



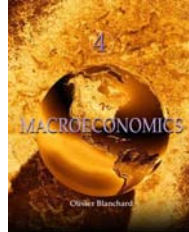
Business Conditions Analysis

ECON 736

Professor Yamin Ahmad

Lecture 7: 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

Note: These lecture notes are incomplete without having attended lectures

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In an open economy,

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

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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”)
= $EX - IM$

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GDP = expenditure on domestically produced Goods & Services

$$\begin{aligned}
 Y &= C^d + I^d + G^d + EX \\
 &= (C - C^f) + (I - I^f) + (G - G^f) + EX \\
 &= C + I + G + EX - (C^f + I^f + G^f) \\
 &= C + I + G + EX - IM \\
 &= C + I + G + NX
 \end{aligned}$$



The national income identity in an open economy

$$\begin{aligned}
 Y &= C + I + G + NX \\
 \text{or, } NX &= Y - (C + I + G)
 \end{aligned}$$

Diagram showing the relationship between variables:

- Output (Y) is represented by a purple box.
- Net exports (NX) is represented by a green box.
- Domestic spending (C + I + G) is represented by a blue box.
- Arrows point from the green box to the 'NX' term in the equation and from the purple box to the 'Y' term.
- A bracket under the '(C + I + G)' term in the second equation points to the blue box.



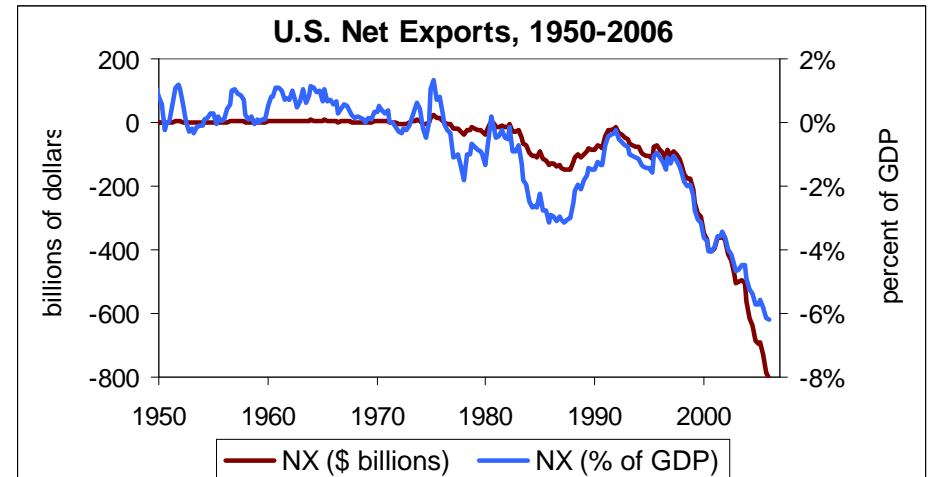
Trade surpluses and deficits

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

- 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, 1950-2006





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 12/31/2005:
 - U.S. residents owned \$10.0 trillion worth of foreign assets
 - Foreigners owned \$12.7 trillion worth of U.S. assets
 - U.S. net indebtedness to rest of the world: \$2.7 trillion--higher than any other country, hence U.S. is the “**world’s largest debtor nation**”



