

# Open-economy macroeconomics notes assignment

[Economics](#)



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Ch28 " Open-Economy Macroeconomics" FOREIGN TRADE AND ECONOMIC ACTIVITY Imports ? goods and services produced abroad and consumed domestically Exports ? goods and services produced domestically and purchased by foreigners Net exports ? defined as exports of goods and services minus imports of goods and services Net foreign investment ? counterpart of net exports Denotes net US savings abroad and is approximately equal to the value of net exports ? ? ? appreciation in the exchange rate and a corresponding decline in net exports; monetary easing does the opposite.

The impact of changes in interest rates on net exports reinforces the impact on domestic investment In a full-employment closed economy (always holding other things constant), higher government spending, lower taxes, or lower desired private saving will raise the real interest rate and lower equilibrium saving and investment net exports are determined by the difference between national saving and national investment, which is determined by domestic factors plus the world interest rate changes in exchange rates ? re the mechanism by which saving and investment adjust Domestic expenditures ? equal to consumption plus domestic investment plus government purchases

Examples of open-economy saving-investment theory in the small open economy an increase in private saving or lower government spending will increase national saving; this will lead to a depreciation of the exchange rate until net exports have increased enough to balance the increase in domestic saving an increase in domestic investment, say, because of an improved business climate or a burst of innovations, will lead to a shift in the

investment schedule; this will lead to an appreciation of the exchange rate until net exports decline enough to balance saving and investment.

In this case, domestic investment crowds out foreign investment and an increase in world interest rates will reduce the level of investment. This will lead to an increase in the difference between saving and investment, to a depreciation in the foreign exchange rate, and to an increase in net exports and foreign investment (this would be a shift along the investment schedule) integration of a country into the world economy adds an important new dimension to macroeconomic performance and policy. The foreign sector provides an important source of domestic investment and a potential outlet for domestic saving. Higher saving at home— whether in the form of higher private saving or higher public saving will lead to higher net exports. A country's trade balance is primarily a reflection of its national saving and investment balance rather than of its absolute productivity or wealth ?

The volume and value of imports will be affected by domestic output and the relative prices of domestic and foreign goods – Marginal propensity to import ? the increase in the dollar value of imports for each \$1 increase in GDP ?

Because a fraction of any income leaks into imports in an open economy, the open-economy multiplier is smaller than the multiplier for a closed economy.

OPEN ECONOMY Multiplier =  $1 / (MPS + MPm)$  Where MPS = marginal propensity to save and MPm = marginal propensity to import ? ? – Real

exchange rate ? corrects for movements in the price levels in different countries Overvalued currency ? one whose value is high relative to its long-run or sustainable level High mobility of financial capital ? when financial investments can flow easily among countries and the regulatory barriers to <https://assignbuster.com/open-economy-macroeconomics-notes-assignment/>

financial investments are low? Foreign trade produces a new and powerful link in the monetary transmission mechanism when a country has a flexible exchange rate. When monetary policy changes interest rates, this affects exchange rates and net exports as well as domestic investment. Monetary tightening leads to an adjustment in a country's trade accounts require a change in domestic saving or investment in the long run, adjustments in trade accounts will be brought about by movements in the country's relative prices, often through exchange-rate changes. Optimal currency area? One whose regions have high labor mobility or have common and synchronous aggregate supply or demand shocks. In an optimal currency area, significant changes in exchange rates are not necessary to ensure rapid macroeconomic adjustment. European Monetary Union? One of history's great economic experiments. Never before has such a large and powerful group of countries turned its economic fortunes over to a multinational body like the European Central Bank. Never before has a central bank been charged with the macroeconomic fortunes of a large group of nations with 325 million people producing \$16 trillion of goods and services.

While optimists point to the microeconomic benefits of a larger market and lower transactions costs, pessimists worry that monetary union threatens stagnation and unemployment because of the lack of price and wage flexibility and insufficient labor mobility among countries. The financial crisis of 2007-2009 is the first major test of this new monetary system. Stable macroeconomic climate? Taxes are reasonable and predictable and that inflation is low, so lenders need not worry about inflation confiscating their

investments ? promoting economic growth in an open economy involves ensuring that business is attractive for foreign and domestic investors who have a wide array of investment opportunities in the world economy. The ultimate goals of policy are to have high rates of saving and investment in productive channels and to ensure that businesses use bestpractice techniques.

Achieving these goals involves setting a stable macroeconomic climate, guaranteeing dependable property rights for both tangible investments and intellectual property, providing exchange-rate convertibility that allows investors to take home their profits, and maintaining confidence in the political and economic stability of the country

Success for the countries of North America and Western Europe: robust economic performance o rapid and sustained economic growth emerging monetary system o conduct independent monetary policies with flexible exchange rates, while smaller countries either float or have “ hard” fixed exchange rates tied to one of the major blocks

reemergence of free markets

Competitiveness ? refers to the extent to which a nation’s goods can compete in the marketplace; this depends primarily upon the relative prices of domestic and foreign products

Productivity ? easured by the output per unit of input, fundamental to the growth of living standards in a nation; to a first approximation, a nation’s real income grows in step with its productivity growth ? conclusion on productivity and competitiveness ? as the theory of comparative advantage demonstrates, nations are not inherently uncompetitive. Rather, they become uncompetitive when their prices move out of line with those of their trading partners. The surest route to high productivity and high living

standards is to expose domestic industries to world markets and to encourage vigorous domestic competition with foreign companies that have adopted the most advanced technologies -