Chapter 14

THE GLOBAL ECONOMY AND POLICY

Macroeconomics in Context (Goodwin, et al.)

Chapter Overview

This chapter will take you through the basics of international trade and finance. The chapter introduces you to recent trends in the flows of trade and finance, as well as to the controversies over globalization. Imports and exports are added to the circular flow diagram that was introduced in Chapters 9 and 10. The chapter discusses the ways in which trade impacts fiscal and monetary policy. You will learn about exchange rates as well as different exchange rate systems. The chapter also examines the real world political economy of international economic relations.

Objectives

After reading and reviewing this chapter, you should be able to:

1. Describe various ways in which national economies are economically interconnected.
2. Understand the major policy tools countries have used to manage the degree of "openness" of their economies.
3. Describe major recent developments in the volume of international trade and financial flows.
4. Explain the macroeconomic impact of imports and exports using the circular flow model.
5. Understand basic principles of international finance.
6. Understand the implications of "openness" for monetary and fiscal policies.
7. Identify important international institutions concerned with trade and finance.

Key Terms

protectionism
trade quota
tariffs
non-tariff barriers to trade
trade-related subsidies
import substitution
capital controls
domestic content requirements
foreign trade zone
migration controls
free trade area
customs union
common market
World Trade Organization (WTO)
trade deficit
purchasing power parity (PPP)
exchange rate
purchasing power parity (PPP) adjustments
currency depreciation
currency appreciation
real exchange rate
foreign exchange
balance of payments (BOP) account
current account (in the BOP account)

trade account
capital account (in the BOP account)
portfolio investment
foreign direct investment (FDI)
capital flight
official reserve account
flexible (floating) exchange rate system
fixed exchange rate system
Bretton Woods system
devaluation
revaluation
foreign exchange market intervention
balance of payments crisis
International Monetary Fund (IMF)
fiscal capacity
World Bank
Washington Consensus

Active Review

Fill in the Blank

1. Suppose the U.S. government puts a tax on the imports of steel produced abroad. Such taxes charged on imports or exports are called __________.

2. Policies that provide subsidies to domestic producers to encourage the production of goods for domestic market and reduce the quantity of imports are called _ ________________ policies.

3. Countries sometimes set up ____________________ within their borders, where foreign-owned manufacturers can operate free of many taxes, tariffs, and regulations.

4. ________________ refer to the regulation or taxation of international transactions involving financial assets.

5. The exchange rate between two currencies, when adjusted for inflation in each country, is known as the ____________________.

6. A _______________________ can occur when a country gets precariously close to running out of foreign exchange and is therefore unable to purchase imports or service its existing debt.

7. The notion that, under certain idealized conditions, the exchange rate between the currencies of two countries should be such that the purchasing power of currencies is equalized is called ____________________.

8. The national account that tracks inflows and outflows arising from international trade, earnings, transfers, and transactions in assets is called the _______________.

9. The account that tracks flows arising from international transactions in assets is called the ______________________.

10. Under a fixed exchange system, if a government lowers the value at which it fixes its exchange rate, the currency will undergo a __________________.

True or False

11. Both quotas and tariffs provide a monetary revenue benefit to the government that has imposed them.

12. When a currency becomes less valuable in a flexible (floating) exchange rate system the correct term to use is "devaluation."

13. When foreigners buy U.S. bonds or invest in a U.S. business, these are capital outflows in the balance of payments account.

14. The fixed exchange rate system of Bretton Woods broke apart in 1972, when the U.S. dollar came under too much selling pressure.

15. Under a fixed exchange rate system, it becomes impossible for an individual country to conduct independent monetary policy (as exemplified by the case of the EU countries that have adopted the euro).

Short Answer

16. List three policy tools to regulate trade in goods and services.

17. Identify and describe each of the three leakages and the three injections in the open economy version of the circular flow model.

18. Explain the difference between "depreciation" and "devaluation."

19. Explain how a foreign exchange market intervention could be used to protect a currency that market forces are pushing toward a potential devaluation. Under what circumstances would this intervention potentially turn into a balance of payments crisis?

20. Explain what is meant by purchasing power parity (PPP), and purchasing power parity (PPP) adjustments.

21. Explain what happens to the value of the currency when there's an increase (or decrease) in the supply (or demand) of the currency in a foreign exchange market with flexible exchange rates.

22. Explain what is meant by the balance of payments account, the current account (in the BOP account), and the capital account (in the BOP account).

23. Describe the impact of an expansionary monetary policy in an open economy.

24. Why do some countries try to control the value of their currencies through a fixed exchange rate system? And how can they do so?

