

Econ 1115: Principles of Macroeconomics

Lecture 23: Trade, Exchange Rates and Balance of Payments

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22. An inward shift of the money-demand curve could be a result of

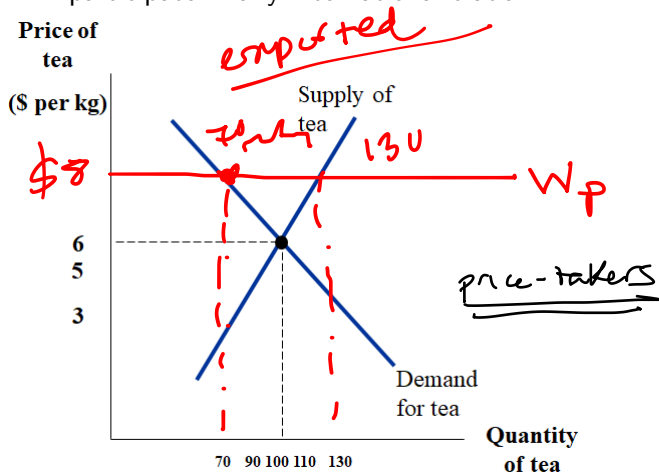
- a. a decrease in taxes.
- b. an increase in government spending.
- c. an increase in the price level.
- d. All of the above are correct.

None of the above

Outline

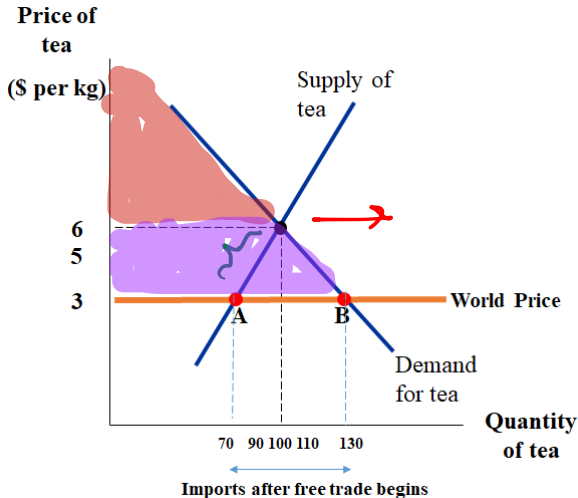
- 1 Small country, trade model
- 2 International trade and WTO
- 3 Exchange rates

Let's first consider the market for tea in a country that does not participate in any international trade.

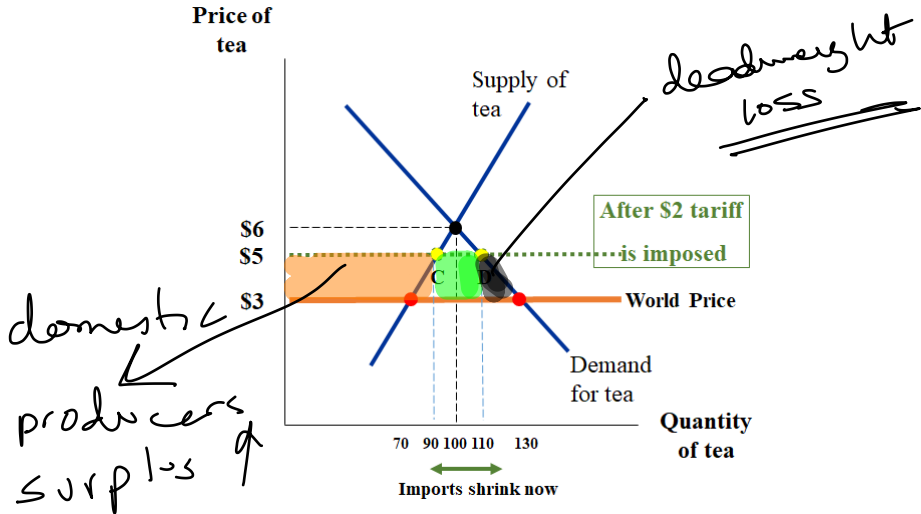


Now, the country starts trading with the outside world.

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Assumption: Small country, free trade.



To protect the domestic tea industry, the country imposes a tariff of \$2 on the tea.



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What are the functions of the WTO?

GATT

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- 1 To set and enforce rules for international trade
- 2 To provide a forum for negotiating and monitoring further trade liberalization
- 3 To resolve trade disputes
- 4 To increase the transparency of decision-making processes
- 5 To cooperate with other major international economic institutions involved in global economic management
- 6 To help developing countries benefit fully from the global trading system.

