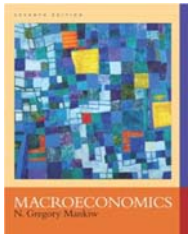
Intermediate Macroeconomics

ECON 302

Professor Yamin Ahmad

Lecture 10: The Small Open Economy

- Accounting Identities
- Savings and Investment
- Exchange Rates
- Purchasing Power Parity



Key Concepts…

- Accounting identities for the open economy
- The *Small Open Economy* model
  - what makes it "small"
  - how the trade balance and exchange rate are determined
  - how policies affect trade balance & exchange rate
- Exchange Rates (Nominal and Real)
- Purchasing Power Parity

Trade-GDP ratio, selected countries, 2004

(Imports + Exports) as a percentage of GDP

Luxembourg	275.5%
Ireland	150.9
Czech Republic	143.0
Hungary	134.5
Austria	97.1
Switzerland	85.1
Sweden	83.8
Korea, Republic of	83.7
Poland	80.0
Canada	73.1

Germany	71.1%
Turkey	63.6
Mexico	61.2
Spain	55.6
United Kingdom	53.8
France	51.7
Italy	50.0
Australia	39.6
United States	25.4
Japan	24.4

In an open economy,

- Spending need not equal Output
  i.e. $Y = C + I + G + NX$
- Saving need not equal Investment
  i.e. $I = S - NX$

Preliminaries

$$C = C^d + C^f$$

$$I = I^d + I^f$$

$$G = G^d + G^f$$

superscripts:
d = spending on domestic goods
f = spending on foreign goods

EX = exports = foreign spending on domestic goods

IM = imports = $C^f + I^f + G^f$ = spending on foreign goods

NX = net exports (*a.k.a.* the "trade balance") = ***EX*** – ***IM***

GDP = expenditure on domestically produced Goods & Services

$$Y = C^d + I^d + G^d + EX$$

$$= (C - C^f) + (I - I^f) + (G - G^f) + EX$$

$$= C + I + G + EX - (C^f + I^f + G^f)$$

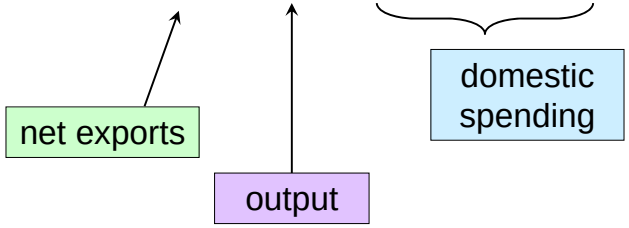
$$= C + I + G + EX - IM$$

$$= C + I + G + NX$$

The national income identity in an open economy

$$Y = C + I + G + NX$$

or, $NX = Y - (C + I + G)$

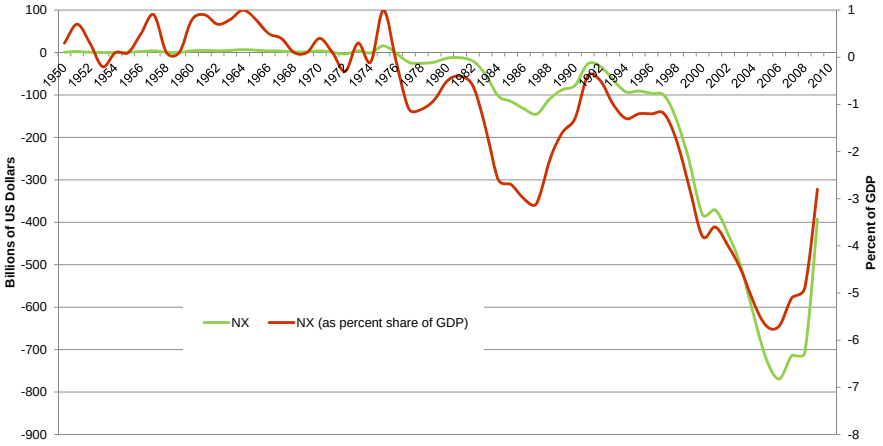


Trade surpluses and deficits

$$NX = EX - IM = Y - (C + I + G)$$

- **Trade Surplus:**
  output > spending and exports > imports
  Size of the trade surplus = ***NX***
- **Trade Deficit:**
  spending > output and imports > exports
  Size of the trade deficit = –***NX***

