In this chapter, look for the answers to these questions

• How are international flows of goods and assets related?
• What’s the difference between the real and nominal exchange rate?
• What is “purchasing-power parity,” and how does it explain nominal exchange rates?
Introduction

- One of the Ten Principles of Economics from Chapter 1: *Trade can make everyone better off.*
- This chapter introduces basic concepts of international macroeconomics:
  - The trade balance (trade deficits, surpluses)
  - International flows of assets
  - Exchange rates
Closed vs. Open Economies

- A **closed economy** does not interact with other economies in the world.
- An **open economy** interacts freely with other economies around the world.
The Flow of Goods & Services

- **Exports**: domestically-produced g&s sold abroad
- **Imports**: foreign-produced g&s sold domestically
- **Net exports (NX)**, aka the **trade balance**
  \[ \text{value of exports} - \text{value of imports} \]
What do you think would happen to U.S. net exports if:

A. Canada experiences a recession (falling incomes, rising unemployment)

B. U.S. consumers decide to be patriotic and buy more products “Made in the U.S.A.”

C. Prices of goods produced in Mexico rise faster than prices of goods produced in the U.S.
Answers

A. Canada experiences a recession (falling incomes, rising unemployment)

U.S. net exports would fall
due to a fall in Canadian consumers’ purchases of U.S. exports

B. U.S. consumers decide to be patriotic and buy more products “Made in the U.S.A.”

U.S. net exports would rise
due to a fall in imports
C. Prices of Mexican goods rise faster than prices of U.S. goods.

This makes U.S. goods more attractive relative to Mexico’s goods.

Exports to Mexico increase, imports from Mexico decrease, so U.S. net exports increase.
Variables that Influence Net Exports

- Consumers’ preferences for foreign and domestic goods
- Prices of goods at home and abroad
- Incomes of consumers at home and abroad
- The exchange rates at which foreign currency trades for domestic currency
- Transportation costs
- Govt policies
Trade Surpluses & Deficits

\( NX \) measures the imbalance in a country’s trade in goods and services.

- **Trade deficit:**
  an excess of imports over exports

- **Trade surplus:**
  an excess of exports over imports

- **Balanced trade:**
  when exports = imports
The U.S. Economy’s Increasing Openness

Percent of GDP

Imports
Exports

The Flow of Capital

- **Net capital outflow (NCO):**
  - domestic residents’ purchases of foreign assets minus
  - foreigners’ purchases of domestic assets

- **NCO** is also called **net foreign investment**.
The Flow of Capital

The flow of capital abroad takes two forms:

- **Foreign direct investment:**
  Domestic residents actively manage the foreign investment, e.g., McDonalds opens a fast-food outlet in Moscow.

- **Foreign portfolio investment:**
  Domestic residents purchase foreign stocks or bonds, supplying “loanable funds” to a foreign firm.
The Flow of Capital

\textit{NCO} measures the imbalance in a country’s trade in assets:

- When \textit{NCO} > 0, “capital outflow”
  Domestic purchases of foreign assets exceed foreign purchases of domestic assets.

- When \textit{NCO} < 0, “capital inflow”
  Foreign purchases of domestic assets exceed domestic purchases of foreign assets.
Variables that Influence NCO

- Real interest rates paid on foreign assets
- Real interest rates paid on domestic assets
- Perceived risks of holding foreign assets
- Govt policies affecting foreign ownership of domestic assets
The Equality of NX and NCO

- An accounting identity: \( NCO = NX \)
  - arises because every transaction that affects \( NX \) also affects \( NCO \) by the same amount (and vice versa)

- When a foreigner purchases a good from the U.S.,
  - U.S. exports and \( NX \) increase
  - the foreigner pays with currency or assets, so the U.S. acquires some foreign assets, causing \( NCO \) to rise.
The Equality of NX and NCO

- An accounting identity: $\text{NCO} = \text{NX}$
  - arises because every transaction that affects $\text{NX}$ also affects $\text{NCO}$ by the same amount (and vice versa)

- When a U.S. citizen buys foreign goods,
  - U.S. imports rise, $\text{NX}$ falls
  - the U.S. buyer pays with U.S. dollars or assets, so the other country acquires U.S. assets, causing U.S. $\text{NCO}$ to fall.
The Equality of NX and NCO

- An accounting identity: \( NCO = NX \)
  - Imbalances in the net capital outflow (NCO) are associated with imbalances in the trade balance (or net exports, NX), following the identity \( NCO = NX \).
  - Each exchange that affects the net capital outflow, also affects net exports in the same amount.
  - For instance, if an economy is running a trade deficit, it must be financing the net purchase of goods and services by selling assets abroad. If it’s running a trade surplus, the excess in foreign currency it receives is being used to buy assets from abroad.
Saving, Investment, and International Flows of Goods & Assets

\[ Y = C + I + G + NX \]  
accounting identity

\[ Y - C - G = I + NX \]  
rearranging terms

\[ S = I + NX \]  
since \( S = Y - C - G \)

\[ S = I + NCO \]  
since \( NX = NCO \)

- When \( S > I \), the excess loanable funds flow abroad in the form of positive net capital outflow.

