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Introduction

This book attempts to provide a non-mathematical introduction to the macroeconomic analysis of both the open economy and the world economy. Such analysis is appropriate for a number of reasons. First, all economies are, at least to some extent, open; they have trading and financial links with other economies. Second, what holds for a closed economy may not hold for an open one. Dropping the closed economy assumption from simple macroeconomic models is a strategic step which may even reverse the policy conclusions reached. Third, while it is important to see how the operation of an open economy differs from that of a closed one, it is also important to examine the operation of the world economy – or a substantial part of it – as a whole. Many macroeconomic problems are shared across countries and it is therefore relevant to ask whether these problems and their potential solutions should not be dealt with at a more aggregated level than that of individual countries. Furthermore, does it follow that what is right for an individual economy in isolation is right for the world economy?

Of course, none of this is very new. A great deal has been written over recent years – and indeed not so recent years – about open-economy macroeconomics, although perhaps rather less has been written on the macroeconomics of the world economy.¹ Much of what has been produced, however, has been quite mathematical and technical. Yet the issues raised are sufficiently important to warrant dissemination to and discussion by a wider audience which, while it may be happy to look at diagrams and to follow some elementary analysis, feels uncomfortable with too many formulae and equations. The purpose of this book is to provide just such an exposition. Of course, the simplification of theory has costs as well as benefits. The principal cost is a loss of analytical precision and rigour, although there can be legitimate debate over just how high a cost this is.

The book's purpose is not only to work through a certain amount of economic theory, but also to relate the theory to problems of

macroeconomic management and policy formulation at both the individual and world-economy level. Theory is then not presented for its own sake, but rather as a means of assisting in the realisation of basic macroeconomic policy targets. As such, it is hoped that the contents will be of some interest to policy-makers as well as to students of economics.

The book presumes some basic understanding of macroeconomics but does not require any significant mathematical capability.² It could be used for first- or second-year undergraduates, either as a course text in its own right or as a supplement to other more conventional macroeconomics textbooks. It could also be used as a complementary source on courses which provide a more descriptive and institutionally based treatment of international financial economics.

The book is written in a rather terse style and there is a noticeable absence of subtlety. The reasons for this are, first, the desire to avoid the book becoming over long and to explain the basic ideas in international macroeconomics as crisply and efficiently as possible. With more comprehensive textbooks it is often possible to lose sight of the wood for the trees. Besides, with long chapters it is sometimes difficult to keep the momentum going. Second, it is hoped that readers will be encouraged to read the book actively rather than passively; in other words, they will have to work carefully through the arguments and may have to dip into other textbooks in macroeconomics to fill gaps in their existing knowledge that is taken for granted here.

The layout of the book is as follows. Part I examines the macro theory of the open economy. Chapter 2 sets up a basic open-economy model which, in essence, simply augments *IS-LM* with a balance of payments component. Chapter 3 decomposes this model and focuses on the current and capital accounts of the balance of payments. Chapter 4 examines the various approaches to analysing the balance of payments and the causes of payments problems, while Chapter 5 looks at the theory of exchange-rate determination. Part I is brought to a conclusion by Chapter 6, which examines theories of currency crisis.

Having amassed these analytical building blocks, Part II examines policy. Chapter 7 sets the scene and briefly examines balance of payments policy options in broad terms. It discusses structural adjustment and the politics of policy choice. Chapter 8 examines macroeconomic stabilisation policy in the context of an open economy, concentrating on monetary and fiscal policy, with Chapter 9 focusing more narrowly on exchange-rate policy. Chapters 10 and 11 discuss international capital volatility and the international co-ordination of macroeconomic policy, respectively.

International macroeconomics remains in a rather strange condition. Simple models which focus on the short run and which largely put to

one side many of the recent 'advances' in macroeconomic theory such as rational expectations, efficient markets, and inter-temporal optimisation, remain remarkably resilient at explaining many aspects of the real world. Indeed, they frequently provide both a clearer and more accurate guide than do the more 'advanced' models which theoretical purists prefer. Simple models continue to supply an expedient way of understanding many global macroeconomic events and therefore yield a higher intellectual rate of return. That this book ignores some modern theoretical macroeconomic work does not only therefore reflect its introductory status, but also the fact that incorporating these newer ideas does not significantly improve our ability to explain the world economy. Indeed, in many cases the newer theories are at odds with the empirical evidence. While making do with a basic model which contains theoretical shortcomings may not be ideal, it may be the best we can do for the present.

Part III of the book sets out to show that the simple model constructed earlier does indeed provide a useful framework within which to analyse aspects of the world economy. It gives us a worthwhile analytical tool kit. Chapter 12 examines the oil crisis of the 1970s and the debt crisis of the 1980s in the context of the *IS-LM-BP* model. Chapter 13 seeks to explain the near collapse of Europe's Exchange Rate Mechanism (ERM) in 1992 and the subsequent move to the euro. Chapter 14 turns attention to the sequence of crises in emerging economies during the 1990s and early 2000s. Chapter 15 uses balance of payments theory to better understand the enduring current account deficit in the USA and related global economic imbalances. Finally, Chapter 16 examines the choice of macroeconomic policy favoured by the International Monetary Fund (IMF). In each case, the applications are intended to bring the analysis to life and to show that it is relevant to the real world.

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