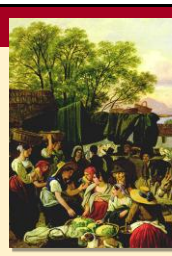
N. Gregory Mankiw

Principles of
Economics
Sixth Edition



32

A Macroeconomic Theory of the Open Economy

Premium PowerPoint Slides by Ron Cronovich

In this chapter, look for the answers to these questions:

- In an open economy, what determines the real interest rate? The real exchange rate?
- How are the markets for loanable funds and foreign-currency exchange connected?
- How do government budget deficits affect the exchange rate and trade balance?
- How do other policies or events affect the interest rate, exchange rate, and trade balance?

Introduction

- The previous chapter explained the basic concepts and vocabulary of the open economy: net exports (*NX*), net capital outflow (*NCO*), and exchange rates.
- This chapter ties these concepts together into a theory of the open economy.
- We will use this theory to see how govt policies and various events affect the trade balance, exchange rate, and capital flows.
- We start with the loanable funds market…

The Market for Loanable Funds

- An identity from the preceding chapter:

$$S = I + NCO$$

Saving — Domestic investment — Net capital outflow

- Supply of loanable funds =
- A dollar of saving can be used to finance
  -
  -
- So, demand for loanable funds =

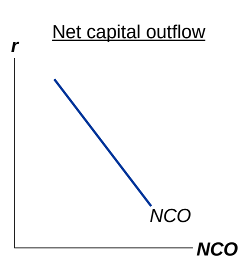
The Market for Loanable Funds

- Recall:
  - ***S*** depends positively on the real interest rate, ***r***.
  - ***I*** depends negatively on ***r***.
- What about *NCO*?

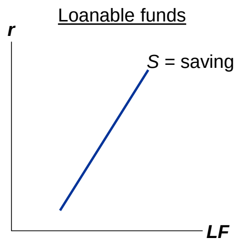
How NCO Depends on the Real Interest Rate

The real interest rate, ***r***, is the real return on domestic assets.

A fall in ***r***



The Loanable Funds Market Diagram



ACTIVE LEARNING 1

Budget deficits and capital flows

- Suppose the government runs a budget deficit (previously, the budget was balanced).
- Use the appropriate diagrams to determine the effects on the real interest rate and net capital outflow.

ACTIVE LEARNING 1

Answers

The Market for Foreign-Currency Exchange

- Another identity from the preceding chapter:

$$NCO = NX$$

Net capital outflow

Net exports

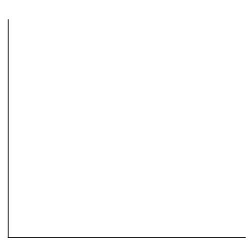
- In the market for foreign-currency exchange,

The Market for Foreign-Currency Exchange

- Recall:
  The U.S. real exchange rate (***E***) measures
  the quantity of foreign goods & services
  that trade for one unit of U.S. goods & services.
  - ***E*** is the real value of a dollar in the market for foreign-currency exchange.

The Market for Foreign-Currency Exchange

An increase in ***E*** makes U.S. goods more expensive to foreigners,



FYI: Disentangling Supply and Demand

When a U.S. resident buys imported goods, does the transaction affect supply or demand in the foreign exchange market? Two views:

1. The person needs to sell her dollars to obtain the foreign currency she needs to buy the imports.
2. The increase in imports reduces ***NX***, which we think of as the demand for dollars. (So, ***NX*** is really the <u>net</u> demand for dollars.)

Both views are equivalent. For our purposes, it's more convenient to use the second.

12

FYI: Disentangling Supply and Demand

When a foreigner buys a U.S. asset, does the transaction affect supply or demand in the foreign exchange market? Two views:

1. The foreigner needs dollars in order to purchase the U.S. asset.
2. The transaction reduces *NCO*, which we think of as the supply of dollars. (So, ***NCO*** is really the <u>net</u> supply of dollars.)

Again, both views are equivalent. We will use the second.

