

Some Notes on Open Economy Macro

Quantity equation: $M_s \times V \equiv P \times Y$ or $\dot{M}_s + \dot{V} \equiv \dot{P} + \dot{Y}$

Simple monetarist model assumes V and Y constant so:

$$\Delta M_s \Rightarrow \Delta P.$$

Simple Keynesian model assumes P is fixed so:

$$\Delta(M_s \times V) \Rightarrow \Delta Y.$$

It also assumes V varies as a positive function of injections $I + G + X$ relative to leakages $S + T + M$.

In the Keynesian model Y will rise or fall until injections and leakages are equal.

Under Keynesian assumptions the cost of adjusting macro policy to correct a balance of payments deficit will be higher as the marginal propensity to import is smaller, since the adjustment must come through lowering Y until M falls enough to correct the imbalance:

$$\Delta M = m \Delta Y.$$

The relationship between changes in the trade balance and jobs in the short run will depend on what caused the change in the trade balance:

$$\text{Multiplier: } K = 1/(m + s + t) \quad \Delta Y = K \times \Delta X$$

In the monetarist approach an increase in Y improves the trade balance because it lowers P . In the Keynesian approach $Y \uparrow$ causes a trade deficit because it increases imports. Monetarists assume the ΔY comes from the supply side, Keynesians assume it comes from the demand side.

Some Major Elements Of Optimum Currency Area Theory --which focuses on the factors which influence the costs and benefits of fixed versus flexible exchange rates.

1. Wage and price flexibility and high labor mobility makes the costs of fixed rates less.
2. A low marginal propensity to import makes the costs of fixed rates greater.

3. For a small open economy exchange rate adjustments are less effective because the feedback effects on domestic prices are greater.
4. Countries need fairly similar trends in their tendencies to inflate or need to be prepared to make major changes in domestic policies to bring these trends in line.
5. The patterns of shocks may also be important. The relationships can be complicated and depend on the degree of international capital mobility. Where capital mobility isn't too high, fixed rates will help dampen domestically generated income fluctuations, while flexible rates will help protect a country from income fluctuations abroad.

International Monetary System

The ^{UN} "Holy Trinity" analysis shows that one cannot sustain a system with fixed exchange rate, no controls, and independent monetary policy.

Macro Aspects of the Balance of Payments
Note in equilibrium

$$(I - S) + (G - T) + (X - M) = 0$$

From this we can see how domestic savings and investment and budget deficits will influence the trade balance (net exports)

For balance of payments equilibrium

$$(X - M) + K = 0$$

Thus in equilibrium a capital exporting country must run a trade (current account) surplus and a capital importing country must run a trade deficit.