

6

Literature, Russian Literature



1. Define net exports and net capital outflow. Explain how and why they are related. Net exports (NX) is the country's exports value minus imports value, which is given by the equation below;

Net capital out flow (NCO) is the value of foreign assets bought by domestic investors minus the value of country's assets bought by foreign investors, which can be given as below;

Countries earn foreign currencies by exporting goods and services abroad. Countries spend these foreign currencies by importing goods and services or purchasing assets abroad. In an open economy, the proportion of country's foreign currency earned and spent for purchasing goods and services does not impact the net exports value. If country's net exports value is greater than zero, domestic investors are buying assets in abroad, increasing NCO. If country's net exports value is less than zero, foreign investors are buying assets in domestic country, decreasing NCO. These transactions may involve multiple investors and banks.

2. Explain the relationship among saving, investment, and net capital outflow.

The relationship between saving (S), investment (I), and net exports (NX) can be given as below where Y is the country's GDP.

Country's savings mean the value of GDP minus the value of domestic consumption and government expenditures. Thus, the relationship can be obtained as below.

By equations (1) and (2);

In a closed economy, the value of domestic investments is given by the value of national savings. In an open economy, the value of domestic

investments is the summation of national savings and NCO.

3. If a Japanese car costs 500, 000 yen, a similar American car costs \$ 10, 000, and a dollar can buy 100 yen, what are the nominal and real exchange rates?

Nominal exchange rate= (100yen/dollar)

Real exchange rate= (100yen/\$ ×10 000\$ ÷500000yen)

Real exchange rate = 2 Japanese cars per one American car

4. Describe the economic logic behind the theory of purchasing- power parity.

Purchasing power parity states that a unit of any given currency should be able to buy the same amount of goods in all countries. The monetary policies practiced in countries are different. Therefore, different inflation rates are experienced by the countries. Price levels reflect the country's rate of inflation. In case if the amount of goods that can be bought by spending a unit of dollar in country A is higher than the amount that can be bought in country B, selling such goods from country A to B is profitable. Ideally, arbitrage process occurs until the purchasing power of the currency is equal in both countries.

5. If the Fed started printing large quantities of U. S. dollars, what would happen to the number of Japanese yen a dollar could buy? Why?

Quantity or quality of the goods and services produced by the country is not changed. Only the amount of money circulating in the economy is increased. The real value of a dollar is now low while the amount of goods and services

it can buy is now less. Similarly, the units of yen a dollar can buy in market for foreign currency exchange are also decreased.

1. Describe supply and demand in the market for loanable funds and the market for foreign-currency exchange. How are these markets linked?

Supply of market for loanable funds is generated from domestic savings while demand is generated from domestic investments and net capital out flow. The cost of borrowing from market for loanable funds is denoted by real interest rate ( $i$ ). Market for loanable funds can be graphically illustrated as below.

Supply of market for foreign-currency exchange is generated from net capital out flow while the demand is generated from net exports. NCO is determined by real interest rate. The cost of purchasing foreign currencies is denoted by real exchange rate ( $r$ ) as illustrated bellow.

Therefore, the link between two markets can be graphically illustrated as bellow.

2. Why are budget deficits and trade deficits sometimes called the twin deficits?

These are called twin deficits because the first can trigger the latter. As the government draws money from national savings to fund its expenditures, the cost of borrowing by public is increasing. Therefore, investing in domestic businesses becomes more profitable. Capital is now flowing into the country while decreasing the NCO. Low capital out flow also decreases the supply to market of foreign currency exchange. When there is less supply in market for

foreign currency exchange, the dollar is appreciating. Therefore, the domestically produced goods and services become more expensive abroad and at local markets. Hence, more goods and services are imported to the country. Thus, it creates a trade deficit.

3. Suppose that a textile workers' union encourages people to buy only American-made clothes. What would this policy do to the trade balance and the real exchange rate? What is the impact on the textile industry? What is the impact on the auto industry?

The demand for garments reduces in country's exports market. This improves country's trade balance by increasing NX. Increased NX value increases the real exchange rate in market for foreign currency exchange while appreciating US dollar. Consequently, locally produced garments become more expensive in exports market. Therefore, NX value decreases again. This offsets the impact of shifting demand for local garments. However, increased price of textiles changes the producers' and consumers welfare. This policy does not have a direct impact on auto industry. However, the increased real exchange rate results in locally produced auto become more expensive. Therefore, importing of auto from abroad is increasing.

4. What is capital flight? When a country experiences capital flight, what is the effect on its interest rate and exchange rate?

Capital flight is a large and sudden reduction in the demand for assets located in a country. When a large amount of capital is flowing out of the country, supply to the market of foreign currency exchange is increased. Therefore, the units of domestic currency which can be bought from a unit of foreign currency are increasing. Depreciating of domestic currency results in

improving NX because local produce is now cheap, as compared to the world market prices. This can be graphically illustrated as bellow.