U.S. Net Exports, 1950-2010



International capital flows

- **Net capital outflow**
  - = $S - I$
  - = net outflow of "loanable funds"
  - = net purchases of foreign assets
    i.e. the country's purchases of foreign assets
    minus foreign purchases of domestic assets
- When $S > I$, country is a net lender
- When $S < I$, country is a net borrower

The link between trade & cap. flows

$$NX = Y - (C + I + G)$$

implies

$$NX = (Y - C - G) - I$$
$$= S - I$$

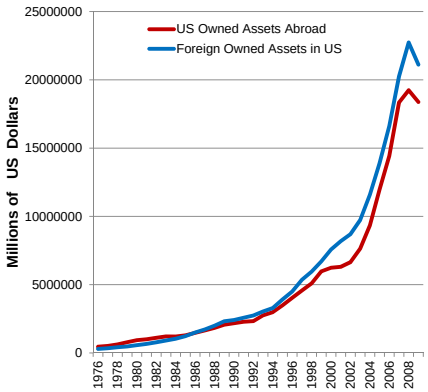
trade balance = net capital outflow

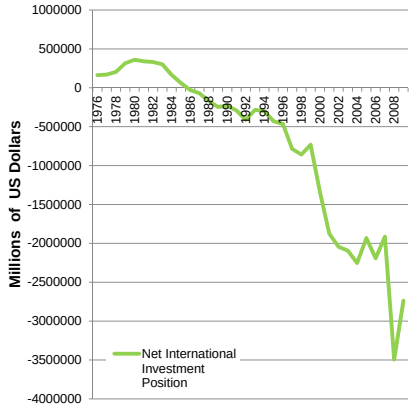
Thus,
a country with a trade deficit ($NX < 0$)
is a net borrower ($S < I$).

"The world's largest debtor nation"

- U.S. has had large trade deficits, been a net borrower each year since the early 1980s.
- As of 12/31/2009:
  - U.S. residents owned $18.4 trillion worth of foreign assets
  - Foreigners owned $21.1 trillion worth of U.S. assets
  - U.S. net indebtedness to rest of the world: $2.74 trillion--higher than any other country, hence U.S. is the "world's largest debtor nation"
  - This number is slightly lower from the end of 2008, where the US net indebtedness was $3.49 trillion.

US Net International Investment Position



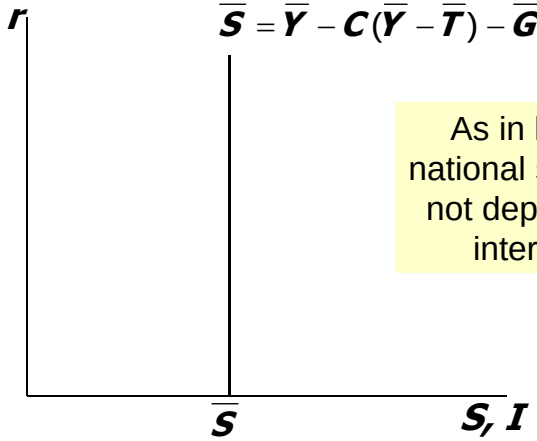


Saving and investment in a small open economy

- An open-economy version of the loanable funds model we saw from lecture 4.
- Includes many of the same elements:
  - production function $Y = \bar{Y} = F(\bar{K}, \bar{L})$
  - consumption function $C = C(Y - T)$
  - investment function $I = I(r)$
  - exogenous policy variables $G = \bar{G}, \quad T = \bar{T}$

National saving: The supply of loanable funds

$$\bar{S} = \bar{Y} - C(\bar{Y} - \bar{T}) - \bar{G}$$



As in lecture 4, national saving does not depend on the interest rate

Assumptions re: Capital flows

a. domestic & foreign bonds are perfect substitutes (same risk, maturity, *etc.*)

b. **perfect capital mobility**: no restrictions on international trade in assets

