Economics Notes PDF

On

Open Economy Macroeconomics

(Class – 12)

Open Economy: It is one that conducts business with other countries in a range of methods. The majority of modern economies are open.

There are three ways in which these linkages are established:
1. Output Market: An economy can trade in goods and services with other countries. This widens choice in the sense that consumers and producers can choose between domestic and foreign goods.
2. Financial Market: Most often an economy can buy financial assets from other countries. This gives investors the opportunity to choose between domestic and foreign assets.
3. Labour Market: Firms can choose where to locate production and workers to choose where to work. There are various immigration laws which restrict the movement of labour between countries.

BALANCE OF PAYMENT (BOP)

The balance of payment is a comprehensive and systematic record of all economic transactions between normal residents of a country and the rest of the world during an accounting year.

Accounts of Balance of Payments:

1. Current Account: The current account records export and import of goods and services and unilateral transfers.

Two Components of the Current Account:

- **Balance of Trade (BOT):** It is the difference between the value of a country's exports and imports of goods over a specified timeframe. The export of products is recorded as a credit in the BOT, whereas the import of goods is recorded as a debit. It is also referred to as the Trade Balance.
- **Balance of Invisibles:** The difference between a country's exports and imports of invisible over a certain time frame is known as the balance of invisible. Services, transfers, and income movements between countries are all examples of invisible.

2. Capital Account: It records all such transactions between normal residents of a country and the rest of the world which relate to sale and purchase of foreign assets and liabilities during an accounting year.

Components of Capital Account:

1. Investments:

- **Direct Investment:** Equity Capital, FDI, Reinvested Earning, and other Direct Capital Flows.
- **Portfolio Investment:** Offshore Funds, FII.

2. External Borrowings: Includes Short-term Debt, External Commercial Borrowings.
3. External Assistance: Multilateral and Bilateral Loans, Government Aid, Inter-governmental Aid.

Deficit of Balance of Payment Account: When total inflows of foreign exchange on account of autonomous transactions are less than total outflows on account of such transactions then there is a deficit in Bop. A deficit in the balance of payment happens when total payment surpasses total receipts; ergo BOP = Credit < Debit. A deficit of the balance of payment can be amended through an official reserve deal which signifies the sale of foreign exchange by the Reserve Bank.

Autonomous items: These are those items of balance of payment which are related to such transactions as are determined by the motive of profit maximisation and not to maintain equilibrium in balance of payments. These items are recorded as a first item before calculating deficit or surplus in balance of payment a/c.

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These items are generally called 'Above the Line items' in balance of payment.

Accommodating items:
(a) Accommodating items refer to the transactions that are undertaken to cover deficit or surplus in autonomous transactions, i.e., such transactions are determined by net consequences of autonomous transactions.
(b) These items are also known as 'below the line items'.
(c) For example, if there is a current account deficit in BOP, then this deficit is settled by capital inflow from abroad. The sources used to meet a deficit in BOP, are:

- Foreign exchange reserves.
- Borrowings from IMF or foreign monetary authorities.

Errors and Omissions: It is difficult to keep accurate records of all international transactions. As a result, in addition to the current and capital accounts, there is a third element of the balance of payment called errors and omissions, which reflects this. The entries made under this head relate for the most part to leads and lags in the detailing of exchange. It is a balancing entry that is expected to counterbalance the exaggerated or underestimated components.

Foreign Exchange Market: The foreign exchange market is the market where national currencies are exchanged for one another. Commercial banks, foreign exchange brokers, other authorized dealers, and monetary authorities are the main participants in the foreign exchange market. The foreign exchange markets are the first and most established financial markets and remain the premise whereupon the remainder of the financial edifice is built. It provides global liquidity, ideally with reasonable stability.

Foreign exchange rate: It refers to the rate at which one unit of currency of a country can be exchanged for the number of units of currency of another country. In simple words, we can say that the price of one currency in terms of other currency is known as foreign exchange rate or exchange rate.

1. Demand of Foreign Exchange: These have the inverse relation with flexible exchange rate. If the flexible exchange rate rises, the demand of foreign exchange falls. Vice versa.

Sources of Demand for Foreign Exchange:
(a) To purchase goods and services from the rest of the world.
(b) To purchase financial assets (i.e.to invest in bonds and equity shares) in a foreign country.
(c) To invest directly in shops, factories, and buildings in foreign countries.
(d) To send gifts and grants abroad.
(e) To speculate on the value of foreign currency.
(f) To undertake foreign tours.

