Lecture 20

Analyzing Open Economy Macro Issues

- Optimal currency areas. Labor mobility, capital mobility, similar fiscal policies. Europe not so good. When countries join the euro, they lose their monetary policy—both interest rates and exchange rates. U.S. states are fine.
- Greece. Cannot devalue.

- China: yuan was undervalued for a number of years—maybe not anymore. How did China keep the yuan low?
  - I buy tea from China. I need to buy yuan with dollars first. So yuan appreciates? No. Chinese central bank sells the yuan (buys the dollars). I have tea; China has dollars.
  - I want to buy a Chinese government bond, so demand for yuan increases. Yuan appreciates? No. Capital controls.
- Argentina earlier: Fixed exchange rate (in fact, currency board). Peso overvalued. Citizens want to buy U.S. goods. Use pesos to buy dollars. Who sells the dollars? Not I; peso is a risky deal. Argentina's central bank sells the dollars out of its reserves (dollar holdings). Eventually it runs out of dollars. Then a crisis.

- Crises
  - Many examples in history
  - Foreign reserves run out and the country is forced to devalue its currency. Sometimes capital controls are used to try to avoid devaluation.
  - A country may default on its sovereign debt—Reinhart and Rogoff, *This Time is Different*. Many examples in this book. Many times countries borrow in foreign currencies—like issuing government bonds in dollars. Bad wealth effect if the country's currency then depreciates relative to the dollar.

- A primary budget is revenue minus expenditures not counting interest payments.
  - If the nominal interest rate is equal to the nominal growth rate of GDP and if the primary deficit is zero, the debt to GDP ratio remains constant over time. Debt/GDP is constant because both Debt and GDP grow at the same rate.
  - How close is Greece to a primary budget balance?

- Is a financial crisis like the United States had in 2008 more than just a large drop in wealth and thus just a negative wealth effect?
  - Credit rationing
  - Companies forced to go bankrupt only because of liquidity reasons
  - Is there such a thing as a "financial meltdown?"
  - Bond holders versus taxpayers
- Much of the world financial crisis in 2008 was driven by a worldwide fall in housing prices—huge drop in housing wealth.

- Depreciation is not always expansionary
  - Inflation has some contractionary features. Review what these are.
  - As noted above, debt may be denominated in foreign currencies. Negative wealth effect.
- What is the risk of holding dollars by a foreign country, like China.
  - Inflation in the United States
  - Depreciation of the dollar relative to currencies other than one's own
  - United States restructures its debt—haircut