Imported Intermediate Goods, Foreign Price Increases, and Domestic Monetary Policy: The IS-LM Analysis Revived*

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Until recently imports of intermediate goods have been neglected in monetary (not in real) trade theory. This paper deals with the macroeconomic consequences of such imports. The basic analytical tool is a suitably modified Hicksian IS-LM diagram. It is shown that trade in intermediate goods does have some particular implications that do not arise otherwise.

I. Introduction

For a number of years the *Fleming/Mundell* (FM) model[1] has been the corner-stone of open economy macroeconomics.[2] This model was based on a number of simplifying assumptions the main ones being:

> "To focus attention on policies affecting the level of employment, we assume unemployed resources, constant returns to scale, and fixed money wages; this means that the supply of domestic output is elastic and *its price level constant.*"[3]

Mundell mentions three conditions for a fixed domestic product price, and there is still a fourth one: absence of imported intermediate goods (raw materials, semi-finished products etc.). The recent oil-price crises, however, have reminded us that the fourth condition is untenable. In addition, since the worldwide upsurge of inflation rates money wages have become indexed in many countries and in others wage negotiations are geared at preventing a fall in real wages. Hence, the assumption of a fixed money wage should be abandoned.[4] In other words, the FM

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[1] *Fleming* (1962), *Mundell* (1963).

[2] Cf. *Chacoliades* (1978), chapt. 17, *Dornbusch* (1980), chapt. 11, *Dornbusch & Fischer* (1978), chapts. 18, 19, *Sohmen* (1969), chapt. V, *Takayama* (1972), chapts. 10, 11. (This list is far from exhaustive.)

[3] *Mundell* (1963), 476; our emphasis.

[4] The wide use of expectation-augmented Philipps curve indicates that this condition is no longer generally accepted.