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 +

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:

\[ 1 + i(t) \quad \text{versus} \quad \left( \frac{1}{E(t)} \right) (1 + i^*(t)) \bar{E}(t+1) \]

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