

**Introduction to**

**International**

**Macroeconomics**

**(Ch. 11)**

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# International Macroeconomics: 2 components

## *1. Macroeconomics*

- Concerns the study of the aggregate performance of an economy:

Q: Total output (GDP) and its components, consumption, investment, govt spending; savings; employment, unemployment,

P: Inflation, wages, interest rates,..

Subject of study: How the economy responds to various shocks (new technologies, uncertainty, loss of confidence, terms-of-trade,...), and policy changes (monetary-fiscal, trade, policy, regulations,...)

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## 2. International

The aggregate performance of an **open** economy

Openness

i) Additional variables

Q: Balance of payments, trade balance, current account, Net International Investment Position (NIIP)

P: Exchange rate (nominal and real)

ii) Behavior of other variables is altered

Example: savings and investment in a closed (US) vs an open (CH) economy

- How to study the effects of the shocks on the economy?
- Write down an economic model that describes the relationships between the variables and shocks (*in red*) of interest

### Static IS-LM example

- $C = a_1 + a_2 * Y$
- $I = b_1 + b_2 * r$
- $Y = C + I + G$
- $m^s = d_1 * Y + d_2 * r$
- Solve to get  $\{Y, r, C, I\}$  as a function of shocks to business optimism,  $b_1$ , fiscal,  $G$ , and monetary,  $m^s$ , policy
- **$Y = k_1 * b_1 + k_2 * G + k_3 * m^s$**
- **$r = z_1 * b_1 + z_2 * G + z_3 * m^s$**
- ...

# Preview of the topics

- **Ch 12: Definitions and measurement of the foreign accounts**
- **Balance of Payments (BOP)**
- **BOP**—a record of a country's economic transactions with the rest of the world.
- The BOP's main components are the current account (CA) and the Financial-Capital Account (KFA).
- The CA's main components are the trade balance (TB) (or net exports (NX)) and the income account.

# Ch 12

## Interesting questions

How do BOP variables relate to standard National Income Accounts variables (Consumption, Investment, Savings,..) and national wealth?

- What happens to the CA if people start saving more because of greater uncertainty?
- Does a country become richer or poorer when it runs a CA surplus? The US has run trade deficits for 40+ years. What has happened to its relative wealth? Can it continue doing so indefinitely?
- What causes CA imbalances? Why for many years has CH been running CA surpluses and Greece CA deficits?

# Ch. 13. The foreign exchange market, FEM

- What is the Exchange Rate (ER)?
- Types of Exchange Rates (spot, forward)
- Activities in the FEM: Arbitrage, Hedging, Speculation
- Instruments for these activities: Swaps, Futures, Options
- Central Bank Intervention in FEM (the recent Swiss –SNB- experience)

## Interesting questions:

- Are risk free profits available in the FEM?
- How to use FEX derivatives –and which one- for hedging and speculation?

# Ch. 14, 15. Relationship between the key aggregate prices

- Prices and Exchange Rates (Purchasing Power Parity, PPP)
- Interest Rates and Exchange Rates (Interest Rate Parity, IRP)

## Interesting questions

- Do higher interest rates imply a stronger currency?
- Does inflation matter for the exchange rate?
- When is a currency overvalued? Is the CHF overvalued?
- Why have the Turkish Lira and the Argentinian Peso lost so much of their value this year?
- Does it pay to borrow in foreign currency when foreign interest rates are low?

# Ch. 17,18: Theories of the international quantities (BOP) and prices (FE)

- What moves exchange rates,  $s$ ?
- How does  $s$  matter for GDP,  $Y$  and inflation  $P$ ?

A model

- $s = a_1 * X_1 + a_2 * Y + a_3 * P + \dots + u_1$
- $Y = d_1 * Z_1 + d_2 * s + d_3 * P + \dots + u_2$
- $P = f_1 * Z_2 + f_2 * s + f_3 * Y + \dots + u_3$
  
- Solve for  $\{s, Y, P, \dots\}$  as a function of the shocks  $\{X_1, Z_1, Z_2, u, \dots\}$

- Various theories focus on different determinants of exchange rates and BOP
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- Trade flows
- Capital flows
- Monetary factors
- Behavioural (traders) ...
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- Trade flows
- Capital flows
- Price stickiness ....

# Ch. 19: International Monetary Arrangements

- Types of exchange rate regimes (Fixed, Flexible, Currency Union, Dollarization)

## Interesting questions

- What are the relevant trade offs in the choice of the regime?
- Pros/cons for CH from EUR adoption/fixing
- Have economies fared better under fixed or flexible
- What causes currency crises? Can they be averted/defended against? Does a Central Bank have complete control over the exchange rate? Why did the SNB abandon the floor?

# Ch. 20: International Credit Markets; Sovereign Debt

- *International Financial (Credit) Markets*
- Main function: Int'l asset trade is done for consumption smoothing over time/across states of nature. It is limited by repayments issues
- Main Implications

## Interesting questions

- Why some countries can borrow cheaply while other cannot?
- What causes defaults?
- What are the consequences of defaults?
- Case studies: Greece, Argentina

# ch 21: Open-Economy Macroeconomic Policy and Adjustment ()

- How does economic (monetary and fiscal) policy matter in open economies?
- Is it more or less effective in open economies?
- Capital controls