Ch.5 Saving and Investment in the Open Economy

- Open Economies: engage in international trade of G&S and borrowing & lending
- What are the benefits & problems of OEs?

- 5.1 Balance of Payment Accounting
- 5.2 Goods Market Equilibrium in an Open Economy
- 5.3 Saving and Investment in a SOE
- 5.4 Saving and Investment in LOEs
- 5.5 Fiscal Policy and the Current Account

5.1 Balance of Payments Accounting

- BoP Accounts - record of a country’s international transactions
- Current Account: records trade and transfers
  1) Net Exports => trade of G&S: X-M
  2) Net Investment Income: receipts - payments
  3) Current Transfers => not a purchase of G&S => eg. foreign aid, remittances => receipts - payments

5.1 Balance of Payments Accounting

- The Capital Account: records trade in existing assets
  - Capital and financial account: capital inflows - capital outflows
- Official Settlements Balance (balance of payments) => net increase in official reserves
- See Table 5.1

5.1 Balance of Payments Accounting

- Relationship: CA + KA = 0 or CA = - KA
- See Table 5.2
- Statistical discrepancy: measurement error => World error (CA deficits) 1990s: $60 - $130 Billion (poor reporting of interest earned in foreign countries?)
- The net amount of new foreign assets (cap. outflows) a country can acquire is equal to the CA surplus =>

  CA = - KA and KA = cap inflows - outflows

  So, CA = net outflows

5.2 Goods Market Equilibrium in an OE

- Goods Market EQm for Closed Economy:

  $$S^d = I^d$$

- Open Economy:

  $$S^d = I^d + CA = I^d + NX + NFP$$

  (no current transfers)

- Assume $NFP = 0$ then $S^d = I^d + NX$
- So, $Y = C^d + I^d + G + NX$
- Or $NX = Y - (C^d + I^d + G)$

  ('absorption' of domestic product)

5.3 Saving and Investment in a SOE

- SOE: too small to affect the world interest rate => the world rate is exogenously set
- Residents can borrow or lend at the world rate
- Economic Shocks in a SOE
  1) Adverse Supply Shock
  2) Favorable Technological Shock

5.4 Saving and Investment in LOEs

- LOE: an economy large enough to affect the world interest rate
- Analysis: one LOE and ROW (rest of the world)
- Equilibrium: the world interest rate is that where desired international lending by one economy equals desired intern’l borrowing by the other (so that goods mrkt eqm holds)

5.5 Fiscal Policy and the Current Account

- The Twin Deficit Problem: What is the relationship between the current account deficit and the gov’t deficit?
- National Saving in response to Gov’t Borrowing: an increase in the gov’t deficit will raise the CA deficit only if the increase in the budget deficit reduces desired national saving
- Case 1: Increase in G
- Case 2: Decrease in T
- Ricardian Equivalence