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 $C = C(Y - T)$

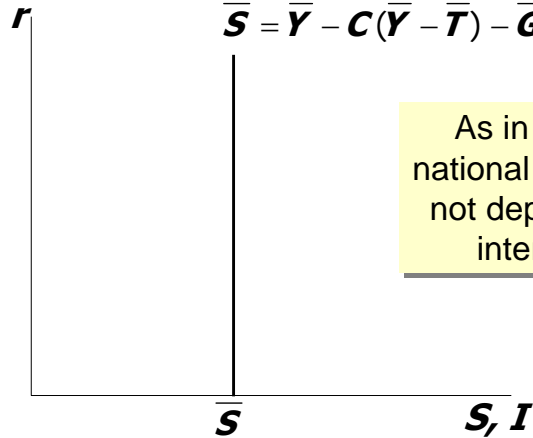
➢ investment function $I = I(r)$

➢ exogenous policy variables $G = \bar{G}, T = \bar{T}$



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

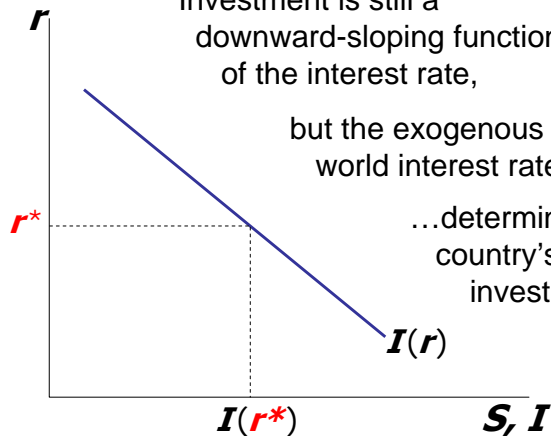


Investment: The demand for loanable funds

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

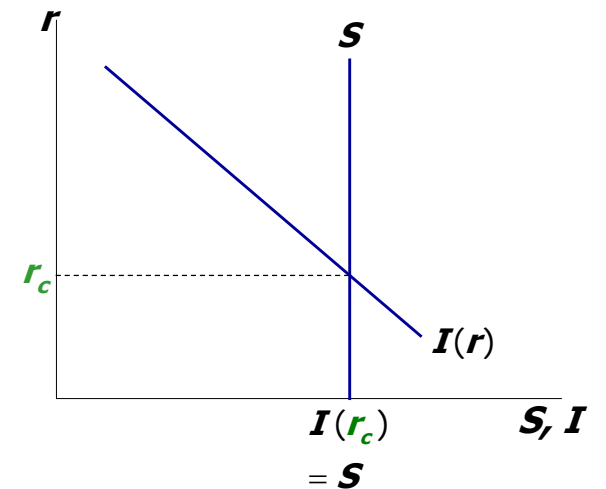
but the exogenous
world interest rate...

...determines the
country's level of
investment.



If the economy were closed...

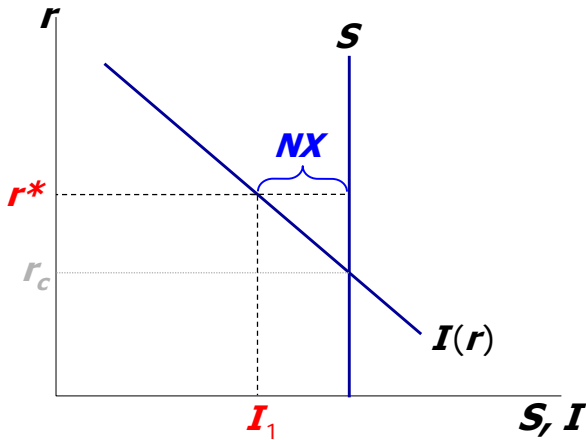
...the interest
rate would
adjust to
equate
investment
and saving:



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



Note: These lecture notes are incomplete without having attended lectures

Next, three experiments:

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

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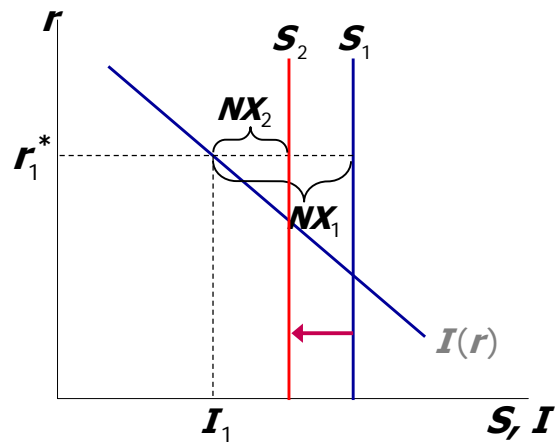
1. Fiscal policy at home

An increase in G or decrease in T reduces saving.