- When \( S < I \), foreigners are financing some of the country’s investment, and \( NCO < 0 \).
Case Study: The U.S. Trade Deficit

- Recall, $NX = S - I = NCO$. A trade deficit means $I > S$, so the nation borrows the difference from foreigners.
- In 2007, foreign purchases of U.S. assets exceeded U.S. purchases of foreign assets by $775$ million.
- Such deficits have been the norm since 1980…
U.S. Saving, Investment, and NCO, 1950–2012
Case Study: The U.S. Trade Deficit

Why U.S. saving has been less than investment:

- In the 1980s and early 2000s, huge govt budget deficits and low private saving depressed national saving.

- In the 1990s, national saving increased as the economy grew, but domestic investment increased even faster due to the information technology boom.
Case Study: The U.S. Trade Deficit

- Is the U.S. trade deficit a problem?
  - The extra capital stock from the ’90s investment boom may well yield large returns.
  - The fall in saving of the ’80s and ’00s, while not desirable, at least did not depress domestic investment, since firms could borrow from abroad.

- A country, like a person, can go into debt for good reasons or bad ones. A trade deficit is not necessarily a problem, but might be a symptom of a problem.
The Nominal Exchange Rate

- **Nominal exchange rate**: the rate at which one country’s currency trades for another.

- We express all exchange rates as foreign currency per unit of domestic currency.

- Some exchange rates as of 29 March 2016,
  - 1 US Dollar: 2.87 TL
  - 1 Euro: 3.21 TL
  - 1 Japanese Yen: 0.025 TL
  - 1 Indian Rupee: 0.043 TL
  - 1 US Dollar: 0.893 Euro
Appreciation and Depreciation

- **Appreciation** (or “strengthening”): an increase in the value of a currency as measured by the amount of foreign currency it can buy

- **Depreciation** (or “weakening”): a decrease in the value of a currency as measured by the amount of foreign currency it can buy

- **Examples:** During 2007, the U.S. dollar...
  - depreciated 9.5% against the Euro
  - appreciated 1.5% against the S. Korean Won
Appreciation and Depreciation

Examples:

- During 2007, the U.S. dollar…
  - depreciated 9.5% against the Euro
  - appreciated 1.5% against the S. Korean Won

- In January 1980, the Turkish Lira…
  - depreciated by 48.9% against U.S. dollar
  - 1 U.S. dollar went up from 47.1 TL to 71.1 TL
  - due to Turgut Özal’s 24 January ‘ekonomik istrikrar programı’
The Real Exchange Rate

- **Real exchange rate**: the rate at which the g&s of one country trade for the g&s of another

- Real exchange rate = \( \frac{e \times P}{P^*} \)

where

- \( P \) = domestic price
- \( P^* \) = foreign price (in foreign currency)
- \( e \) = nominal exchange rate, i.e., foreign currency per unit of domestic currency
Example With One Good

- A Big Mac costs $2.50 in U.S., 400 yen in Japan
- \( e = 120 \) yen per $\
- \( e \times P = \) price in yen of a U.S. Big Mac\
  \[= (120 \text{ yen per } \$) \times ($2.50 \text{ per Big Mac})\]
  \[= 300 \text{ yen per U.S. Big Mac}\]
- Compute the real exchange rate:
  \[\frac{e \times P}{P^*} = \frac{300 \text{ yen per U.S. Big Mac}}{400 \text{ yen per Japanese Big Mac}}\]
  \[= 0.75 \text{ Japanese Big Macs per U.S. Big Mac}\]
Interpreting the Real Exchange Rate

“The real exchange rate = 0.75 Japanese Big Macs per U.S. Big Mac”

Correct interpretation:
To buy a Big Mac in the U.S., a Japanese citizen must sacrifice an amount that could purchase 0.75 Big Macs in Japan.
ACTIVE LEARNING 2

Compute a real exchange rate

e = 10 pesos per $

price of a tall Starbucks Latte

$P = 3$ in U.S., $P^* = 24$ pesos in Mexico

A. What is the price of a U.S. latte measured in pesos?

B. Calculate the real exchange rate, measured as Mexican lattes per U.S. latte.
A. What is the price of a U.S. latte in pesos?

\[ e \times P = (10 \text{ pesos per } \$) \times (3 \text{ } \$ \text{ per U.S. latte}) \]

\[ = 30 \text{ pesos per U.S. latte} \]

B. Calculate the real exchange rate.

\[ \frac{e \times P}{P^*} = \frac{30 \text{ pesos per U.S. latte}}{24 \text{ pesos per Mexican latte}} \]

\[ = 1.25 \text{ Mexican lattes per U.S. latte} \]
The Real Exchange Rate With Many Goods

\[ P = \text{U.S. price level, e.g., Consumer Price Index, measures the price of a basket of goods} \]

\[ P^* = \text{foreign price level} \]

