Wages, the Terms of Trade, and the Exchange Rate Regime

By Douglas D. Purvis*

The issue of relative country size is obviously one of much practical significance. But the choice of relative country size as the central theme of this conference is also timely in terms of the development of the current literature on macroeconomic theory in an open economy. Certainly the dominant theme in the current literature is the monetary approach to balance of payments and exchange rate analysis. One of the most attractive features of the monetary approach in its early stages was its general equilibrium nature, and one of its earliest and most important "victories" was the laying-to-rest of the partial equilibrium elasticities approach. But in emphasizing the monetary nature of balance of payments and exchange rate phenomena, recent writings in the field have paid increasingly less attention to general equilibrium interactions, and have worked with highly aggregated models which abstract from the type of real phenomena which the earlier traditions had emphasized. The question of relative country size is one which necessitates that attention be refocussed on structural aspects of the economy. The purpose of this paper is to explore the implications of imposing some "real, structural characteristics" on a model which is otherwise very monetary in spirit.

One of the key insights of the monetary approach is that it made explicit the distinction between the exchange rate, being the relative price of national monies, and the terms of trade, being the relative price of traded goods. This distinction was often blurred in older Keynesian models in which output prices were treated as constant in terms of the domestic currency so that a change in the exchange rate was also a change in the relative price of national outputs. Monetary models, in contrast, have tended to emphasize models with full employment and fixed terms of trade, although neither assumption is essential to the

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* Yale University.

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