25. How has the adoption of the euro affected monetary policy-making in the Eurozone countries?

26. What are the international institutions of the "Washington Consensus", and what were the policy prescriptions they imposed on many developing countries in the 1980s and 1990s?

Problems

1. Identify whether each of the following represents an *inflow* or an *outflow* from either the *current account* or the *financial account*:

    a. A Mexican banker purchases a United States government bond.

    b. A U.S. corporation invests in a Chinese facility.

    c. A U.S. corporation collects profits earned in Mexico and sends the money back to United States.

    d. An exporter in the U.S. receives payment for goods shipped to France.

    e. The U.S. government pays interest to bondholders in China

2. Exchange rates

    a. Suppose under a flexible exchange system, there is a drop in the demand for the U.S. dollar, as investors find higher returns in countries that use the Euro. Use a graph of the foreign exchange market, with the price of dollars expressed as "Euros per dollar" to illustrate the impact on the value of the dollar.

    b. Suppose that under a fixed (or managed) exchange system, China strives to keep the value of its Yuan artificially low. Illustrate with a graph of the foreign exchange market, how China's Central Bank can do this.

Self Test

1. Which of the following is *not* one of the policy tools to regulate trade in goods and services?

   a. Import quotas
   b. Tariffs
   c. Licensing requirements on imports
   d. Capital controls
   e. Trade-related subsidies

2. Suppose Hereland puts a quota on imports of oranges from Thereland. Which of the following groups is most likely to reap financial benefits from the imposition of the quota?

   a. Hereland's orange producers
   b. Hereland's government
   c. Thereland's government
   d. Hereland's consumers
   e. None of the above

3. Which of the following characterizes the trends in trade and financial flows for the U.S. in recent years?

   a. The volume of trade in goods and services (as a % of GDP) has increased over time, from about 10% in 1965 to almost 30% in 2015.
   b. China has emerged as a major source of U.S. imports.
   c. The volume of financial flows has increased significantly in recent years.
   d. Since the early 1980s, the U.S. has been running current account deficits, mostly due to the trade deficits.
   e. All of the above.

4. Which of the following is *not* one of the top buyers of U.S. exports?

   a. Canada
   b. Mexico
   c. China
   d. Japan
   e. France

5. Which of the following is *not* one of the top sellers of imports to the United States?

   a. Canada
   b. Mexico
   c. Brazil
   d. China
   e. Japan

6. The circular flow model in this chapter frames aggregate expenditure as:

   a. AE = Consumption + Intended Investment + Taxes + Exports
   b. AE = Consumption + Actual Investment + Government Spending + Exports - Imports
   c. AE = Consumption + Actual Investment + Government Spending - Taxes + Exports
   d. AE = Consumption + Intended Investment + Government Spending + Net Exports
   e. None of these accurately describes aggregate expenditure.

7. Which of the following best describes trends in trade expressed as a percentage of production from 1960 - 2015?

   a. both the worldwide volume of trade grew and the U.S. volume of trade grew
   b. the worldwide volume of trade grew while the U.S. volume of trade fell
   c. the U.S. volume of trade grew while the worldwide volume of trade fell
   d. both the worldwide volume of trade fell and the U.S. volume of trade fell
   e. None of the above.

8. Suppose that the exchange rate between U.S. dollars and currency in France, the euro, is 1.25 dollars per euro. If purchasing parity holds, how much would we expect a bottle of perfume that costs €100 in France to sell for in the United States?

   a. 80 dollars
   b. 100 dollars
   c. 120 dollars
   d. 125 dollars
   e. 150 dollars

9. Suppose that the exchange rate between U.S. dollars and currency in Mexico, the peso, is 0.10 dollars per peso. If purchasing parity holds, how much would we expect a scooter that costs $10,000 in the United States to sell for in Mexico?

   a. 1,000 pesos
   b. 10,000 pesos
   c. 20,000 pesos
   d. 50,000 pesos
   e. 100,000 pesos

10. Suppose the German demand for United States stocks increases due to a stock market boom in the U.S. What would we expect to happen in the foreign exchange market, holding all other factors constant?

a. The dollar will depreciate and more dollars will be traded.
b. The dollar will depreciate and fewer dollars will be traded.
c. The dollar will appreciate and more dollars will be traded.
d. The dollar will appreciate and fewer dollars will be traded.
e. The dollar could appreciate or depreciate, but fewer dollars will be traded.

