

Class 10

Econ 402

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Class 10 Outline

- Macroeconomic Equilibrium and Predictions
- More on Purchasing Power Parity
- Does the Current Account deficit portend a financial crisis?
- Intertemporal Considerations

CASE STUDY: The Reagan deficits revisited

	1970s	1980s	actual change	closed economy	small open economy
$G - T$	2.2	3.9	↑	↑	↑
S	19.6	17.4	↓	↓	↓
r	1.1	6.3	↑	↑	no change
I	19.9	19.4	↓	↓	no change
NX	-0.3	-2.0	↓	no change	↓
■	115.1	129.4	↑	no change	↑

Big Mac Index (2/1/2007)

	Big Mac Prices				
Country	in local currency	in dollars	Implied PPP FX rate	Actual Dollar FX	Under/Over valuation %
US	\$3.22	3.22			
Argentina	Peso 8.25	2.65	2.56	3.11	-18
Britain	Pound 1.99	3.90	1.62	1.96	21
Canada	C\$ 3.63	3.08	1.13	1.18	-4
Euro Area	Euro 2.94	3.82	1.10	1.30	19
Japan	Yen 280	2.31	87.0	121	-28

Big Mac Index (2/1/2007)

	Big Mac Prices				
Country	in local currency	in dollars	Implied PPP FX rate	Actual Dollar FX	Under/Over valuation %
US	\$3.22	3.22			
Mexico	Peso 29.0	2.66	9.01	10.9	-17
Norway	Kroner 41.5	6.63	12.9	6.26	106
Sri Lanka	Rupee 190	1.75	59.0	109	-46
Switzerland	SFr 6.30	5.05	1.96	1.25	57
Turkey	Lire 4.55	3.22	1.41	1.41	nil

Forecasting

- The Economist claims that the Big Mac Index does a better job forecasting exchange rates than PPP measures based on relative CPIs
- Over what time frame do you expect PPP to hold for US\$ exchange rate with the Euro, Swiss Franc, Sri Lankan Rupee, Canadian dollar?

Estimated Half-Lives of Exchange Rate Deviations from PPP

Country	Half-Life in Years
Canada	13
Japan	4
UK	2

PPP Persistence Puzzle

- Exchange rates too volatile to be driven just by real shocks
- Exchange rates too persistent to be driven by monetary shocks and sticky prices

