

LECTURE 12: GLOBALIZATION & BALANCE OF PAYMENTS

- I. A trading game
 - a. Trade increases aggregate utility.
 - b. *The Fundamental Theorem of Exchange*—voluntary trade with complete information is always mutually beneficial.
 - i. Note this is not the same thing as equally beneficial.
 - ii. Trade also encourages peace and understanding.
 - c. Mistakes surely happen but either the harm is small (a movie wasn't all that good) or people make special effort to ensure they don't make a mistake (research a new car, inspect a house, consult a critic).
- II. Law of One Price
 - a. Suppose, at current exchange rates, rugs cost \$10 in one country and \$200 in another country. What do you do?
 - i. This causes the cheap rugs to be more expensive and the expensive rugs to be cheaper.
 - ii. This should continue until the prices are equal (or nearly equal, since you have to pay to ship the rugs).
 - iii. Thus the *law of one price*—when there are no barriers to trade, the price of a good or service should be the same everywhere.
 - b. All things being equal...
 - i. The currency with the cheaper rugs will appreciate and
 - ii. The currency with the expensive rugs will depreciate.
 - c. That prices are converging across the world is the result of *globalization*—the process of countries being open to more foreign trade and investment.
- III. Purchasing Power Parity
 - a. In reality, though, barriers to trade exist. There are transportation costs. There are tariffs and customs. There is spoilage. Prices for many products vary widely.
 - i. By looking at many goods and services, you can get a “big picture” view.
 - ii. However, quality of goods and services changes from country to country, biasing the index.
 - iii. Thus the *purchasing power parity (PPP)*—technique used to determine the relative value of different currencies.

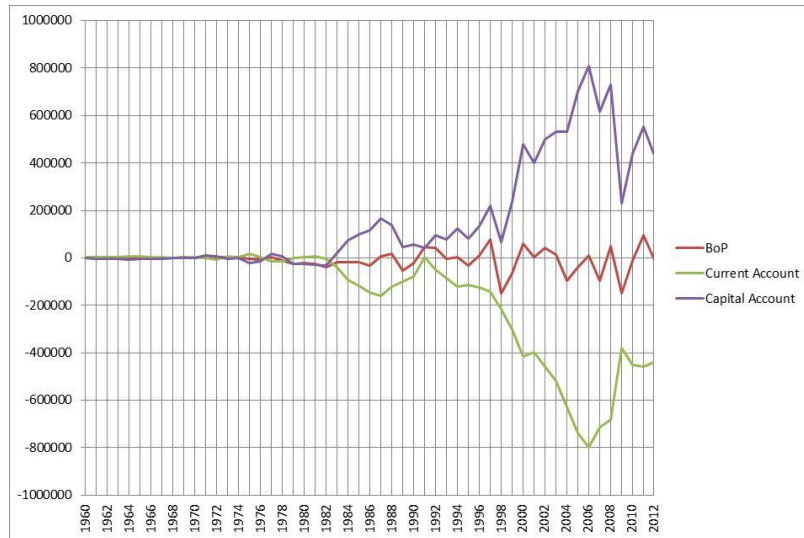
- b. Like the law of one price, PPP has a prediction (called *purchasing power parity theory*): exchange rates between any two currencies will adjust to reflect differences in the price levels of various currencies.
- c. Consider the Big Mac Index. Big Macs are famously the same everywhere. That uniform quality helps judge purchasing power and, in theory, can be used to predict how prices will adjust.
 - i. In July 2015, a Big Mac in the U.S. cost on average \$4.79.
 - ii. At the same time, using July 2015 exchange rates, it cost...
 - 1. \$1.88 in Russia, suggesting the Russian rouble is undervalued; it should appreciate soon.
 - 2. \$6.82 in Switzerland, suggesting the Swiss franc is overvalued; it should depreciate soon.
 - 3. \$1.83 in India, suggesting the Indian rupee is undervalued; should it appreciate soon?
 - iii. The Big Mac Index is by no means perfect—it is just one product, after all, but it’s a useful way to help think about PPP and the law of one price.

IV. The trade deficit

- a. Exports – Imports = NX (or the balance of trade).
- b. The “deficit” is when imports > exports, or when NX is negative.
- c. People are very concerned that the US’s NX is negative, seeing it as a sign of a weak economy. There are several things wrong with this view.
 - i. Trade deficits occur within countries.
 - ii. People are buying things they want—utility is increasing.
 - iii. The trade deficit is only part of the equation. This last point warrants further exploration.

V. Balance of Payments (BoP)

- a. All trade activity is captured in this equation: $NX + CA = 0$.
 - i. Where CA is the capital account, or the net flow of investment. Note that sometimes NX is called the current account, as in the flow of goods that *currently* exist, while the capital account speaks to the money used to create *capital*, the investment.
 - ii. Note your book splits CA into a narrower version of capital account (debt forgiveness) and financial account (sale of financial assets).
- b. But does it balance in practice? It does indeed! Note how one account is almost the perfect mirror of the other and the BoP always hovers around zero. (Source: BEA, International Economic Accounts).



- c. In a trade, the domestic country gave up their currency for goods and services. Abroad, this currency can have three different uses:
 - i. Import from the domestic country (NX increases).
 - ii. Invest in the domestic country (CA increases).
 - iii. Circulating it outside the domestic country.
- d. The only reason people would accept currency that's worthless in their country is because they think they can use in the country it is worth something.
 - i. Circulating it outside the domestic country is rare.
- e. The trade deficit is not, *repeat not*, debt. It is merely an arbitrary distinction between the flow of goods and the flow of investment.
- f. This harkens back to the distinction between increasing GDP and increasing wealth. A fall in NX reduces GDP but it doesn't necessary mean people are poorer.