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Open Economy Macroeconomics

So far, we have simplified the analysis of income determination by assuming a closed economy. In reality, most modern economies are open. Interaction with other economies of the world widens choice in three broad ways

(i) Consumers and firms have the opportunity to choose between domestic and foreign goods. This is the product market linkage which occurs through international trade.

(ii) Investors have the opportunity to choose between domestic and foreign assets. This constitutes the financial market linkage.

(iii) Firms can choose where to locate production and workers to choose where to work. This is the factor market linkage. Labour market linkages have been relatively less due to various restrictions on the movement of people through immigration laws. Movement of goods has traditionally been seen as a substitute for the movement of labour. We focus here on the first two linkages.

An **open economy** is one that trades with other nations in goods and services and, most often, also in financial assets. Indians, for instance, enjoy using products produced around the world and some of our production is exported to foreign countries. Foreign trade, therefore, influences Indian aggregate demand in two ways. First, when Indians buy foreign goods, this spending escapes as a **leakage** from the circular flow of income decreasing aggregate demand. Second, our exports to foreigners enter as an **injection** into the circular flow, increasing aggregate demand for domestically produced goods. Total foreign trade (exports + imports) as a proportion of GDP is a common measure of the **degree of openness** of an economy. In 2004-2005, this was 38.9 per cent for the Indian economy (imports constituted 17.1 per cent and exports 11.8 per cent of GDP). This is substantially higher than a total of 16 per cent that prevailed in 1985-86. However, in comparison to other countries, India is relatively less open. There are several countries whose foreign trade proportions are above 50 per cent of GDP.

Now, when goods move across national borders, **money** must move in the opposite direction. At the international level, there is no single currency that is issued by a central authority. Foreign economic agents will accept a national currency only if they are convinced that the currency will maintain a stable purchasing power. Without this confidence, a currency will not be used as an international medium of exchange and unit of account since there is no international authority with the power to force the use of a particular currency in international transactions. Governments have tried to gain confidence of potential users by announcing that the national currency will be freely convertible at a fixed price into another asset, over whose value the issuing authority has no control. This other asset most often has been gold, or other national currencies. There are two aspects of this commitment that has affected its credibility – the ability to convert freely in unlimited amounts and the price at which conversion takes place. The **international monetary system** has been set up to handle these issues and ensure stability in international transactions. A nation's commitment regarding the above two issues will affect its trade and financial interactions with the rest of the world.

We begin section 6.1 with the accounting of international trade and financial flows. The next section examines the determination of price at which national currencies are exchanged for each other. In section 6.3, the closed economy income-expenditure model is amended to include international effects.

6.1 The Balance of Payments

The balance of payments (BoP) record the transactions in goods, services and assets between residents of a country with the rest of the world. There are two main accounts in the BoP – the current account and the capital account.

The **current account** records exports and imports in goods and services and transfer payments. Trade in services denoted as invisible trade (because they are not seen to cross national borders) includes both factor income (payment for inputs-investment income, that is, the interest, profits and dividends on our assets abroad minus the income foreigners earn on assets they own in India) and non-factor income (shipping, banking, insurance, tourism, software services, etc.). Transfer payments are receipts which the residents of a country receive 'for free', without having to make any present or future payments in return. They consist of remittances, gifts and grants. They could be official or private. The balance of exports and imports of goods is referred to as the **trade balance**. Adding trade in services and net transfers to the trade balance, we get the **current account balance**. The capital account records all international purchases and sales of assets such as money, stocks, bonds, etc. We note that any transaction resulting in a payment to foreigners is entered as a **debit** and is given a negative sign. Any transaction resulting in a receipt from foreigners is entered as a **credit** and is given a positive sign.

6.1.1 BoP Surplus and Deficit

The essence of international payments is that just like an individual who spends more than her income must finance the difference by selling assets or by borrowing, a country that has a deficit in its current account (spending more abroad than it receives from sales to the rest of the world) must finance it by selling assets or by borrowing abroad. Thus, any current account deficit is of necessity **financed** by a net capital inflow. Table 6.1 (given at the end of chapter) shows that there has been a trade deficit throughout the period and a surplus in invisibles except for 1990-91. The current account deficit (which has been observed for 24 years from 1977-78) had started shrinking and turned into surplus from 2001-02. The surplus continued till 2003-04, but turned into a deficit in 2004-05. The large trade deficit could not be bridged by the invisibles surplus. In April-September 2005-06, the current account deficit of

US$13 billion was financed by a capital inflow of US$19.5 billion, the extra capital inflow of US$ 6.5 billion being added to our stock of foreign exchange.

Alternatively, the country could engage in **official reserve transactions**, running down its reserves of foreign exchange, in the case of a deficit by selling foreign currency in the foreign exchange market. The decrease (increase) in official reserves is called the overall balance of payments deficit (surplus). The basic premise is that the monetary authorities are the ultimate financiers of any deficit in the balance of payments (or the recipients of any surplus). A country is said to be in balance of payments equilibrium when the sum of its current account and its non-reserve capital account equals zero, so that the current account balance is financed entirely by international lending without reserve movements. We note that the official reserve transactions are more relevant under a regime of pegged exchange rates than when exchange rates are floating.

***Autonomous and Accommodating Transactions*:** International economic transactions are called **autonomous** when transactions are made independently of the state of the BoP (for instance due to profit motive). These items are called 'above the line' items in the BoP. The balance of payments is said to be in surplus (deficit) if autonomous receipts are greater (less) than autonomous payments. **Accommodating transactions** (termed 'below the line' items), on the other hand, are determined by the net consequences of the autonomous items, that is, whether the BoP is in surplus or deficit. The official reserve transactions are seen as the accommodating item in the BoP (all others being autonomous).

Errors and Omissions constitute the third element in the BoP (apart from the current and capital accounts) which is the 'balancing item' reflecting our inability to record all international transactions accurately.