Estimated Half-Lives of Price Level Deviations from PPP

Country	Half-Life in Years
Canada	<1
Japan	<1
UK	<1

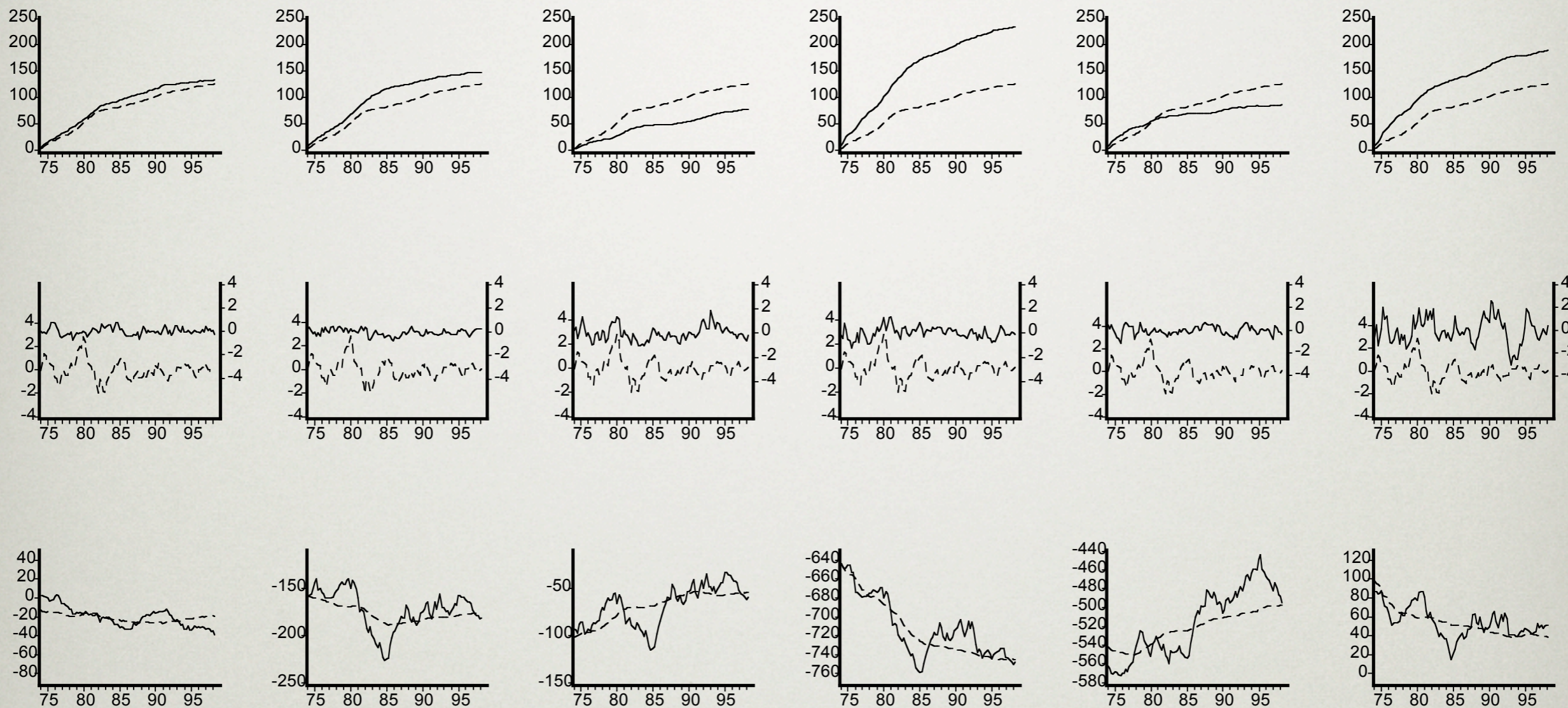


Fig. 2 - Price Components and Exchange Rates for the Seven-Country Model

Dollar Crisis?

- In 2006, the U.S. Trade Deficit is was over 6% of GDP (it was only 4.8% of GDP in 2007)
- What does this imply about national saving and investment?