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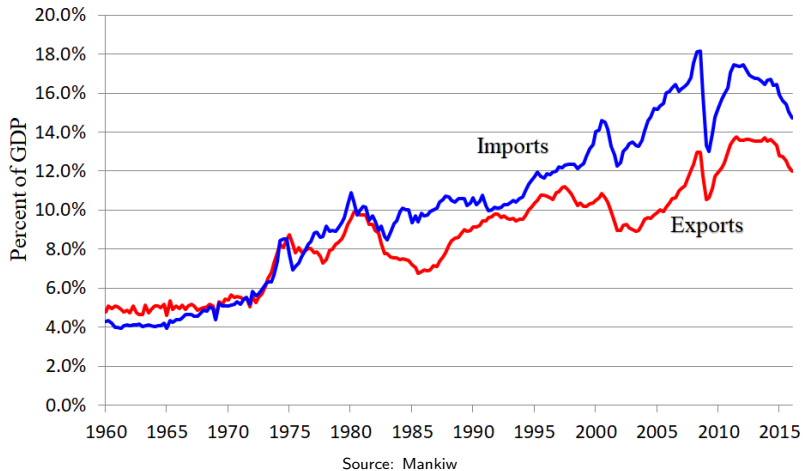
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- Transportation costs
- Government policies including barriers to trade



Capital and Financial accounts

The net flow of capital is the purchase of foreign assets by domestic residents which include

- Foreign direct investment (actual assets)
- Foreign stocks and bonds
- Other investments including loans
- Central Bank reserve account transactions

Less the purchase of domestic assets by foreigners.

Flows of capital

Factors that might influence the flow of capital into or out of the country

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- Government policies
- Real interest rate at home

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Inflows of money are credits or positive, while outflows of money are debits or negative.

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The capital and financial account has two major components

- **Capital account:** The capital account measures financial transactions that don't affect a country's income, production or savings.
- **Financial account:** Records the changes in the domestic ownership of foreign assets (by a country's citizens) and foreign ownership of domestic assets (other countries' citizens).

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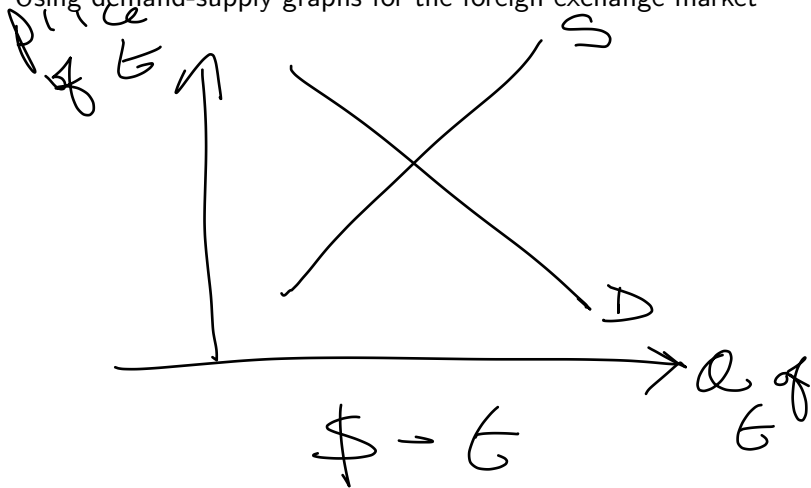
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- Real vs nominal exchange rate

market for Euros

Using demand-supply graphs for the foreign exchange market



Real exchange rates

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- Real exchange rate = nominal exchange rate $\times \frac{\text{DomesticPrice}}{\text{ForeignPrice}}$
where nominal is the foreign currency per unit of domestic currency

Law of one price and PPP

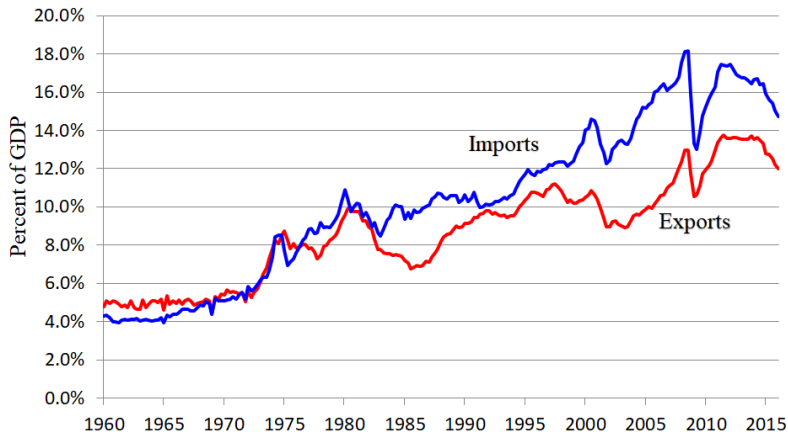
$$\text{Real exchange rate} = \frac{e \times P}{P^*}$$

This is also true for a basket of goods, where price refers to the price of a basket.

Thus we can now apply this to obtain a theory of exchange rates.

- The Law of one price and arbitrage
- Purchasing power parity: Explains long-term trends in exchange rates
- Does not hold in the short-run, and not perfectly in the long-run because of non-tradeable goods and imperfect substitution,

Is the trade deficit a problem?



Source: Mankiw

Trade deficits and other problems

- Should the trade deficit be a concern?

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