13

ACTIVE LEARNING 2

Budget deficit, exchange rate, and NX

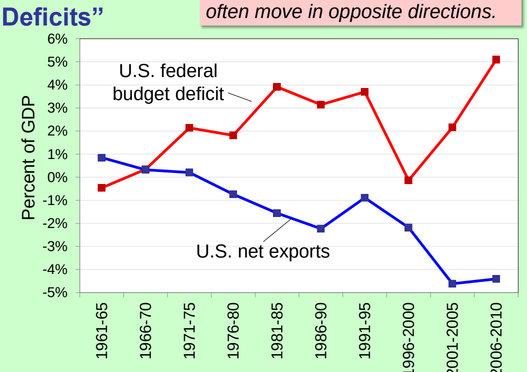
- Initially, the government budget is balanced and trade is balanced (***NX*** = 0).
- Suppose the government runs a budget deficit. As we saw earlier, ***r*** rises and ***NCO*** falls.
- How does the budget deficit affect the U.S. real exchange rate? The balance of trade?

ACTIVE LEARNING **2**

Answers

The "Twin Deficits"

Net exports and the budget deficit often move in opposite directions.



SUMMARY: The Effects of a Budget Deficit

- National saving falls
- The real interest rate rises
-

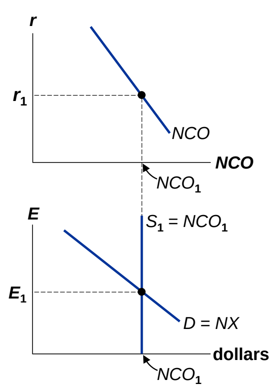
SUMMARY: The Effects of a Budget Deficit

- One other effect:
- Due to many years of budget and trade deficits,

International Investment Position of the U.S. 31 December 2009	
Value of U.S.-owned foreign assets	$18.4 trillion
Value of foreign-owned U.S. assets	$21.1 trillion
U.S.' net debt to the rest of the world	$2.7 trillion

The Connection Between Interest Rates and Exchange Rates

Anything that increases ***r***



ACTIVE LEARNING 3
Investment incentives

- Suppose the government provides new tax incentives to encourage investment.
- Use the appropriate diagrams to determine how this policy would affect:
  - the real interest rate
  - net capital outflow
  - the real exchange rate
  - net exports

ACTIVE LEARNING 3

Answers

Budget Deficit vs. Investment Incentives

- A tax incentive for investment has similar effects as a budget deficit:
- But one important difference:
  - Investment tax incentive
  - Budget deficit

Trade Policy

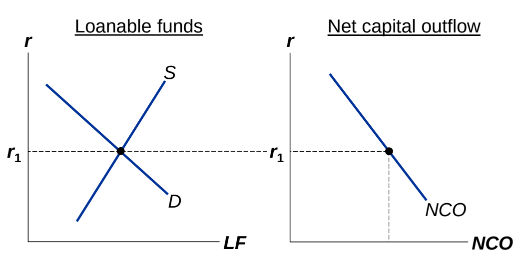
- **Trade policy**:
- Examples:
  - **Tariff**
  - **Import quota**
  - **"Voluntary export restrictions"**

Trade Policy

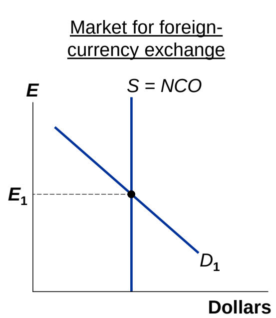
- Common reasons for policies that restrict imports:
- Do such trade policies accomplish these goals?
- Let's use our model to analyze the effects of an import quota on cars from Japan designed to save jobs in the U.S. auto industry.

Analysis of a Quota on Cars from Japan

An import quota



Analysis of a Quota on Cars from Japan



Analysis of a Quota on Cars from Japan

What happens to ***NX***?

- If ***E*** could remain at E_1, ***NX*** would rise, and the quantity of dollars demanded would rise.
- But the import quota does not affect ***NCO***, so
- Since ***NX*** must equal ***NCO***,
- *Hence, the policy of restricting imports*

28

Analysis of a Quota on Cars from Japan

Does the policy save jobs?

The quota reduces imports of Japanese autos.