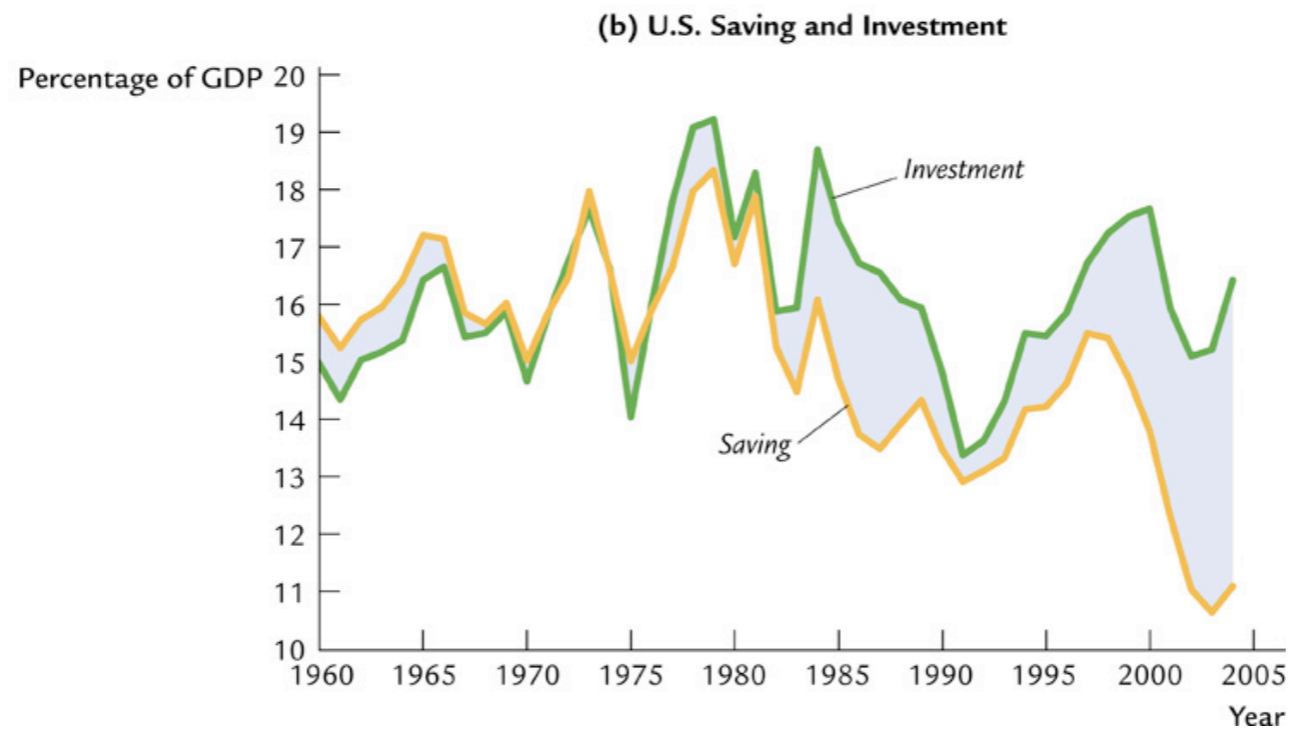
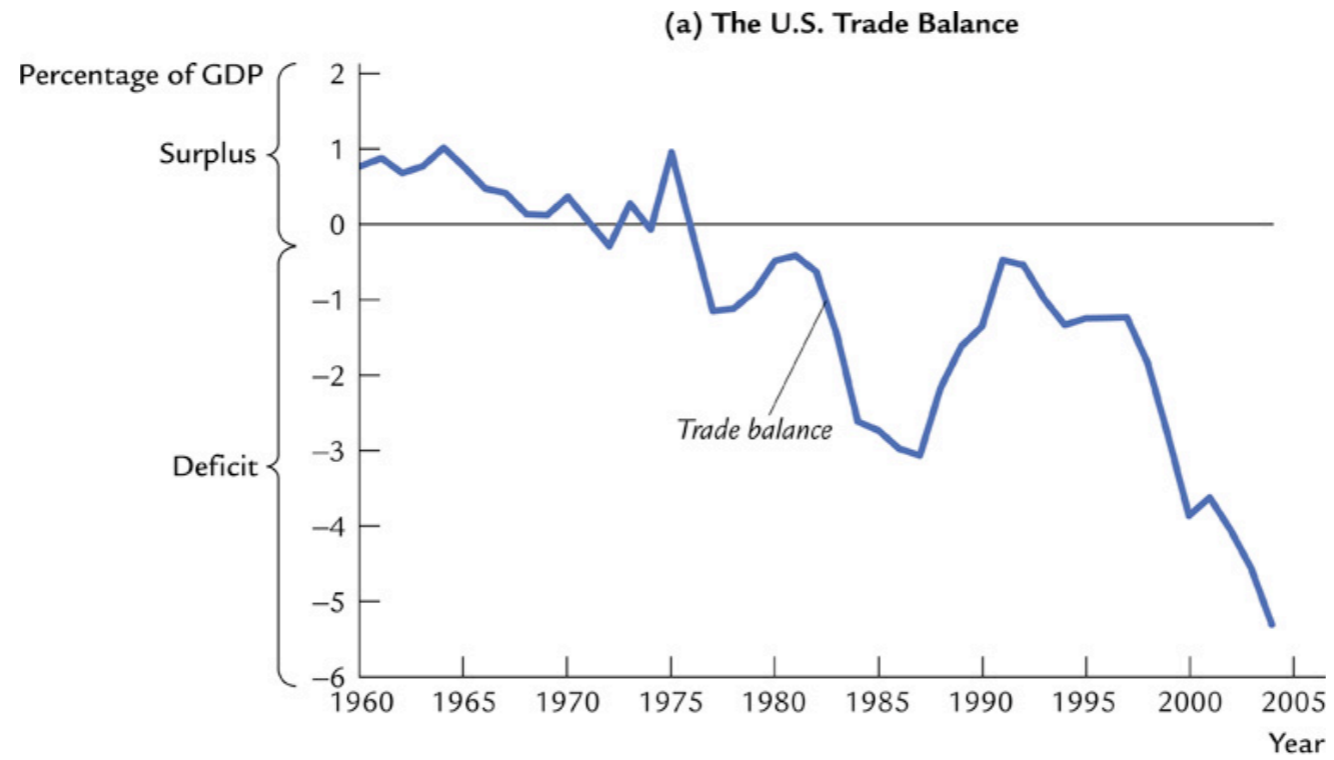


Figure 5.6 The Trade Balance, Saving, and Investment: The U.S. Experience
 Mankiw: Macroeconomics, Sixth Edition
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- Who is lending to the US?
- What would need to happen to NX and the dollar if they stop lending?
- How might the change in NX come about?