Results:

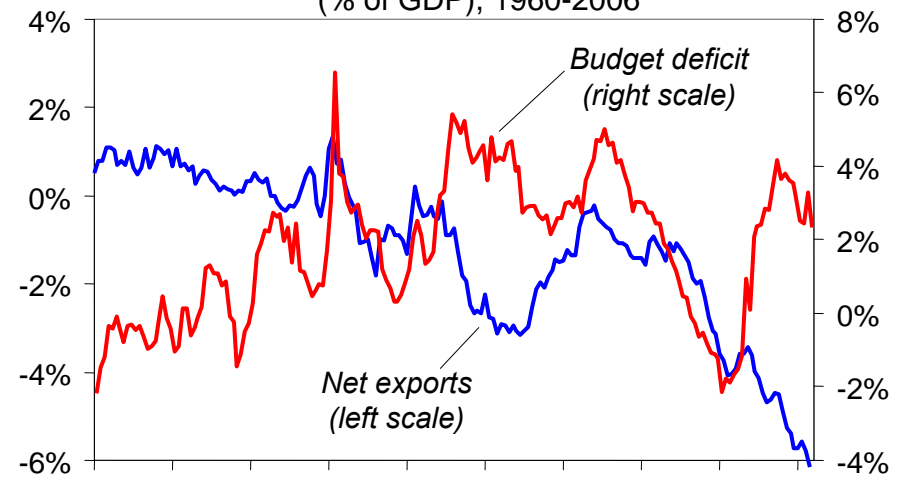
$$\Delta I = 0$$

$$\Delta NX = \Delta S < 0$$



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



1960 1965 1970 1975 1980 1985 1990 1995 2000 2005

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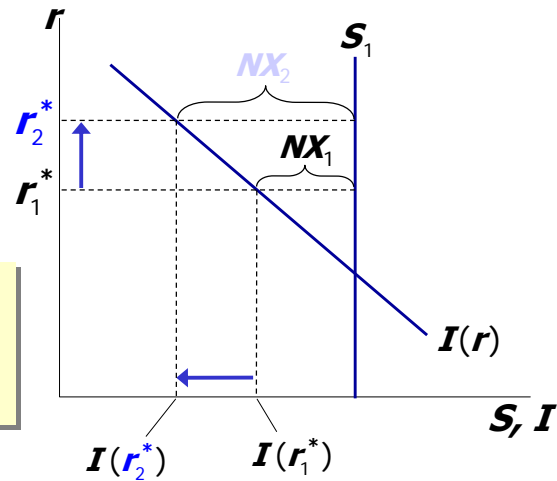
2. Fiscal policy abroad

Expansionary fiscal policy abroad raises the world interest rate.

Results:

$$\Delta I < 0$$

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



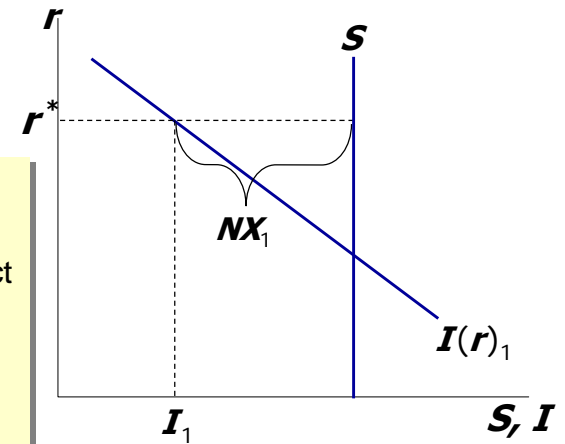
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3. An increase in investment demand

EXERCISE:

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



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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?

