

8 Openness in the goods + financial markets

Openness in the Goods market

- ability of consumers + firms to choose between domestic + foreign goods
- different ways to measure
- most popular is to express imports + exports as a % of the GDP
- Data indicates South African economy is an open economy

Choice between domestic + foreign goods

- goods market is open → consumers have a choice between buying domestically produced goods or foreign goods
- important factor is the exchange rate.
- distinction is made between nominal exchange rate + the real exchange rate

Nominal exchange rate. (E)

- E = price of the domestic currency in terms of foreign currency.
- means Rand (domestic currency) is expressed in terms of dollars, pounds, euro's etc.
- $R1 = \$0.20$ means a Rand is \$0.20 dollars.
- if the nominal exchange rate is defined as a price of foreign currency (dollars) the exchange rate is $\$1 = R5$

- Appreciation in the nominal exchange rate takes place when the price of the domestic currency increases (Rand value is stronger)

→ eg. increased to $\text{R}1 = \$0.25$ means the nominal exchange rate E is worth more than before

→ Domestic currency in this case the Rand appreciated

→ now expressing nominal exchange rate in terms of the dollars
 $\$1 = \text{R}4$. (less Rand is needed to buy a dollar)

→ $E \uparrow$ = domestic currency appreciated

$E \downarrow$ = domestic currency depreciated

Depreciation when the rand value depreciates → more rand is needed to buy a dollar eg: $\text{R}1 = \$0.15$

→ $\$1 = \text{R}6.66$

appreciation - flexible exchange system / revaluation → fixed exchange system

depreciation - flexible exchange system / devaluation → Fixed exchange system.

↑ nominal exchange rate = domestic currency ↑

↑ nominal interest rate = domestic currency appreciated

From nominal exchange rate (E) to the real exchange rate (ϵ)

→ nominal exchange rate = how many dollars we get for a Rand

→ real exchange rate → what happens to the relative price of domestic goods in terms of foreign goods.

→ gives some indication of the affordability of domestic goods compared with foreign goods.

→ increase in the relative price of South African goods (EP) compared with American goods (P^*) increases the real exchange rate.

$$EP \uparrow > P^* \Rightarrow \varepsilon \uparrow = \text{real appreciation.}$$

→ decrease in the relative price of South African goods (EP) compared with American goods (P^*) decreases the real exchange rate.

$$EP \downarrow < P^* \rightarrow \varepsilon \downarrow = \text{real depreciation}$$

→ Real exchange rate is an index number + the value is not important but the trend (what happens to the value) over time.

$$\varepsilon = \frac{EP}{P^*}$$

ε = real exchange rate

E = nominal exchange rate.

P^* = price of foreign product

P = price of SA goods in Rand.

→ increase in P^* + increase in P is the same + the Rand appreciates against the \$ → nominal exchange rate E is higher. → real exchange rate increases + a

- real appreciation takes place
- American Goods are cheaper than before the change in nominal int. rate
 - increase in P^* + P is the same + the Rand depreciates against the dollar, nominal exchange rate E is lower
real exchange rate decreases + a real depreciation takes place
 - American goods are more expensive than before the change in the nominal exchange rate.
 - Nominal exchange rate → same → increase in P^* is greater than increase in P . → real exchange rate decreases + a real depreciation takes place. → American goods more expensive
 - Nominal exchange rate unchanged. → increase in P^* is smaller than P → real exchange rate increases → real appreciation takes place + American goods are relatively cheaper than before.

Bilateral → multilateral exchange rates

→ trade more than one country → average price of SA goods against foreign goods

$\varepsilon \downarrow =$ real depreciation

$\varepsilon \uparrow =$ real appreciation.

closed economy \rightarrow save or buy

open economy \rightarrow save or buy domestic or foreign

E = price of domestic currency in terms of foreign
currency $\&$ $R = \$$

Real appreciation \Rightarrow increase in price of domestic goods
in terms of foreign goods \Rightarrow increase real exchange rate

Real depreciation \Rightarrow decrease in the price of the
domestic goods in terms of foreign goods \rightarrow decrease
real exchange rate

Openness in the Financial Markets

\rightarrow ability of financial investors to choose between
domestic financial assets + foreign financial assets

South African balance of payments.

\rightarrow balance of pmts \rightarrow systematically statistical account
of all the economic transactions between the residents
of one country + the residents of other countries
in a specific period.

\rightarrow 4 basic accounts

① \rightarrow current account

② \rightarrow capital transfer account

③ \rightarrow financial account

④ \rightarrow unrecorded transactions

→ balancing item in the balance of payment (in principle) is the change in the country's gold and other foreign reserves.