11. Suppose the Chinese demand for United States government bonds decreases due to concerns about political battles in Washington D.C. What would we expect to happen in the foreign exchange market, holding all other factors constant?

a. The dollar will depreciate and more dollars will be traded.
b. The dollar will depreciate and fewer dollars will be traded.
c. The dollar will appreciate and more dollars will be traded.
d. The dollar will appreciate and fewer dollars will be traded.
e. The dollar could appreciate or depreciate, but fewer dollars will be traded.

12. In 2012, brokers selling Miami real estate found that some of their best clients were from Argentina. What concept does this story from the chapter provide an example of?

a. foreign exchange market intervention
b. portfolio investment
c. capital flight
d. foreign direct investment
e. None of the above.

13. Assume a foreign exchange market with a flexible exchange system. Suppose the demand for a country's currency decreases. This results in a _______________ in its currency.

a. depreciation
b. appreciation
c. devaluation
d. revaluation
e. The value of the currency will remain unchanged.

14. If the value of a country's currency falls, what is the effect on exports and imports, assuming all else remains unchanged?

a. Exports will fall, and imports will rise.
b. Exports and imports will both fall.
c. Exports will rise, and imports will fall.
d. Exports and imports will both rise.
e. Exports and imports will remain unchanged.

15. How would payments from the sale of fighter jets to Saudi Arabia be registered in the U.S. balance of payments?

a. As an inflow in the current account.
b. As an outflow in the current account.
c. As an inflow in the capital account.
d. As an outflow in the capital account.
e. None of the above.

16. Suppose a Kuwaiti company invests in a U.S. bank. How would this transaction be registered in the balance of payments?

a. As an inflow in the current account.
b. As an outflow in the current account.
c. As an inflow in the capital account.
d. As an outflow in the capital account.
e. None of the above.

17. Which of the following best describes the impact of an expansionary monetary policy in an open economy?

a. The rise in the interest rate dampens investment spending. It also raises capital inflows, raises the demand for and value of the currency, thereby dampening net exports.
b. The fall in the interest rate stimulates investment spending. It also raises capital inflows, raises the demand for and value of the currency, thereby dampening net exports.
c. The fall in the interest rate stimulates investment spending. It also reduces capital inflows, reduces the demand for and value of the currency, thereby boosting net exports.
d. The fall in the interest rate stimulates investment spending. It also reduces capital inflows, reduces the money supply, which raises interest rates, cancelling out the effects of the initial fall in the interest rate.
e. None of the above.

18. How can a Central Bank prop up the value of its currency?

a. It could create more demand for the domestic currency by buying more of it.
b. It could increase the supply of the domestic currency.
c. It could create less demand for the domestic currency by buying less of it.
d. It could declare the currency to have a greater value, by fiat.
e. None of the above.

19. Which of the following is *not* one of the international institutions established in the late 1940s?

a. The Bretton Woods system of fixed exchange rates.
b. The World Bank
c. The International Monetary Fund (IMF)
d. The General Agreement on Tariffs and Trade (GATT)
e. The World Trade Organization

20. Which of the following was *not* one of the policy prescriptions advocated by the "Washington Consensus" in the 1980s and 1990s?

a. Trade liberalization
b. Privatization
c. Deregulation
d. Reduce the size of government
e. Government spending to reduce poverty

Answers to Active Review Questions

1. tariffs
2. import substitution
3. foreign trade zones
4. capital controls
5. real exchange rate
6. balance of payments crisis
7. purchasing power parity (PPP)
8. balance of payments (BOP) account
9. capital account (in the BOP account)
10. devaluation
11. False. Only tariffs provide a monetary revenue benefit to the government.
12. False. “Depreciation” is the correct term.
13. False. They are capital inflows.
14. True.
15. True.
16. Three policy tools to regulate trade are: a trade quota, a tariff, or a trade- related subsidy.
17. The leakages in the open economy circular flow model include savings, taxes, and imports. The injections in the open economy version of this model include intended investment, government spending, and exports.
18. “Depreciation” refers to the reduction in a currency’s value in a flexible exchange rate system, while “devaluation” refers to a reduction in a currency’s value in a fixed exchange rate system.
19. A foreign exchange market intervention to protect a currency threatened with potential devaluation would involve the central bank buying the threatened currency and depleting foreign exchange reserves. If the central bank is in danger of running out of foreign exchange then a balance of payments crisis is a distinct possibility.
20. Purchasing power parity is the theory that exchange rates should reflect the difference in purchasing power among countries, under certain idealized conditions (such as the free trade of currencies and goods, and the absence of transportation costs). However, in reality these conditions often do not exist. Thus purchasing power parity (PPP) adjustments are made to take account of differences in the cost of living between countries.
21. If the supply of the currency increases, the value of the currency will fall. If the demand of the currency increases, the value of the currency will rise. (And vice versa for the decrease.)
22. The balance of payment account tracks the inflows and outflows arising from international trade, earnings, transfers, and transactions in assets. It’s divided into two subsections: the current account and the capital account. The current account tracks the inflows and outflows from trade in goods and services, as well as earnings and transfers. The capital account tracks inflows and outflows from transactions in assets.
23. In an expansionary monetary policy, interest rates fall, which stimulates investment spending. But the lower interest rates also lead to capital outflows, a fall in the demand for the currency, and thereby a depreciation in the currency and an increase in net exports. The increase in investment spending and net exports both boost