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The Nominal Exchange rate

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

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The Real Exchange Rate

the lowercase Greek letter epsilon

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)



Understanding the units of ϵ

$$\begin{aligned} \epsilon &= \frac{e \times P}{P^*} \\ &= \frac{(\text{Yen per \$}) \times (\$ \text{ per unit U.S. goods})}{\text{Yen per unit Japanese goods}} \\ &= \frac{\text{Yen per unit U.S. goods}}{\text{Yen per unit Japanese goods}} \\ &= \text{Units of Japanese goods per unit of U.S. goods} \end{aligned}$$



~ McZample ~

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



$$\begin{aligned} \epsilon &= \frac{e \times P}{P^*} \\ &= \frac{120 \times \$2.50}{200 \text{ Yen}} = 1.5 \end{aligned}$$

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

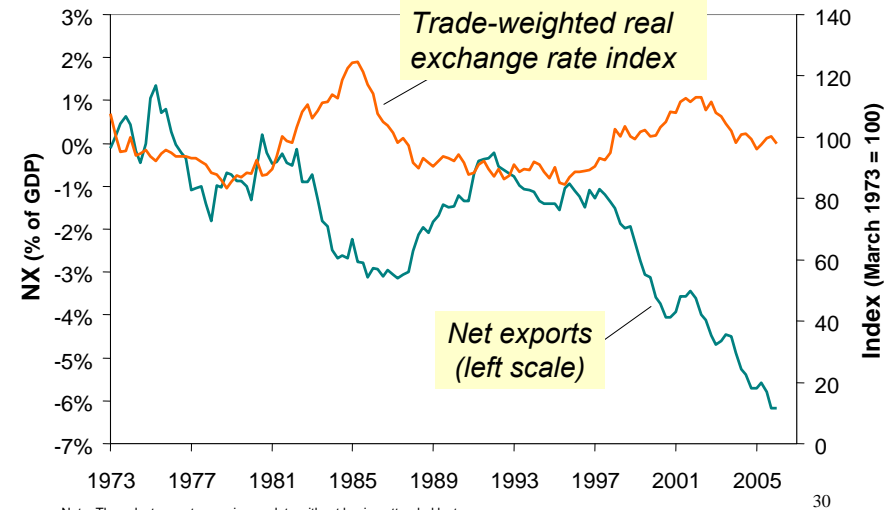


How NX depends on ϵ

$\uparrow \epsilon \Rightarrow$ 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



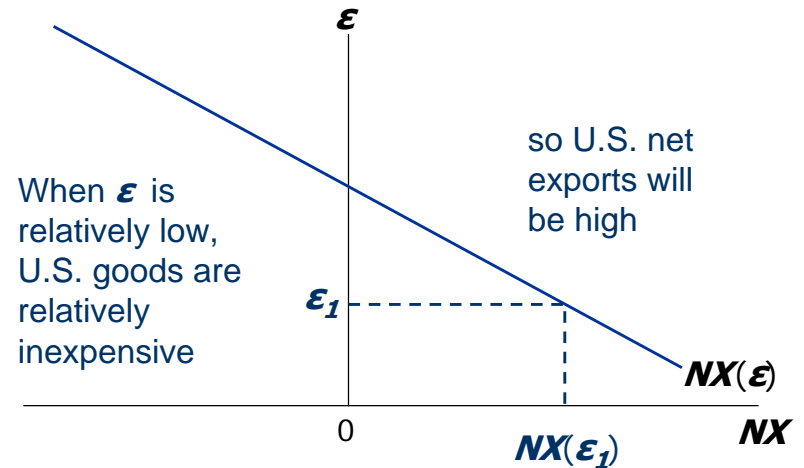
The net exports function

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

$$NX = NX(\epsilon)$$



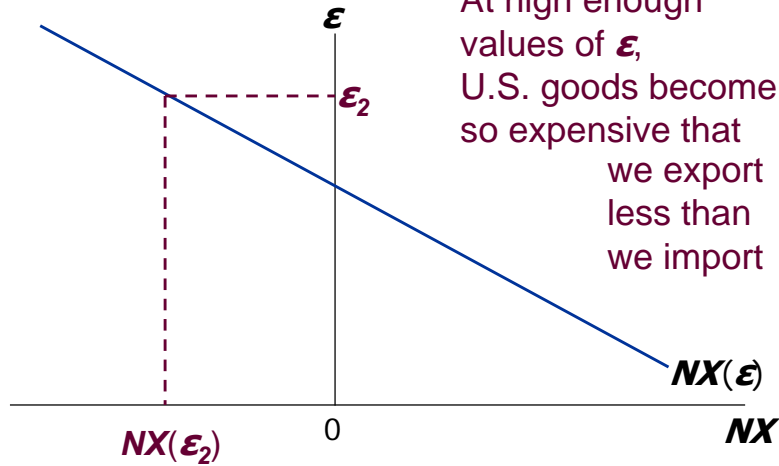
The NX curve for the U.S.





