Macro economics

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A country’s transactions with the rest of the world, including both trade flows and financial flows, are summarized by a set of accounts called the balance of payments. The sum of net payments to and from the world is known as the current account. The summary of a country’s asset transactions (mainly financial) with the rest of the world is known as the capital account (Blanchard, 2010) . The balance of trade is the difference between the exports and imports of a country. Balance of trade = Total exports – total imports. a) In an open economy with a floating exchange rate, a current account balance of payment surplus causes appreciation in the exchange rate of the domestic currency. A current account deficit causes depreciation in the value of the currency. b) In an economy with a fixed exchange rate, the government or the central bank interfere through buying and selling of foreign currency to maintain a fixed exchange rate. However, a continuing current account deficit may propel the central bank to devalue the currency. The managed exchange rate regime of China is not a floating one. In spite of the huge current account surplus of China, the government and the central bank of China have not allowed the exchange rate of Chinese “ yuan” to appreciate in spite of the upward pressure on the currency. 2. The BP or “ FE” curve was first given by Robert Mundell of Columbia University and Marcus Fleming of the International Monetary fund. This curve explains the effect of monetary policy and fiscal policy on the exchange rate of an open economy. According to the BP curve analysis, an increase in government spending or fiscal expansion leads to an increase in output, an increase in interest rate, an appreciation in the foreign exchange rate and vice-versa. Similarly a monetary contraction leads to a decrease in output, increase in interest rate and appreciation in the exchange rate. Under a floating

exchange rate regime a fiscal expansion leads to an increase in government spending, an increase in output, an increase in interest rate and an appreciation in the exchange rate (Blanchard, 2010). In case there is perfect capital mobility and the BP curve is flat, the curve will have a parallel shift upwards because of the appreciation in exchange rate due to increase in interest rate caused by the fiscal expansion. Under the fixed exchange rate regime, the fiscal expansion will not have an effect on the exchange rate because the central bank will interfere in the foreign exchange market and will keep the exchange rate fixed. The Latin American debt crisis of the 80s happened when the external dollar denominated debt of many Latin American countries reached to such a point where they found it difficult to service the interest liabilities on them(Samuelson, Nordhaus, 2000). The main cause of this crisis was the rise in interest rates in United States. As a result Latin American currencies depreciated and this further increased their dollar liabilities. Mexico became the first country to default on its interest payments. 3. The original nature and function of the International Monetary fund was to stabilize the exchange rates and provide monetary assistance and support to countries facing balance of payments crisis. The different member countries of the IMF contributed to a pool from which countries facing balance of payments crisis could borrow on a temporary basis. Since then the role of IMF has evolved in that now IMF sets preconditions known as Structural Adjustment Programs (SAP) for countries facing balance of payments crisis and requiring the bailout from IMF(Samuelson, Nordhaus, 2000) . The main objective of these structural adjustments is to introduce economic reforms in the countries facing the balance of payments crisis. In its revised function, the structural adjustments of IMF have performed quite

well in spite of the criticisms of noble economists like Joseph Stieglitz. The structural adjustments of IMF triggered economic reforms and liberalization in countries like India. These economic reforms were one of the main causes behind the emergence of emerging economies like India. 4. The equilibrium equation of the circular flow model is: Savings + taxes + imports = Investment + government spending + exports. The disequilibrium equation of the circular flow model is: Savings + taxes + imports ? investment + government spending + exports. a)The equation of the Harrod- Domar model is given by: Growth rate of the economy = Savings rate * Marginal product of Capital – Depreciation. The main assumption in this model is that Savings = Investments. Now according to Harrod-Domar model if the growth rate of an economy is to be increased then either its savings rate or marginal product of capital should be increased or its depreciation should be brought down. So in the above circular model, if savings is increased then the rate of growth of output will also be increased. The capital-output ratio plays a great role in the Harrod – Domar model, because the rate of growth of an economy can be increased by increasing the productivity of its capital through capital deepening. b) In the neo-classical model of Robert Solow, capital deepening initially increases the productivity of the economy. The marginal product of labor is increased as there is more capital to work with per unit of labor. As a result the output per worker increases. However, after a time the rate of growth of output slows down as the capital-output ratio is not matched by the population growth. The output per worker goes down. The essential difference between the current economic growth in developed versus developing countries is that the economic growth in developing countries is driven by capital deepening (increase in capital stock) accompanied by the

availability cheap skilled and semi-skilled labor. The economic growth in developed countries is mainly driven by technological innovation. This technological innovation has kept the Total factor productivity of developed countries high. However the Total factor productivity of developed economies like US and Germany is lower than Total factor productivity of developing economies like China and India. 5) The classical school of thought did not favor fiscal and monetary intervention for managing the economy. The three basic assumptions of the classical school of thought are: flexibility of prices and wages, supply creates its own demand (Say's law) and the equality of savings and investments. The interventionist school of thought favors government intervention through fiscal expansion or contraction (Keynesian school of thought). The monetarists favor monetary intervention through the monetary policy (Samuelson, Nordhaus, 2000) . The government deficits like the present one of United States can be managed by cutting down on fiscal expenditure. This fiscal contraction should be accompanied by a monetary expansion. This monetary expansion will keep the interest rates low and accelerate growth rate in the short run. The high growth rate through monetary expansion will translate into higher tax revenues for the government. This will bring down the fiscal deficit further down and will also enable the US government to control and pay its massive public debt. Once the fiscal deficit and the public debt as a ratio of GDP is brought down, then the government can support the growth rate of the economy in the medium run through fiscal expansion. References: Olivier Blanchard, 2010, Macroeconomics, Pearson education. Paul Samuelson, William Nordhaus, 2010, Economics, Prentice- Hall.