But

29

CASE STUDY: Capital Flows from China

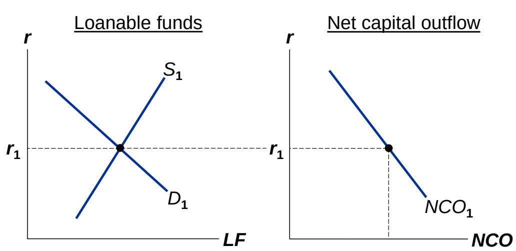
- In recent years, China has accumulated U.S. assets to reduce its exchange rate and boost its exports.
- Results in U.S.:
- Some U.S. politicians want China to stop, argue for restricting trade with China to protect some U.S. industries.
- Yet, U.S. consumers benefit, and the net effect of China's currency intervention is probably small.

30

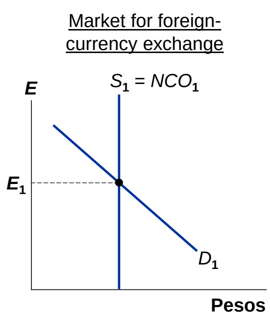
Political Instability and Capital Flight

-
  - People worried about the safety of Mexican assets they owned.
  - People sold many of these assets, pulled their capital out of Mexico.
- **Capital flight**:
- We analyze this using our model, but from the perspective of Mexico, not the U.S.

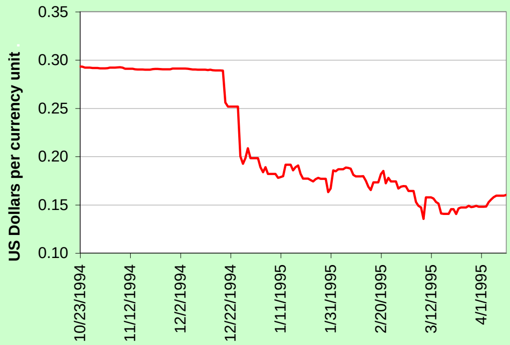
Capital Flight from Mexico



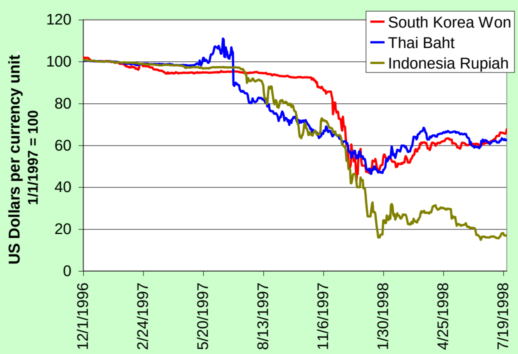
Capital Flight from Mexico



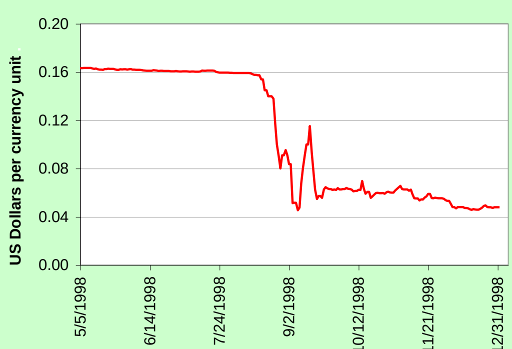
Examples of Capital Flight: Mexico, 1994



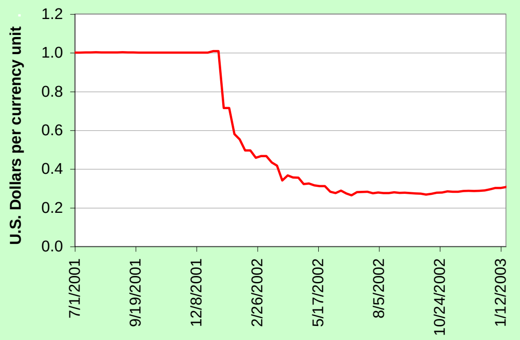
Examples of Capital Flight: S.E. Asia, 1997



Examples of Capital Flight: Russia, 1998



Examples of Capital Flight: Argentina, 2002



CONCLUSION

- The U.S. economy is becoming increasingly open:
  - Trade in g&s is rising relative to GDP.
  - Increasingly, people hold international assets in their portfolios and firms finance investment with foreign capital.

CONCLUSION

- Yet, we should be careful not to blame our problems on the international economy.
- When politicians and commentators discuss international trade and finance, the lessons of this and the preceding chapter can help separate myth from reality.