The NX curve for the U.S.

At high enough values of ϵ , U.S. goods become so expensive that we export less than we import



Note: These lecture notes are incomplete without having attended lectures



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

$$NX(\epsilon) = \bar{S} - I(r^*)$$

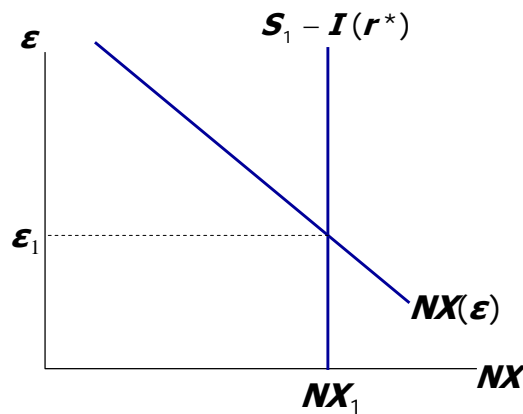
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How ϵ is determined

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

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



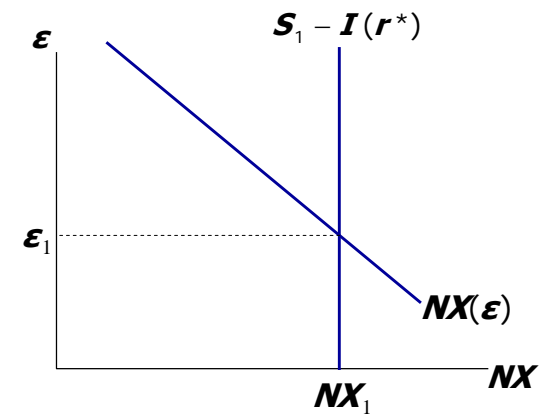
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Interpretation: Supply and demand in the foreign exchange market

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.



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Next, three experiments:

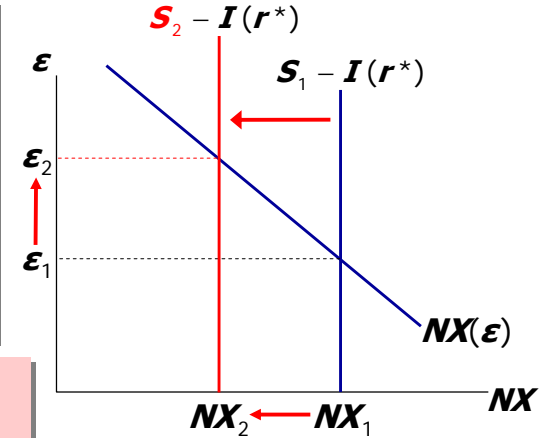
1. Fiscal policy at home
2. Fiscal policy abroad
3. An increase in investment demand



1. Fiscal policy at home

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

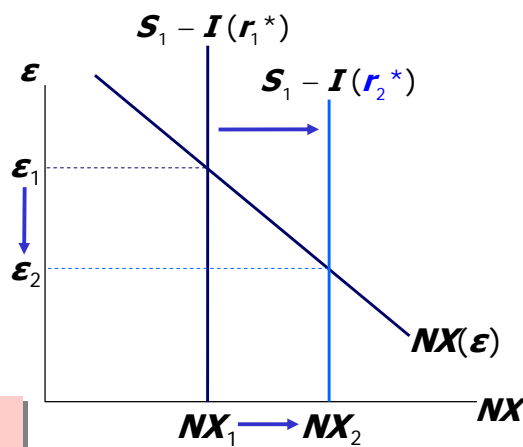
...causing the real exchange rate to rise and NX to fall.



