Week 8

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Suppose you were living in the economy of the figure above and could choose between a real GDP of $900 billion and a price level of 100 and real GDP of $1200 billion and a price level of 110. That is, you would have to choose between moderate unemployment with no inflation and full employment with inflation. Which would you choose?
Recall the Phillips curve?
Understanding Inflation

Inflation redistributes income. Some people win and some people lose from the redistribution.
Inflation

Who loses from Inflation?

Perhaps more than any other group, people living on fixed incomes have reason to worry about inflation. Losers may also include landlords whose incomes are tied to long-term rental leases and workers who accepted union-negotiated, multiyear, fixed-wage contracts.

Why are savers sometimes losers from inflation?
Inflation

Who gains from inflation?
People who borrow money end up winners under inflation if the interest rate a borrower pays on the borrowed funds is less than the rate of inflation.
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Who gains from inflation?
The government, as the largest single borrower, benefits from inflation. Inflation, with time, reduces the real cost to government of carrying the national debt. In addition, inflation may bump more citizens into higher tax brackets, resulting in higher income taxes paid to the government.
Inflation

• Moderating the wins and losses

Inflationary risks are shifted when banks tie mortgage rates to the rate of inflation, union contracts include provisions for a cost-of-living adjustment (COLA) tied to inflation, and when the federal government adjusts income tax brackets based on inflation.
Supply side Economy

• Until know we have discussed about the demand side of Economy (C,I,G). Today we will focus on aggregate supply.

• How can we affect the aggregate supply? Resource, Technology? Harder to change.

• If producers are better off, then they will invest more+pay more wages, which will cause the equilibrium GDP to increase
How can we make producers better off?

- Supply side Economists suggest:
  - Lower tax
  - Less government regulation
  - Less government spending
Lower tax

• Lower tax rate means less revenue for the government? No
• If tax rate is higher, people are less willing to work, the taxable income is less.
• If tax rate is lower, people are more willing to work, the taxable income is more.
• Tax revenue = tax rate * taxable income (tax base)
• Laffer curve !!
Laffer curve
Government regulation

• Regulation is adding an extra cost to the producers
Government spending

• Supply side economists believe that the government’s reliance on its own spending to create employment not only is not a quick fix but a major contributor to the unemployment problem. Why? Crowding-out effect!

• G increases, government budget deficit increases, these deficits are financed by the sale of government securities which raises interest rate, private investment decreases, equilibrium Y decreases
International Trade

• Now we start to assume the economy is open, i.e there are international trades between countries
• Why countries want to trade with others?
• What kind of goods should be imported, and what kind of goods should be exported?
• Who is winning in the international trade, who is losing in the international trade?
Balance of Payment

• Balance of payment account provides a statement of the economy’s financial transactions with the rest of the world.

• Three Major Accounts:
  • a. Current account
  • b. Capital account
  • c. Official Reserves
Current account

• The balance on current account summarizes US. Trade in goods and services, net investment income, and unilateral transfers that occur during the current year.

• Components:
  
  A. Net exports/imports goods & services (Balance of Trade)
  
  B. Net Income (investment income from direct portfolio investment plus employee compensation)
  
  C. Net transfers (sums sent home by migrant abroad)
Capital good account

• These entries refer to the flow of capital into and out of the United States that takes place when people buy and sell real and financial assets across borders.

• Changes in U.S. Assets Abroad: example?

• Changes in foreign Assets in the United States: example?
EXHIBIT 5 THE U.S. BALANCE OF PAYMENTS ACCOUNT: 2007 ($ billions)

<table>
<thead>
<tr>
<th>Current Account</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Merchandise Exports</td>
<td>1,148.5</td>
</tr>
<tr>
<td>2. Merchandise Imports</td>
<td>-1,967.9</td>
</tr>
<tr>
<td>3. Balance of Trade</td>
<td>-819.4</td>
</tr>
<tr>
<td>4. Export of Services</td>
<td>497.3</td>
</tr>
<tr>
<td>5. Import of Services</td>
<td>-378.1</td>
</tr>
<tr>
<td>6. Income Receipts on Investments</td>
<td>817.8</td>
</tr>
<tr>
<td>7. Income Payments on Investments</td>
<td>-726.0</td>
</tr>
<tr>
<td>8. Unilateral Transfers</td>
<td>-112.7</td>
</tr>
<tr>
<td>9. Balance on Current Account</td>
<td>-731.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital Account</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>10. Change in U.S. Assets Abroad</td>
<td>-1,289.9</td>
</tr>
<tr>
<td>11. Change in Foreign Assets in U.S.</td>
<td>2,057.7</td>
</tr>
<tr>
<td>12. Statistical Discrepancy</td>
<td>36.6</td>
</tr>
<tr>
<td>13. Balance on Capital Account</td>
<td>731.2</td>
</tr>
</tbody>
</table>

Official reserves

• If the U.S import more from Japan than the export to Japan, how can we make the difference?
• It records changes in official monetary reserves including gold and foreign exchange reserves
Exchange rate

• Def: Exchange rate specifies how much one currency is worth in term of the other currency

• i.e 1 dollar can exchange with 0.4 U.K pound
• Appreciation: Increase the value of this currency
• Depreciation: Decrease the value of this currency
How to determine the exchange rate?

• Again, it is determined by the demand and supply curve.

• Suppose now more and more people from UK travel to U.S how does the exchange rate changes?
How does the exchange rate affect the international trade?

• Assume U.S and UK are doing international trades: U.S is producing trucks while UK is producing cars

• Suppose now U.S dollar appreciates i.e 1 dollar=0.25 pounds 1 dollar=0.40 pounds

Then how does this affect the international trade?
imports and exports

• U.S import increases while UK exports increases

• U.S export decreases while UK imports decreases