theorems that are useful to establish the existence of closed orbits in a system of nonlinear differential equations</i>	478
A5	<i>References</i>	481
	<b>Index</b>	482