2. Fiscal policy abroad

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

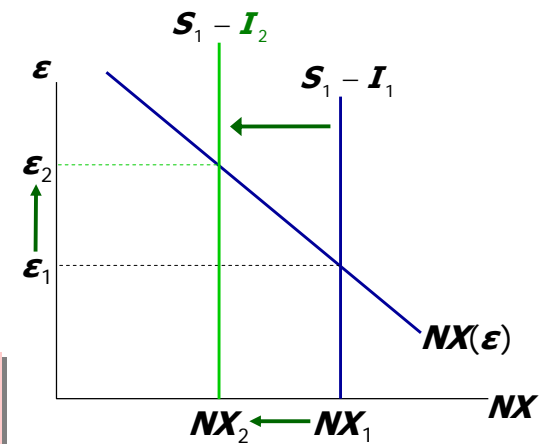
...causing the real exchange rate to fall and NX to rise.



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:

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

- Solve for the nominal exchange rate:

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



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:

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

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

$$NX(\epsilon) = \bar{S} - I(r^*)$$

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



The Determinants of the Nominal Exchange Rate

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

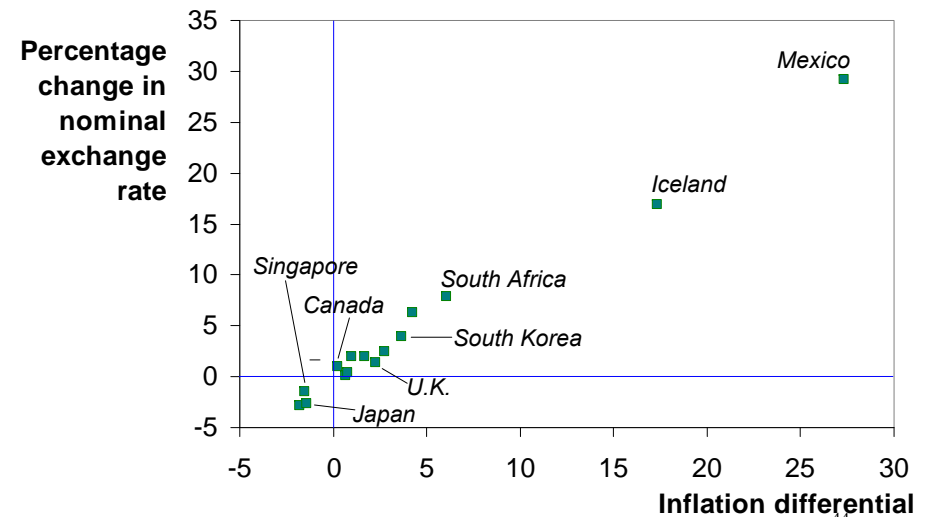
- Rewrite this equation in growth rates (see "arithmetic tricks for working with percentage changes,"):

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

- 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)

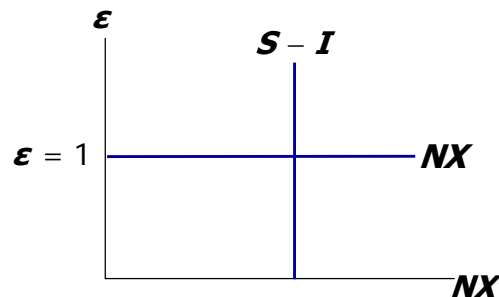
- PPP: $e \times P = P^*$
 - Cost of a basket of foreign goods, in foreign currency.
 - Cost of a basket of domestic goods, in foreign currency.
 - Cost of a basket of domestic goods, in domestic currency.
- Solve for e : $e = P^*/P$
- PPP implies that the nominal exchange rate between two countries equals the ratio of the countries' price levels.



Purchasing Power Parity (PPP)

- If $e = P^*/P$,
then $\epsilon = e \times \frac{P}{P^*} = \frac{P^*}{P} \times \frac{P}{P^*} = 1$

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.



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.