Real exchange rate

\[ = \frac{e \times P}{P^*} \]

\[ = \text{price of a domestic basket of goods relative to price of a foreign basket of goods} \]

- If U.S. real exchange rate appreciates, U.S. goods become more expensive relative to foreign goods.
The Law of One Price

- **Law of one price**: the notion that a good should sell for the same price in all markets
  - Suppose coffee sells for $4/pound in Seattle and $5/pound in Boston, and can be costlessly transported.
  - There is an opportunity for *arbitrage*, making a quick profit by buying coffee in Seattle and selling it in Boston.
  - Such arbitrage drives up the price in Seattle and drives down the price in Boston, until the two prices are equal.
Purchasing-Power Parity (PPP)

- **Purchasing-power parity**: a theory of exchange rates whereby a unit of any currency should be able to buy the same quantity of goods in all countries based on the law of one price.

- implies that nominal exchange rates adjust to equalize the price of a basket of goods across countries.
Purchasing-Power Parity (PPP)

- Example: The “basket” contains a Big Mac.
  \[ P = \text{price of U.S. Big Mac (in dollars)} \]
  \[ P^* = \text{price of Japanese Big Mac (in yen)} \]
  \[ e = \text{exchange rate, yen per dollar} \]

- According to PPP,
  \[ e \times P = P^* \]

- Solve for \( e \):
  \[ e = \frac{P^*}{P} \]
PPP and Its Implications

- PPP implies that the nominal exchange rate between two countries should equal the ratio of price levels.

- If the two countries have different inflation rates, then \( e \) will change over time:
  - If inflation is higher in Mexico than in the U.S., then \( P^* \) rises faster than \( P \), so \( e \) rises—
    the dollar appreciates against the peso.
  - If inflation is higher in the U.S. than in Japan, then \( P \) rises faster than \( P^* \), so \( e \) falls—
    the dollar depreciates against the yen.
PPP and Its Implications

- In 1970, U.S. dollar could buy
  - 3.65 German marks
  - 627 Italian lira

- In 1998, U.S. dollar could buy
  - 1.76 German marks
  - 1737 Italian lira

Why?

- Germany pursued a less inflationary monetary policy than the United States, and Italy pursued a more inflationary monetary policy.

- From 1970 to 1998, inflation in the United States was 5.3 percent per year. By contrast, inflation was 3.5 percent in Germany and 9.6 percent in Italy.
Limitations of PPP Theory

Two reasons why exchange rates do not always adjust to equalize prices across countries:

- Many goods cannot easily be traded.
  - Examples: haircuts, going to the movies
  - Price differences on such goods cannot be arbitraged away

- Foreign, domestic goods not perfect substitutes.
  - E.g., some U.S. consumers prefer Toyotas over Chevys, or vice versa
  - Price differences reflect taste differences
Limitations of PPP Theory

- Nonetheless, PPP works well in many cases, especially as an explanation of long-run trends.
- For example, PPP implies: the greater a country’s inflation rate, the faster its currency should depreciate (relative to a low-inflation country like the US).
- The data support this prediction…
Inflation & Depreciation in a Cross-Section of 31 Countries

Avg annual depreciation relative to US dollar 1993–2003 (log scale)

Avg annual CPI inflation 1993–2003 (log scale)
Chapter review questions

1. Which of the following statements about a country with a trade deficit is not true?
   A. Exports < imports
   B. Net capital outflow < 0
   C. Investment < saving
   D. $Y < C + I + G$

2. A Ford Escape SUV sells for $24,000 in the U.S. and 720,000 rubles in Russia.
   If purchasing-power parity holds, what is the nominal exchange rate (rubles per dollar)?
1. Which of the following statements about a country with a trade deficit is not true?

A. Exports < imports
B. Net capital outflow < 0
C. Investment < saving
D. $Y < C + I + G$

A trade deficit means $NX < 0$.

Since $NX = S - I$,

a trade deficit implies $I > S$. 
Answers

2. A Ford Escape SUV sells for $24,000 in the U.S. and 720,000 rubles in Russia. If purchasing-power parity holds, what is the nominal exchange rate (rubles per dollar)?

\[ e = \frac{P^*}{P} = \frac{720000}{24000} = 30 \text{ rubles per dollar} \]
Summary

• Net exports equal exports minus imports. Net capital outflow equals domestic residents’ purchases of foreign assets minus foreigners’ purchases of domestic assets.

• Every international transaction involves the exchange of an asset for a good or service, so net exports equal net capital outflow.
Summary

• Saving can be used to finance domestic investment or to buy assets abroad. Thus, saving equals domestic investment plus net capital outflow.

• The nominal exchange rate is the relative price of the currency of two countries.

• The real exchange rate is the relative price of the goods and services of the two countries.
Summary

• According to the theory of purchasing-power parity, a unit of any country’s currency should be able to buy the same quantity of goods in all countries.

• This theory implies that the nominal exchange rate between two countries should equal the ratio of the price levels in the two countries.

• It also implies that countries with high inflation should have depreciating currencies.