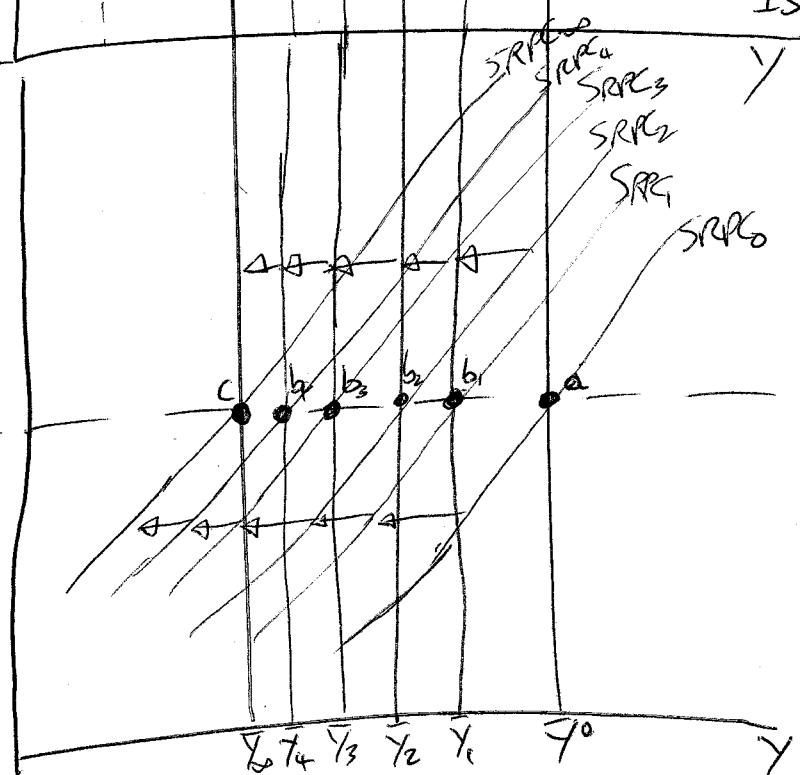
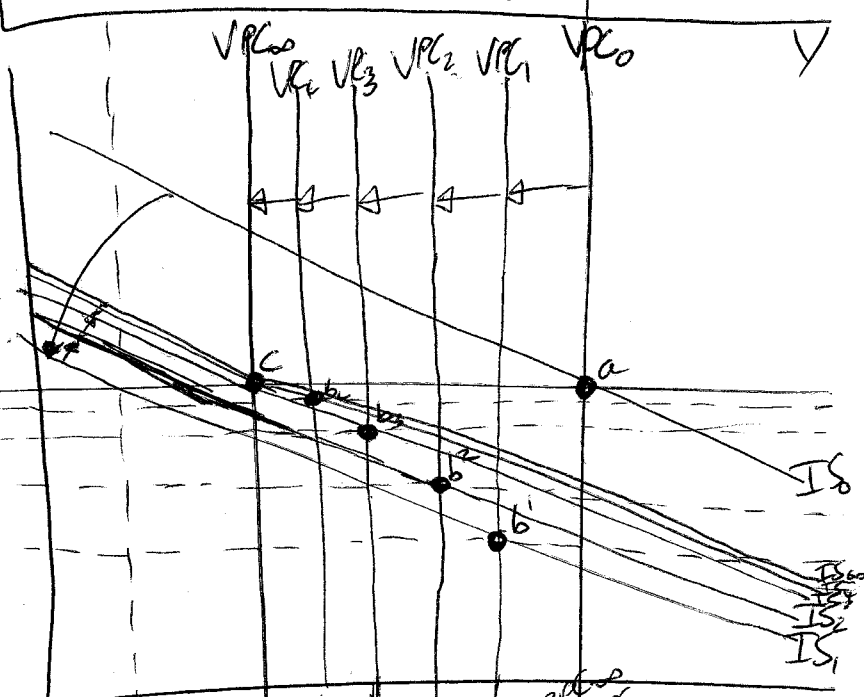
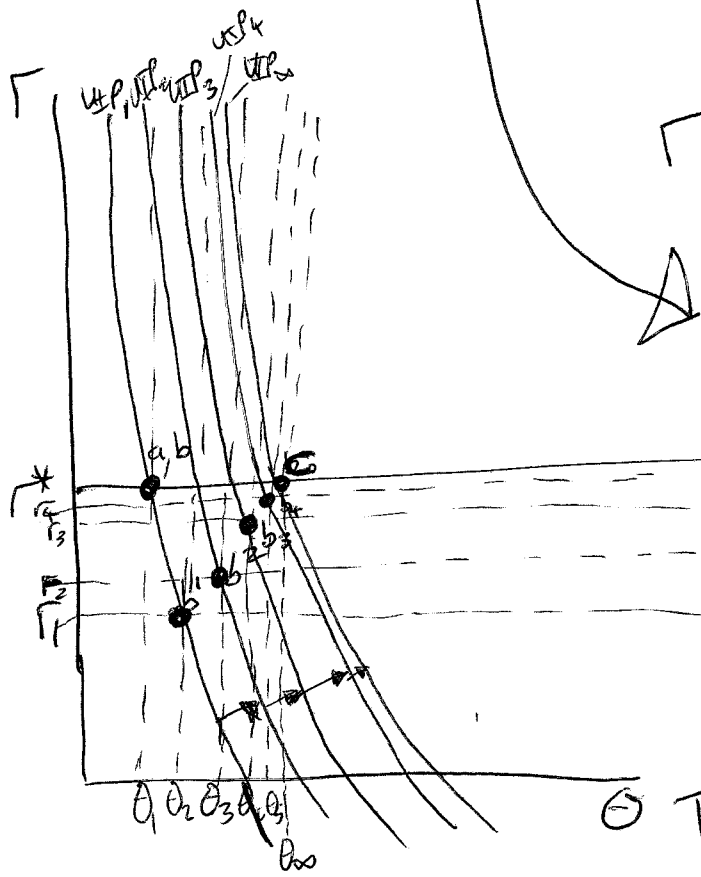
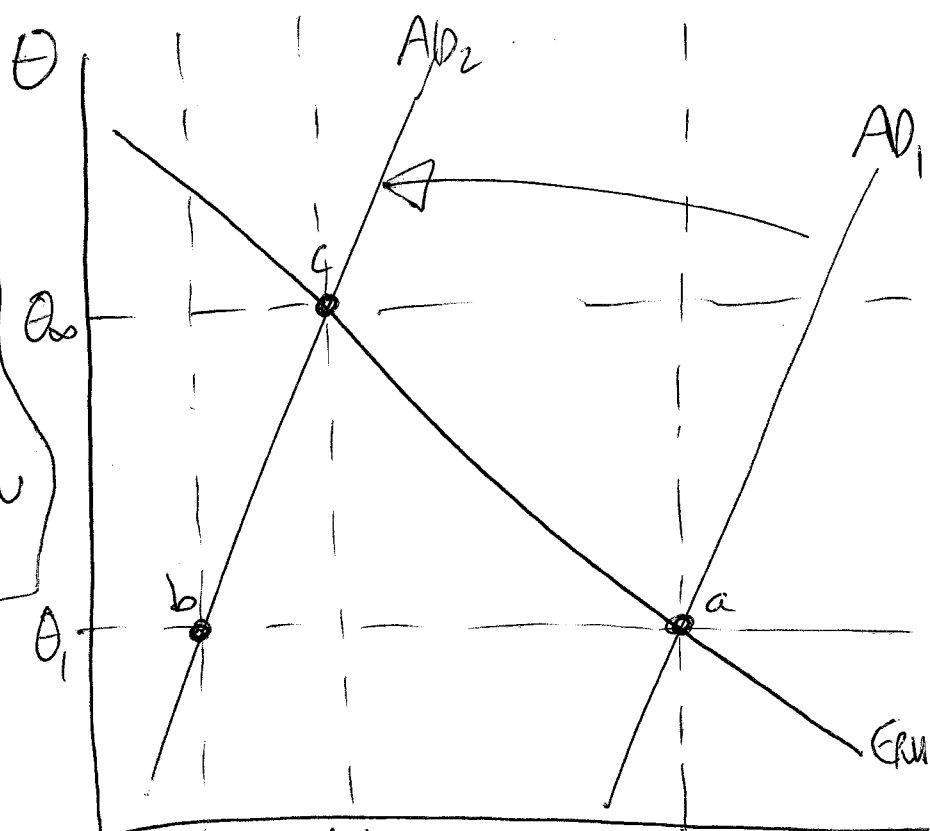


NOTE: IS CURVES INCLUDE THE EFFECT OF τ ON THE REAL EXCHANGE RATE θ AS PART OF THE GRADIENT AND HENCE ARE "FLATTER" THAN IN THE CLOSED ECONOMY



THE PANEL DIAGRAMS ILLUSTRATE THE RESPONSE OF A FLOATING EXCHANGE RATE ECONOMY WHERE UNCOVERED INTEREST PARITY HOLDS WITH ADAPTIVE EXPECTATIONS. OVER A SEQUENCE OF PERIODS, THE CENTRAL BANK LOWERS THE REAL INTEREST RATE BELOW τ^* CAUSING A DEPRECIATION EXPANSION OF AD AND DECREASE IN POTENTIAL OUTPUT Y

With forward-looking / rational expectations on the part of financial market UIP agents, this process happens instantly, and so the economy goes straight from point a to point c as soon as the central bank is able to respond with monetary policy to the AD curve shift.