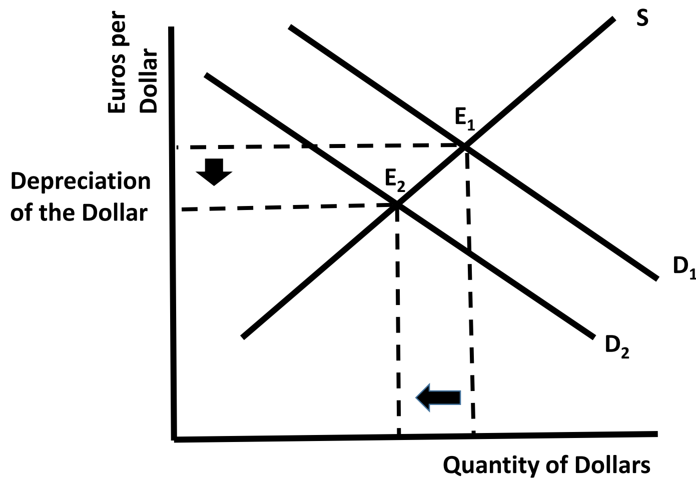
aggregate expenditure and GDP.

24. Because a wildly fluctuating currency can be very destabilizing in conducting economic activities (particularly for producers, or people with financial assets). Their Central Bank can either buy up domestic currency (to prop up its value). Or if it wants to artificially keep the value of its currency low, it can increase the supply of its domestic currency on the market.
25. By adopting a common currency, the Eurozone countries have given up having separate monetary policies and put the European Central Bank in control of their monetary policy-making. Since the different Eurozone countries have different objectives and requirements, it is complicated to design a monetary policy that fits the interest of all member countries. For example, the low interest policies of the ECB after the 2008-09 financial crisis was not sufficient to boost the economies of countries like Greece and Spain where the impacts of the crisis was much more adverse than in countries like Germany and Austria.
26. The “Washington Consensus” consists primarily of the World Bank and IMF, both located in Washington D.C. As a condition for assistance, they required developing countries to engage in trade liberalization, privatization, deregulation, and decreasing the size of government through spending cuts (budget austerity).

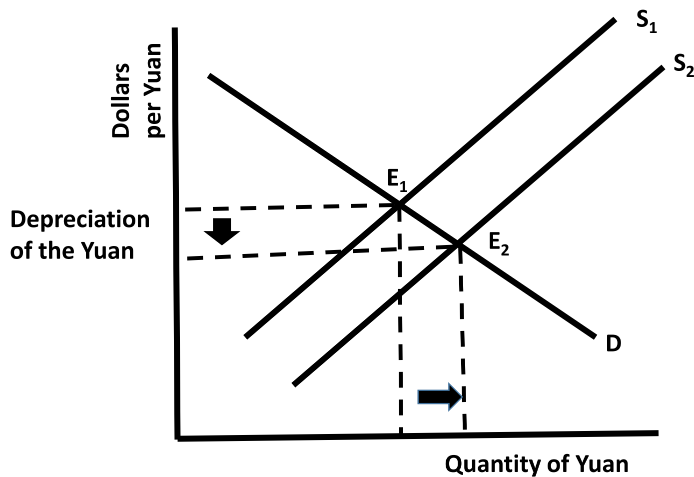
Answers to Problems

1.
   a. Inflow, financial account — This is “borrowing from abroad”
   b. Outflow, financial account — This is “FDI abroad”
   c. Inflow, current account — This is “income receipts”
   d. Inflow, current account — This is “payments for exports of goods”
   e. Outflow, current account — This is “income payments”

2. a. A drop in demand for the U.S. dollar results in a depreciation in the value of the dollar.



b. The Chinese Central Bank can increase the supply of the Yuan to keep its value low.



Answers to Self Test Questions

1. D
2. A
3. E
4. E
5. C
6. D
7. A
8. D
9. E
10. C
11. B
12. C
13. A
14. C
15. A
16. C
17. C
18. A
19. E
20. E