- Suppose the government wants to avoid the decrease in investment, but it wants to maintain the same level of spending.
- What would it need to do to allow $NX=0$ without investment falling?
- What would happen to consumption?

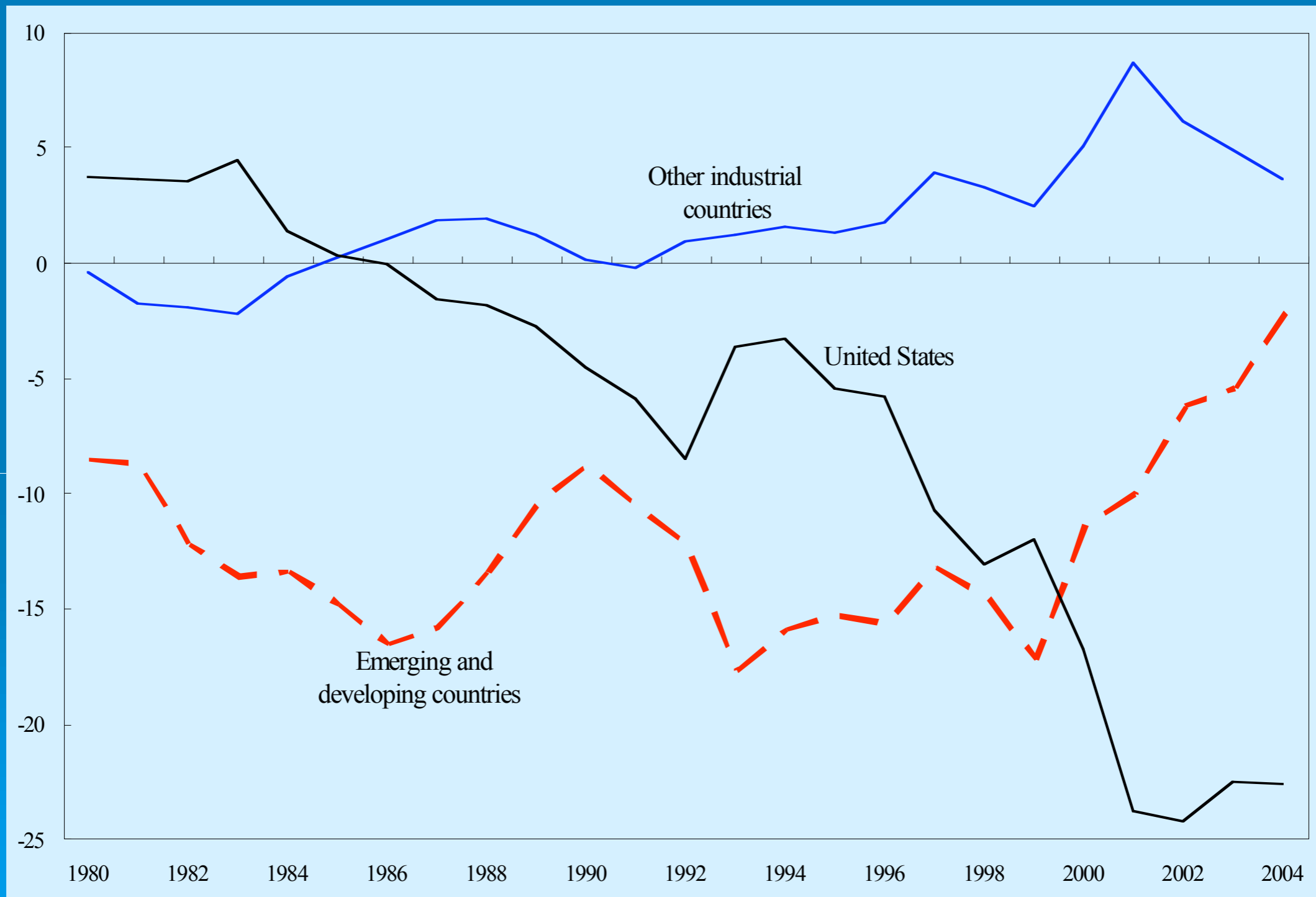
Intertemporal Considerations

- Modern macroeconomics assumes intertemporal considerations are important
- Extend consumption function (Ch. 16)
- Two-period model