c. economy is **small**: cannot affect the world interest rate, denoted r^*

a & b imply $r = r^*$

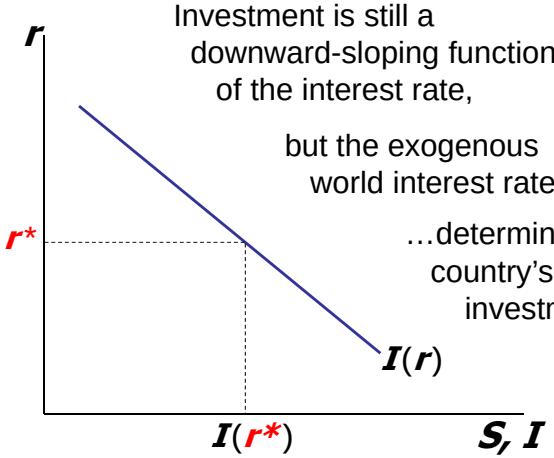
c implies r^* is exogenous

Investment: The demand for loanable funds

Investment is still a downward-sloping function of the interest rate,

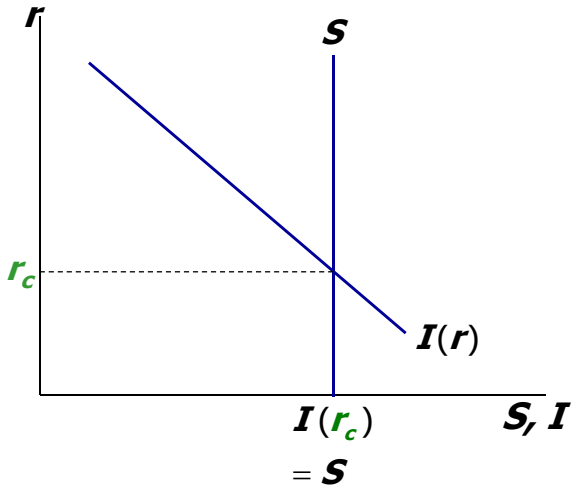
but the exogenous world interest rate…

…determines the country's level of investment.



If the economy were closed…

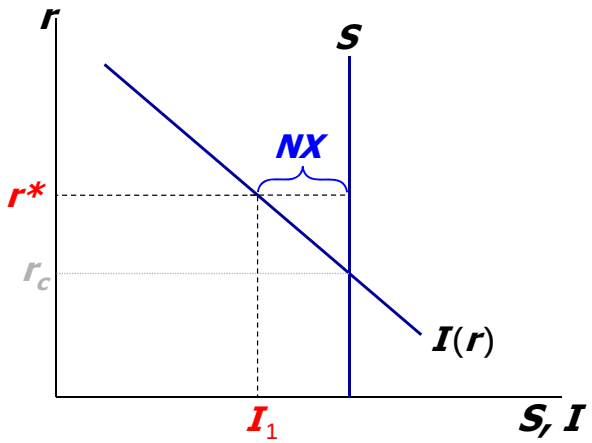
…the interest rate would adjust to equate investment and saving:



But in a small open economy…

the exogenous world interest rate determines investment…

…and the difference between saving and investment determines net capital outflow and net exports



Next, three experiments:

1. Fiscal policy at home
2. Fiscal policy abroad
3. An increase in investment demand

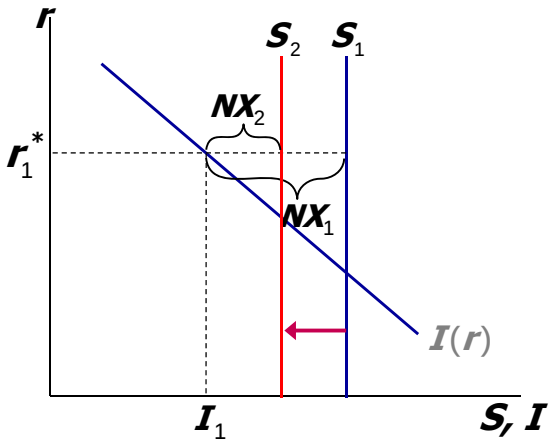
1. Fiscal policy at home

An increase in ***G*** or decrease in ***T*** reduces saving.

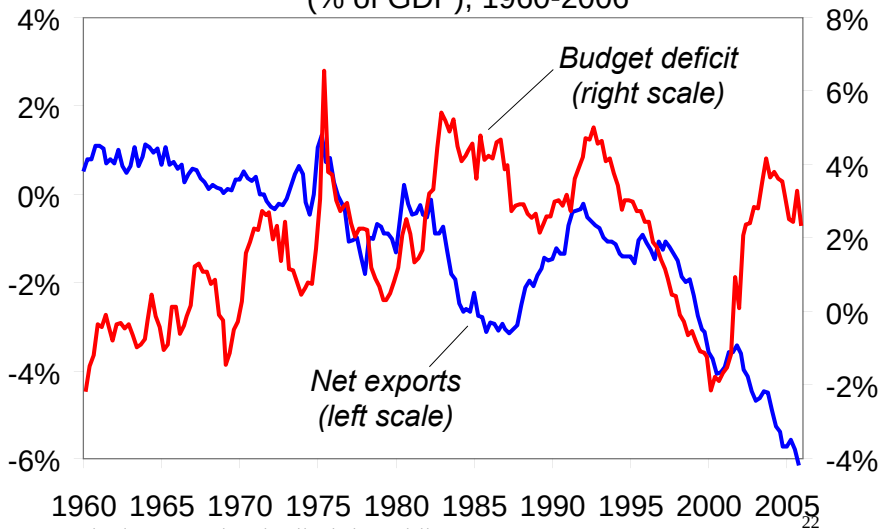
Results:

$\Delta I = 0$

$\Delta NX = \Delta S < 0$



NX and the federal budget deficit
(% of GDP), 1960-2006



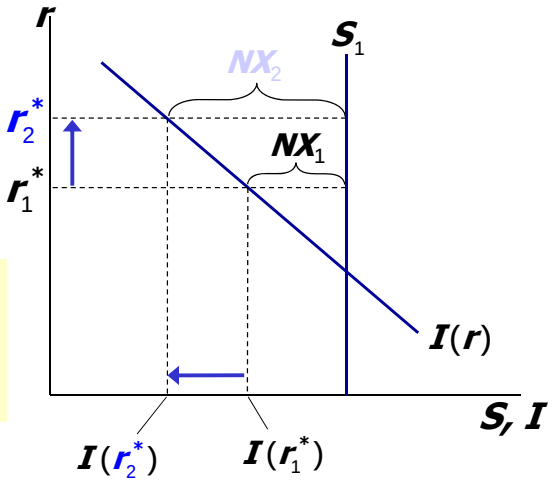
2. Fiscal policy abroad

Expansionary fiscal policy abroad raises the world interest rate.

Results:

$\Delta I < 0$

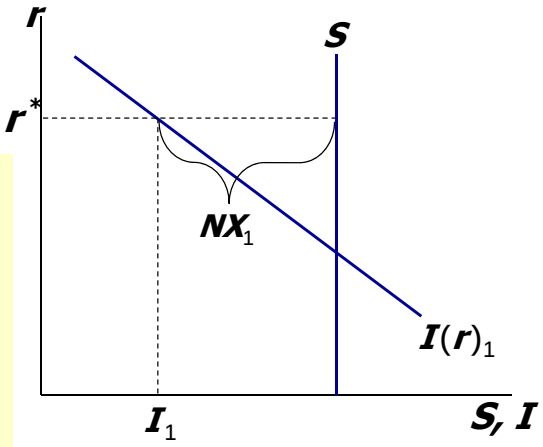
$\Delta NX = -\Delta I > 0$



3. An increase in investment demand

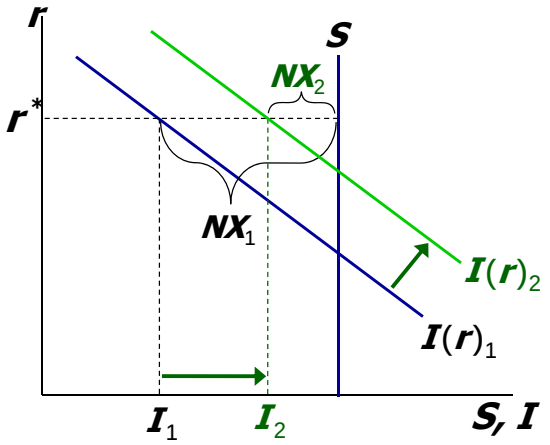
EXERCISE:

Use the model to determine the impact of an increase in investment demand on ***NX***, ***S***, ***I***, and net capital outflow.



3. An increase in investment demand

ANSWERS:
$\Delta I > 0$,
$\Delta S = 0$,
net capital outflow and ***NX*** fall by the amount ΔI



Is the US Current Account Deficit Dangerous?

- The United States is running a large current account deficit: I > S.
- The US is accumulating debt.
- The US debt/GDP ratio is rising.
- Should we be worried?

The Optimistic View – in terms of our model

- A simple, optimistic view of the current account deficit is that the world expects high productivity growth and output growth in the US.
- For any given r, this increases investment demand.
- In addition, saving may be low compared to other economies that do not expect fast growth.
- The S curve is shifted left, the I curve is shifted right.
- The US can afford to accumulate debt because its real GDP will be high in the future.
- Other countries need to worry more about their aging populations.