2. Supply of Foreign Exchange: Foreign currency flows into the home country for the following reasons - a country's exports lead to foreigners purchasing its domestic goods and services; foreigners send gifts or make transfers, and foreigners purchase a home country's assets.

Sources of Supply of Foreign Exchange:
(a) Direct purchase by foreigners in the domestic market.
(b) Direct investment by foreigners in the domestic market.
(c) Remittances by non-residents living abroad.
(d) Flow of foreign exchange due to speculative purchases by N.R.I.

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(e) Exports of goods and services.
(f) Foreign direct investment as well as portfolio investment from the rest of the world.

Flexible Exchange Rate: The market forces of demand and supply determine this exchange rate. It is also referred to as a floating exchange rate:

- An increase in the exchange rate indicates that the price of foreign currency (dollar) in terms of domestic currency (rupees) has risen. This is referred to as depreciation of the domestic currency (rupees) in terms of foreign currency (dollars).
- Appreciation of the domestic currency (rupees) in terms of foreign currency (dollars) occurs when the price of domestic currency (rupees) increases in relation to foreign currency (dollars) (dollars).

Merits of Flexible Exchange Rate:
(i) No need to hold foreign exchange reserves
(ii) Leads to automatic adjustment in the 'balances of payments'.
(iii) To enhance efficiency in resource allocation.
(iv) To remove obstacles in the transfer of capital and trade.
(v) It eliminates the problem of undervaluation or overvaluation of currency.
(vi) It promotes venture capital in the form of foreign exchange.

Demerits of Flexible Exchange Rate:
(i) Future exchange rate fluctuations.
(ii) Is a deterrent to international trade and investment.
(iii) Promotes speculation.
(iv) It contributes to market uncertainty.

Fixed Exchange Rate: The government fixes the exchange rate at a specific level in this exchange rate system. The goal of a fixed exchange rate system is to maintain the value of a currency within a narrow spectrum.

- Devaluation occurs in a fixed exchange rate system when a government action raises the exchange rate, causing the domestic currency to become cheaper.
- In a fixed exchange rate system, a revaluation occurs when the government lowers the exchange rate, making the domestic currency more expensive.

Merits of Fixed Exchange Rate:
(i) stability in exchange rate
(ii) Promotes capital movement and international trade.
(iii) No scope for speculation
(iv) It forces the govt. to keep inflation in check.
(v) Attracts foreign capital.

Demerits of Fixed Exchange Rate:
(i) In relation to the balance of payments, there are no automatic adjustments i.e., it forestalls changes for monetary standards that become under-or over-esteemed.
(ii) Requiring a huge pool of reserves to help the currency of a country in the event that it goes under pressure.
(iii) It could lead to currency undervaluation or overvaluation.
(iv) It undercuts the goal of free markets.

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Determination of Equilibrium Foreign Exchange Rate: Equilibrium FER is the rate at which demand for and supply of foreign exchange is equal. Under a free market situation, it is determined by market forces i.e., demand for and supply of foreign exchange. There is an inverse relation between demand for foreign exchange and exchange rate. There is a direct relationship b/w supply of foreign exchange and exchange rate. Due to above reasons demand curve downward sloping and supply curve is upward sloping curve Graphically intersection of demand Curve and supply curve determines the equilibrium foreign exchange rate.

Devaluation of a Currency: When the external value of a currency is officially lowered by the government or the monetary authority of a country then that is called the devaluation of a currency. This lowering of domestic currency is for all other foreign currencies. This is done under the fixed exchange rate system by the government's order.

Revaluation of a currency: When the government or monetary authority of a country officially raises the external value of its domestic currency is called revaluation. It takes place by government order under fixed exchange rates system.

In currency depreciation: There is a fall in the value of domestic currency, in term of foreign currency due to change in demand and supply of the currency under a flexible exchange rate system.

In currency appreciation: There is a rise in the value of domestic currency in terms of foreign currency due to change in demand and supply of the currency under a flexible exchange rate system.

Managed Floating: It is a hybrid of a flexible exchange rate system, known as the float, and a fixed rate system, known as the managed part. This exchange rate system enables a country's central bank to intervene on a regular basis in foreign exchange markets to moderate exchange rate movements whenever such actions are deemed appropriate.

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