

Lecture 7: Open Economy

Opening the Economy

- Goods markets
 - Imports and exports
 - Tariffs and quotas
- Financial markets
 - Domestic and foreign financial assets
 - Capital controls
 - Emerging market crises
- Factor markets
 - Migration of firms and workers

Basics: Goods Markets

- Trends and U.S. trade deficit - Figure 18.1
- New decision:
 - whether to buy domestic or foreign goods
- Key ingredient: The Real Exchange Rate
 - The nominal exchange rate
 - Price levels

The Nominal Exchange Rate

- The price of foreign currency in terms of domestic currency
 - Chile $E = 610$ (pesos/dollar)
 - Japan $E = 110$ (yens/dollar)
 - Euro $E = 0.82$ (euros/dollar)
- To convert pesos prices into dollar prices; divide peso price by E
- Appreciation and depreciation (trend and cycle) -- Figure 18-6

The Real Exchange Rate

- The price of a foreign good in terms of domestic good

$$e = \frac{E P^*}{P}$$

Real appreciation and depreciation

Financial Markets

- Diversification and speculation
- Very large
- Trade deficits and surpluses become possible

The Balance of Payment

CURRENT ACCOUNT

Exports	+
Imports	-
	Trade Balance
Net investment income and transfers	+
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	Current Account Balance

CAPITAL ACCOUNT

Increase in foreign holding of domestic assets	+
Increase in domestic holding of foreign assets	-
Errors and omissions / statistical discrepancy	
	Capital Account Balance

Foreign or Domestic Assets

- Risk, etc
- Here: Compare returns
- (Uncovered) interest parity condition:

$$1 + i(t) \quad \text{versus} \quad (1/E(t)) (1 + i^*(t)) E^e(t+1)$$

Figure 18-9

The Goods Market

$$Z = C + I + G + X - eQ$$

$$C(Y-T) + I(Y,I) + G$$

$$Q = Q(Y,e)$$

+ -

$$X = X(Y^*,e)$$

+ +

Figures

- Figs 19.1 and 19-2
- Increase in domestic and foreign demand
- games countries play
- depreciation