The Nominal Exchange rate

e = nominal exchange rate, the relative price of domestic currency in terms of foreign currency (*e.g.* Yen per Dollar)

A few exchange rates, as of 4/8/11

country	*exchange rate*
Euro	0.69 Euro/$
Indonesia	8,694 Rupiahs/$
Japan	84.98 Yen/$
Mexico	11.74 Pesos/$
Russia	27.96 Rubles/$
South Africa	6.65 Rand/$
U.K.	0.61 Pounds/$

The Real Exchange Rate

ε = real exchange rate, the relative price of domestic goods in terms of foreign goods (*e.g.* Japanese Big Macs per U.S. Big Mac)

the lowercase Greek letter epsilon

Understanding the units of ε

$$\varepsilon = \frac{e \times P}{P^*}$$

$$= \frac{(\text{Yen per \$}) \times (\text{\$ per unit U.S. goods})}{\text{Yen per unit Japanese goods}}$$

$$= \frac{\text{Yen per unit U.S. goods}}{\text{Yen per unit Japanese goods}}$$

$$= \text{Units of Japanese goods per unit of U.S. goods}$$

~ McZample ~

- one good: Big Mac
- price in Japan: P^* = 200 Yen
- price in USA: P = $2.50
- nominal exchange rate e = 120 Yen/$

$$\varepsilon = \frac{e \times P}{P^*} = \frac{120 \times \$2.50}{200 \text{ Yen}} = 1.5$$

To buy a U.S. Big Mac, someone from Japan would have to pay an amount that could buy 1.5 Japanese Big Macs.

ε in the real world & our model

- *In the real world:*
  We can think of ε as the relative price of a basket of domestic goods in terms of a basket of foreign goods
- *In our macro model:*
  There's just one good, "output."
  So ε is the relative price of one country's output in terms of the other country's output

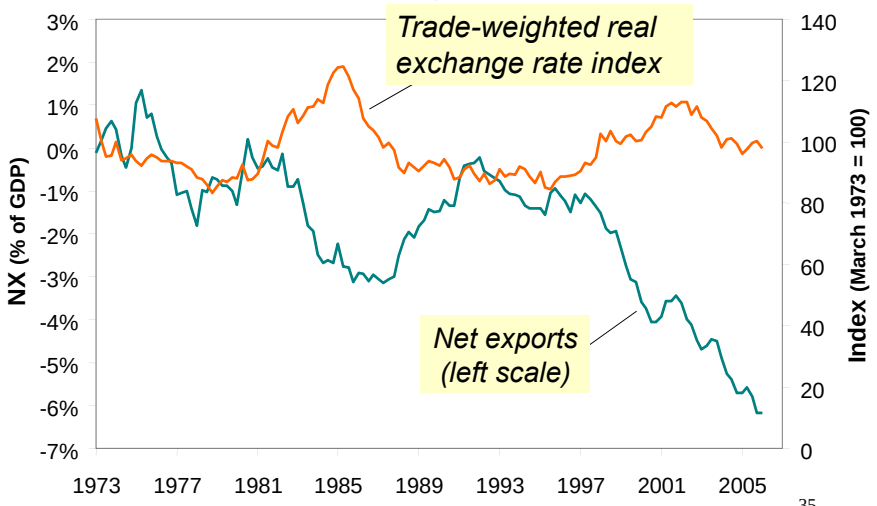
How *NX* depends on ε

$\uparrow\varepsilon \Rightarrow$ U.S. goods become more expensive relative to foreign goods