① Current Account

→ Merchandise exports + imports comprise the real value of the trade in all physical goods, which consists of raw materials, capital goods, intermediate + final goods.

→ importance of gold shown in a separate category:

→ net gold exports represent → net foreign gold sale plus the \pm change in the gold holdings of the SA reserve bank, other banking institutions + gold mines

→ dif between merchandise exports (incl. net gold exports) and merchandise imports is referred to as the TRADE BALANCE

→ if negative → imports exceeded exports.

→ Service receipts + pmts for services include the transport of goods + passengers between countries, travel, construction + technical services (incl. money spent by tourists in SA → receipts) TRAVEL to other countries → service

→ Income → income earned by SA residents in the rest of the world

Income, pmts → income earned by non residents in SA.

↳ wages of non-residents (wages, salaries, benefits)

↳ investment income (div., profits etc)

→ current transfers → social security contribution, benefits, taxes, gifts, personal, immigrant + other remittances + charitable donations.

→ current account surplus → country earns more on exports than it spends on imports

→ current account deficit → country spends more on imports than it earns on exports

→ can have trade deficit + current acc surplus or trade surplus CA -

② Financial account

* Financial account → international transactions in assets, liabilities 3 main components

→ direct investment

→ portfolio investment

→ other investment

Direct investment → all transactions where the purpose of the investor is to gain control or have meaningful say in the management of the enterprise in which the investment is made (new + existing businesses)

Portfolio investment — purchase of assets such as shares, bonds → investor is interested in the financial return on the investment

Other investment → residual category which includes all financial transactions not included under direct

investments or portfolio investments like loans, currency + deposits. → Important trade category is short term trade credit → used to finance imports + exports

→ all shown as net valued (all debts have been deducted - from the credit (inflows))

→ balance on the financial account → adding these investment accounts together.

→ financial account surplus → inflow of investment excess ~~at~~ outflow of investment.

→ financial account deficit → outflow of investment to the rest of the world exceeds → inflow of investment

④ Unrecorded Transactions

→ errors + omissions → double entry accounting system debits + credits should equal → diff ⇒ unrecorded transactions.

→ net sum of debits + credits should equal the change in the country's net gold + other foreign reserves.

→ unrecorded transactions makes sure the account balances

→ country earns foreign currency by exporting goods + services + by receiving transfers + inflows from the financial account (capital inflows)

→ pay foreign currency for imports, services, transfers +

outflows from the financial account (capital)

→ current account, capital transfer account, financial A/C balance + unrecorded transactions = change in foreign reserves.

→ change in net gold + other foreign reserves → combined balance on the current, capital transfer + financial accounts + the unrecorded transactions → change is described as "owing to the balance of payments transactions"

→ supplement reserves by borrowing → increases reserves → increase only a gross change since loan must be repaid → when loan is repaid → gross reserves decline accordingly.

② Capital Account

→ foreign holdings by the USA in the rest of the world

→ foreign holdings by the rest of the world of USA/country assets.

→ foreign holdings of USA Assets increase
LESS

- USA holdings of foreign assets increase.

= Capital account surplus / deficit.

∴ Country that runs a current account deficit must finance

it somehow + does so by positive net capital inflow. \rightarrow must run a capital account surplus.

Statistical discrepancy = diff between current A/C balance + Capital A/C balance

\therefore US-Assets \rightarrow - Foreign Assets by USA = ? surplus/deficit

Choice between Foreign / Domestic Assets.

\rightarrow Interest parity condition implies that the domestic int rate (i) must be (\pm) equal to foreign int rate (i^*) + less the expected appreciation of the domestic currency (E^*)

\rightarrow should not only consider diff in the interest rate, but also take expected changes in the exchange rate into account.

\rightarrow Deciding between bonds

see calculation Study Guide P. 190.

Do Activity 84. \rightarrow

see question 4.

* Interest parity equation

$$(1 + i_t) = (E_t)(1 + i_t^*) \left[\frac{1}{E_{t+1}^e} \right]$$

OR

$$(1 + i_t) = (1 + i_t^*) \left(\frac{E_t}{E_{t+1}^e} \right)$$

Interest Rates + exchange rates.

$$i_t = i_t^* - \frac{E_{t+1}^e - E_t}{E_t}$$

→ domestic int rate must approximately equal the foreign int rate → minus the expected appreciation of the domestic currency.

→ Appreciation / depreciation

$$= \frac{E_{t+1}^e - E_t}{+}$$

if positive appreciation
negative - depreciation

→ if $E_{t+1}^e = E_t$ then $i = i^*$