MARMARA UNIVERSITY
THE DEPARTMENT OF ECONOMICS

ECO 461
International Monetary Economics I
Yrd. Doç. Dr. M. Nedim Süalp

Suppose that an economy is operating under fixed exchange rate, **imperfect** capital mobility and fixed price regime. In addition, <u>assume that</u>, due to some reasons, the capital movements are <u>highly</u> **insensitive** to interest rate differentials between the domestic interest rate and the <u>fixed</u> world interest rate <u>in comparison to</u> the sensitivity of money demand to the interest rate. How would you analyze the effects of devaluation on this economy <u>if</u> <u>initially</u> the domestic interest rate is equal to the world interest rate and the economy is suffering from balance of payments deficit under the **assumptions that** devaluation causes a <u>once-and-for-all</u> increase in the <u>domestic price level</u> (may be due to the increase in the price of import goods) and the effect of devaluation on the balance of payment equilibrium relation is smaller than the effect of devaluation on the IS relation (known as Harberger condition).

How would you compare the result of the dynamics you have obtained above with the one with no devaluation?