$\Rightarrow$ $\downarrow EX$, $\uparrow IM$

$\Rightarrow$ $\downarrow NX$

U.S. net exports and the real exchange rate, 1973-2006

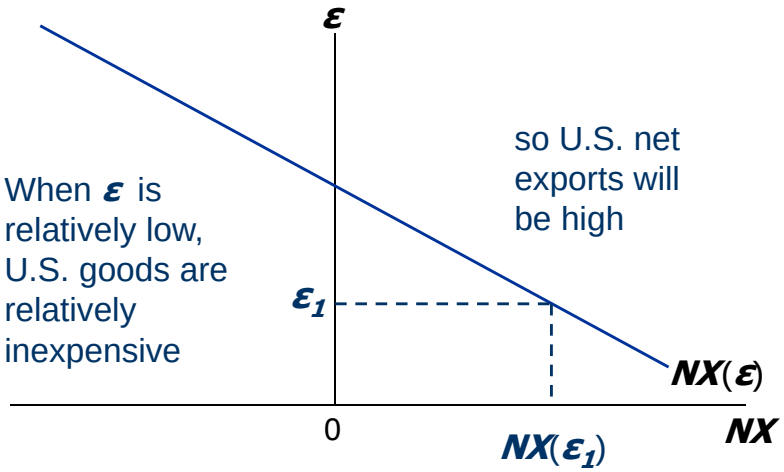


The net exports function

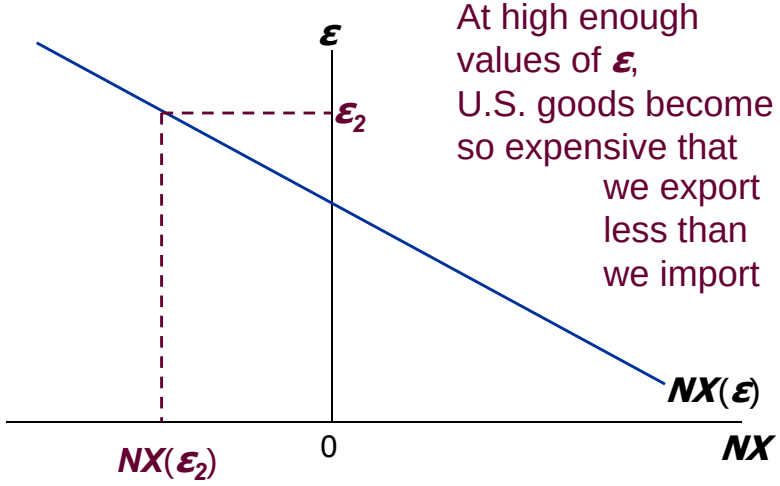
- The **net exports function** reflects this inverse relationship between ***NX*** and ε:

$$NX = NX(\varepsilon)$$

The *NX* curve for the U.S.



The *NX* curve for the U.S.



How ε is determined

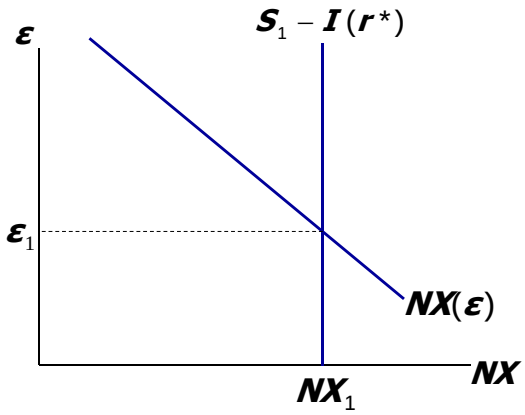
- The accounting identity says $NX = S - I$
- We saw earlier how $S - I$ is determined:
  - S depends on domestic factors (output, fiscal policy variables, *etc*)
  - I is determined by the world interest rate r^*
- So, ε must adjust to ensure

$$NX(\varepsilon) = \overline{S} - I(r^*)$$

How ε is determined

Neither S nor I depend on ε, so the net capital outflow curve is vertical.

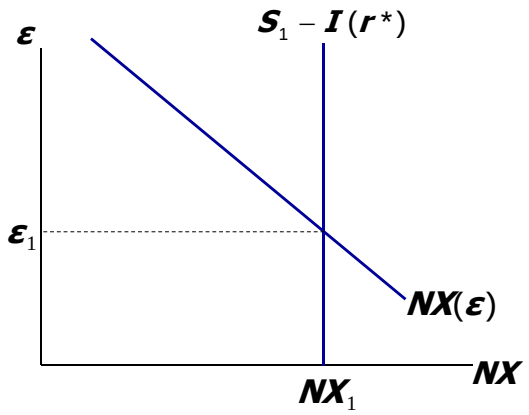
ε adjusts to equate NX with net capital outflow, $S - I$.



Interpretation: Supply and demand in the foreign exchange market

demand:
Foreigners need dollars to buy U.S. net exports.

supply:
Net capital outflow ($S - I$) is the supply of dollars to be invested abroad.

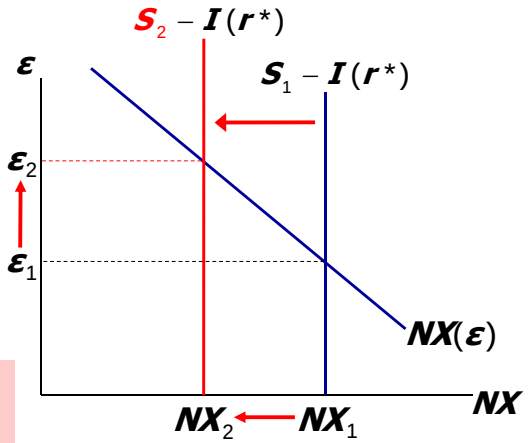


Next, three experiments:

1. Fiscal policy at home
2. Fiscal policy abroad
3. An increase in investment demand

1. Fiscal policy at home

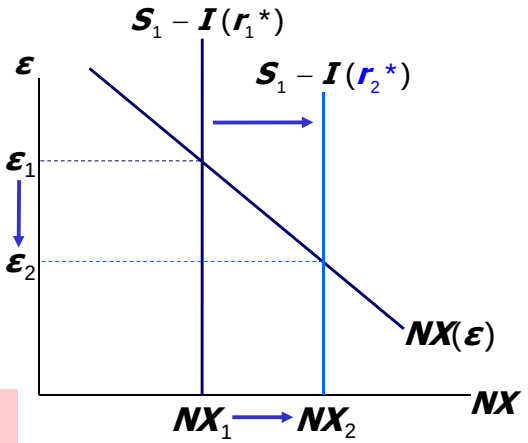
A fiscal expansion reduces national saving, net capital outflow, and the supply of dollars in the foreign exchange market…



...causing the real exchange rate to rise and ***NX*** to fall.

2. Fiscal policy abroad

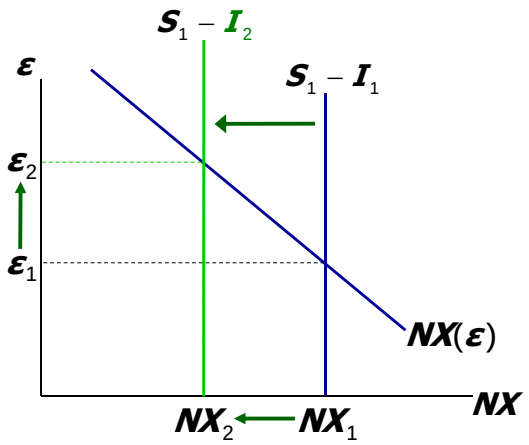
An increase in r^* reduces investment, increasing net capital outflow and the supply of dollars in the foreign exchange market…



...causing the real exchange rate to fall and ***NX*** to rise.

3. Increase in investment demand

An increase in investment reduces net capital outflow and the supply of dollars in the foreign exchange market…



...causing the real exchange rate to rise and ***NX*** to fall.

The Determinants of the Nominal Exchange Rate

- Start with the expression for the real exchange rate:

$$\varepsilon = \frac{e \times P}{P^*}$$

- Solve for the nominal exchange rate:

$$e = \varepsilon \times \frac{P^*}{P}$$

The Determinants of the Nominal Exchange Rate

- So ***e*** depends on the real exchange rate and the price levels at home and abroad…

…and we know how each of them is determined:

$$\frac{M^*}{P^*} = L^*(r^* + \pi^*, Y^*)$$

$$e = \varepsilon \times \frac{P^*}{P}$$

$$NX(\varepsilon) = \overline{S} - I(r^*)$$

$$\frac{M}{P} = L(r^* + \pi, Y)$$

The Determinants of the Nominal Exchange Rate

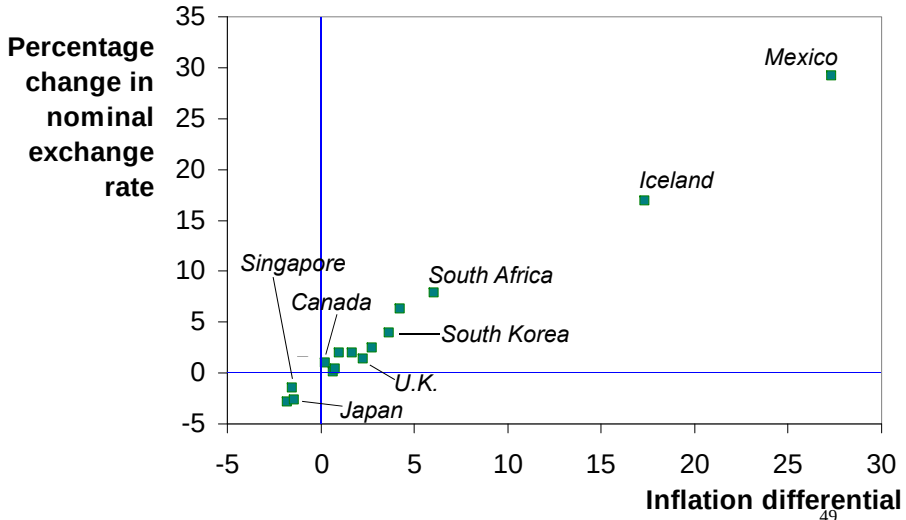
$$e = \varepsilon \times \frac{P^*}{P}$$