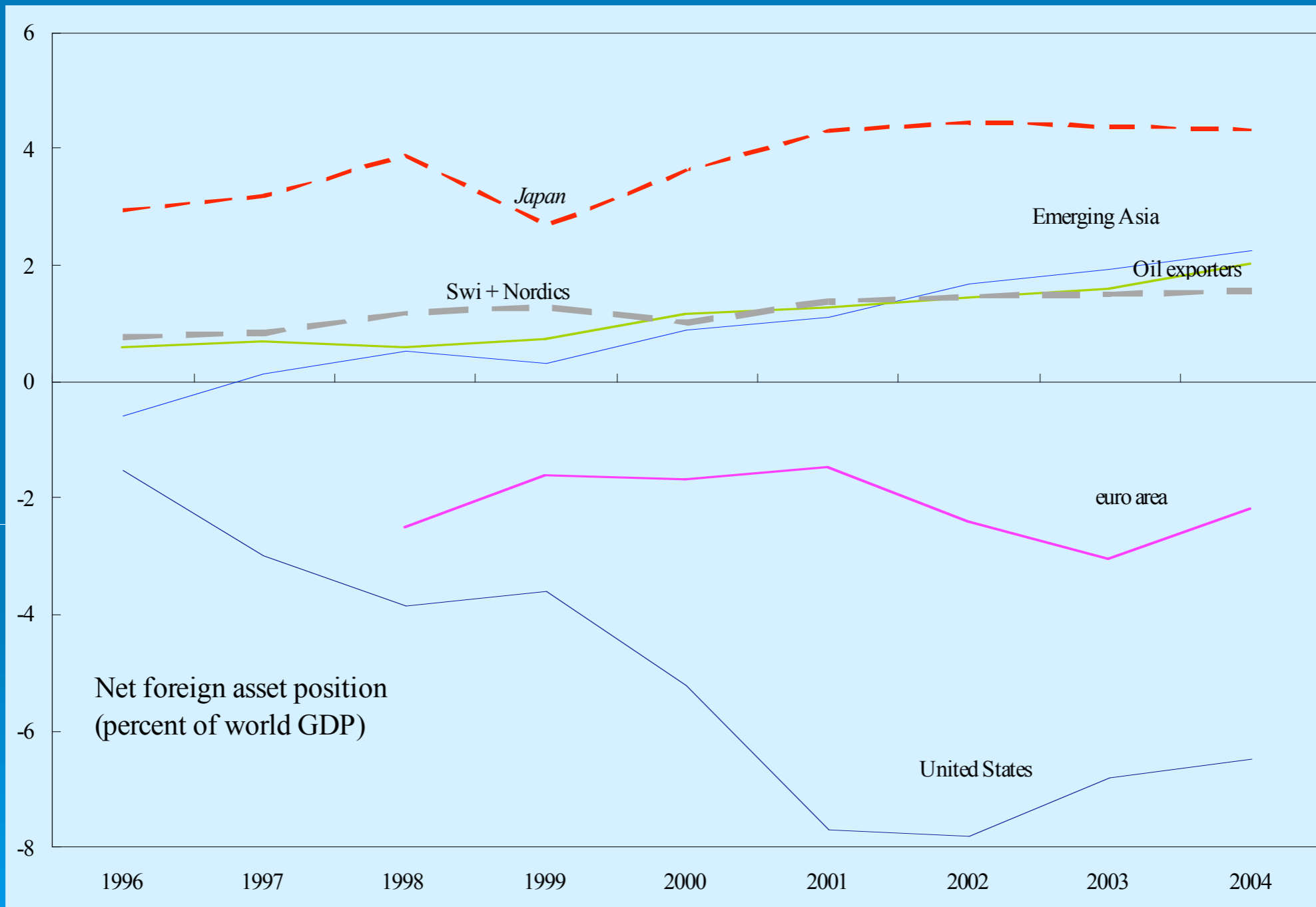
Two-Period Model

- Private Saving in period 1 = $Y_1 - C_1 - T_1$
- $\Rightarrow C_2 = (1+r)(Y_1 - C_1 - T_1) + Y_2 - T_2$
- That is, $C = C(Y - T, \text{Wealth})$