- Rewrite this equation in growth rates (*see* "*arithmetic tricks for working with percentage changes,*"):

$$\frac{\Delta e}{e} = \frac{\Delta \varepsilon}{\varepsilon} + \frac{\Delta P^*}{P^*} - \frac{\Delta P}{P} = \frac{\Delta \varepsilon}{\varepsilon} + \pi^* - \pi$$

- For a given value of ε, the growth rate of ***e*** equals the difference between foreign and domestic inflation rates.

Inflation differentials and nominal exchange rates



Purchasing Power Parity (PPP)

Two definitions:

- A doctrine that states that goods must sell at the same (currency-adjusted) price in all countries.
- The nominal exchange rate adjusts to equalize the cost of a basket of goods across countries.

Reasoning:

- **Arbitrage**, the law of one price

Purchasing Power Parity (PPP)

- PPP: $e \times P = P^*$

$e \times P$: Cost of a basket of domestic goods, in domestic currency.

P^*: Cost of a basket of foreign goods, in foreign currency.

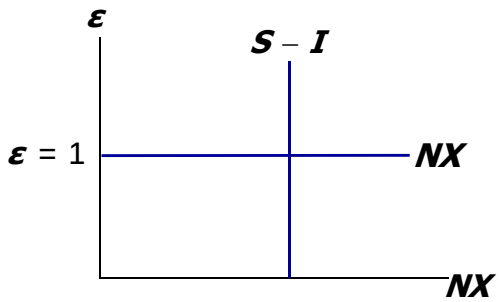
- Solve for e: $e = P^*/P$
- PPP implies that the nominal exchange rate between two countries equals the ratio of the countries' price levels.

Purchasing Power Parity (PPP)

- If $e = P^*/P$,

then $\varepsilon = e \times \frac{P}{P^*} = \frac{P^*}{P} \times \frac{P}{P^*} = 1$

and the NX curve is horizontal:



Under PPP, changes in $(S - I)$ have no impact on ε or e.

Does PPP hold in the real world?

- No, for two reasons:
  1. International arbitrage not possible.
     - nontraded goods
     - transportation costs
  2. Different countries' goods not perfect substitutes.
- Nonetheless, PPP is a useful theory:
  - ➢ It's simple & intuitive
  - ➢ In the real world, nominal exchange rates tend toward their PPP values over the long run.

CASE STUDY: The Reagan deficits revisited

	1970s	1980s	actual change	closed economy	small open economy
G* – *T	2.2	3.9	↑	↑	↑
S	19.6	17.4	↓	↓	↓
r	1.1	6.3	↑	↑	no change
I	19.9	19.4	↓	↓	no change
NX	-0.3	-2.0	↓	no change	↓
ε	115.1	129.4	↑	no change	↑

*Data: decade averages; all except **r** and ε are expressed as a percent of GDP; ε is a trade-weighted index.*

Summary

- Net exports--the difference between
  - ➢ exports and imports
  - ➢ a country's output (***Y***) and its spending (***C*** + ***I*** + ***G***)
- Net capital outflow equals
  - ➢ purchases of foreign assets minus foreign purchases of the country's assets
  - ➢ the difference between saving and investment

Summary

- National income accounts identities:
  - ➢ ***Y*** = ***C*** + ***I*** + ***G*** + ***NX***
  - ➢ trade balance ***NX*** = ***S*** – ***I*** net capital outflow
- Impact of policies on ***NX*** :
  - ➢ ***NX*** increases if policy causes ***S*** to rise or ***I*** to fall
  - ➢ ***NX*** does not change if policy affects neither ***S*** nor ***I***. Example: trade policy

Summary

- Exchange rates
  - nominal: the price of a country's currency in terms of another country's currency
  - real: the price of a country's goods in terms of another country's goods
  - The real exchange rate equals the nominal rate times the ratio of prices of the two countries.

Summary

- How the real exchange rate is determined
  - ***NX*** depends negatively on the real exchange rate, other things equal
  - The real exchange rate adjusts to equate ***NX*** with net capital outflow

Summary

- How the nominal exchange rate is determined
  - ***e*** equals the real exchange rate times the country's price level relative to the foreign price level.
  - For a given value of the real exchange rate, the percentage change in the nominal exchange rate equals the difference between the foreign & domestic inflation rates.