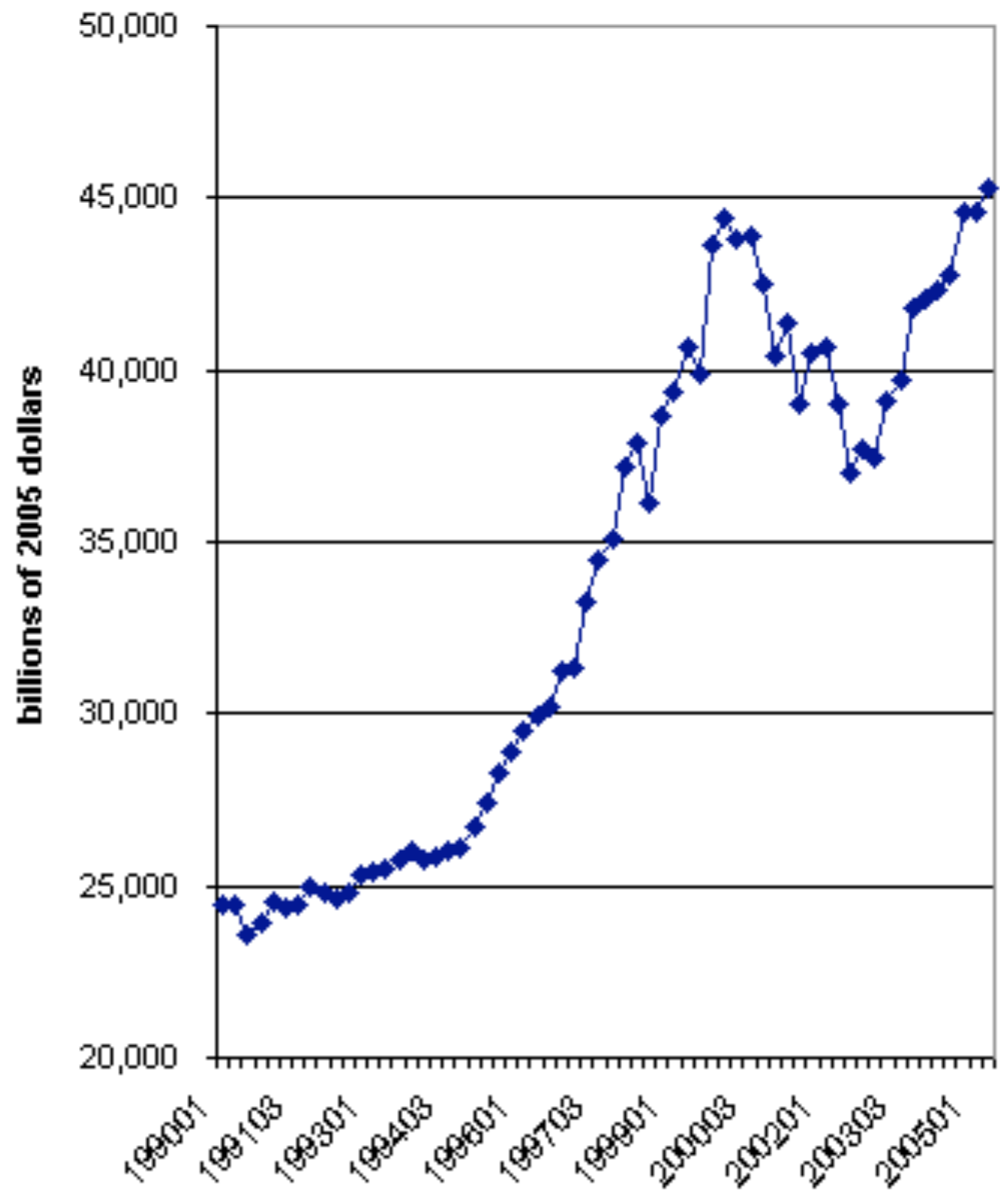
Net foreign assets, broad country groups (pct of GDP)



NFA (pct of world GDP)



Real Net Household Wealth



Open Question

- It is an open question whether capital flows or the stock of wealth matters more
- Historically, both have mattered

• Next time: Unemployment (Chapter 6 of Mankiw)