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INTERNAL AND EXTERNAL ECONOMIC BALANCE

The purpose of economics is to increase economic welfare. This lack of clarity makes it difficult to achieve a common vision. That is why economists have identified some intermediate goals. For a long period it is related to of economic growth and distribution of income. In terms of short-term priority is given to achieving a balance in the intraeconomic development what generally implies employment and price stability. These two elements are interrelated, but each has an independent character and one dimension of two extreme forms: high unemployment leads to stopping of the rise of inflation in prices, while full employment on the contrary, increases it. Thus, all of this concerns achieving the intraeconomic balance. In addition, there are other goals as well which refer to the attainment of equilibrium. Unlike the intraeconomic balance, foreign economic balance indirectly affects economic prosperity.

It should be noted, however, that Tools are necessary for the implementation of the policy, without which the goal will not be achieved. Toolkit for evaluating the effectiveness of economic policy should be called forthcoming economic situation in certain circumstances where they will have a different weight and capacity. As an example, we can consider the open economy model, where the local fixed prices and fixed, but the rate of exchange will be developed in accordance with the international foreign exchange markets. In addition, government spending increases, and reducing policy may perform equally. Result in an increase in the level of government expenditure, revenue and employment growth, which is accompanied by a deterioration of the condition - the balance of payments deficit. Devaluation will lead to improvement in the balance of payments and the increase in income and employment levels too. These results are depicted graphically by Alan Winters [1, 1985]. (Chart - 1) as follows:

Chart - 1. Policies for internal and external balance
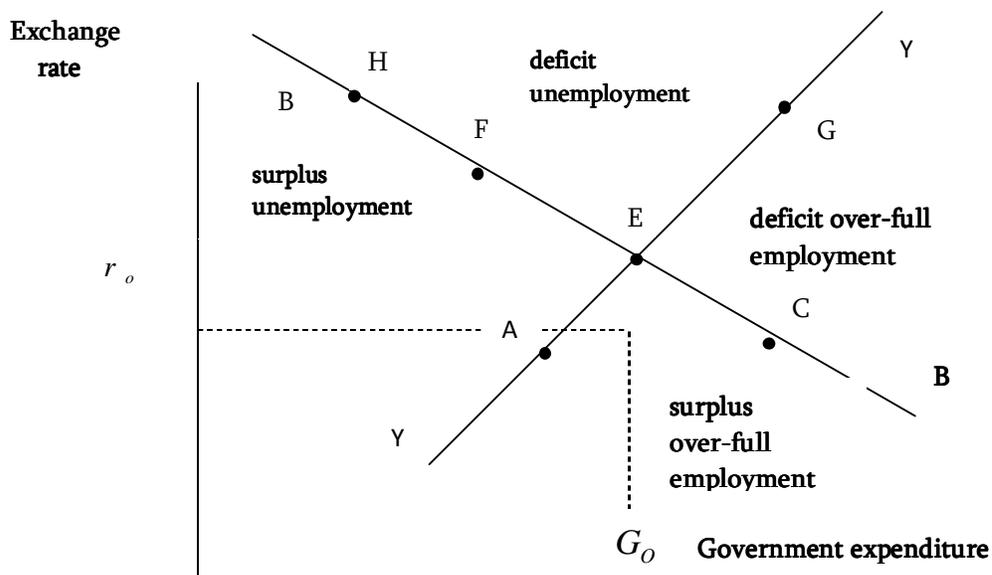
The line YY plots those combinations of government expenditure (G) and the exchange rate (r) thet produce internal equilibrium. Starting from point A on YY, suppose G is increased; this increases employment and to bring it back to equilibrium along YY, a rise in the exchange rate is necessary; hence YY slopes upward. Conversely, BB the locus of points ensuring balance of payments equilibrium, slopes

downwards. Starting from C, an increase in G produces a deficit and this must be counteracted by depreciation to restore balance.

It is plain from Chart 1 that, if YY gives all combinations of G and r for internal equilibrium and BB gives those for external equilibrium, the only policy combination that ensures both is (G_o, r_o), i.e. point E.

Unfortunately, life is not so simple, because the government does not know the precise locations of BB and YY. even so, it can make some progress as follows. BB and YY divide the graph into what Swan, the originator of this analysis, called four zones of "economic unhappiness" [2]. Any point above and to the right of BB involves a balance of payments deficit, while any point below or left of it involves a surplus. Similarly, any point above or left of YY involves unemployment, while any point below or right involves over-full employment. Thus, the schedule revealed four potential areas, which the government already knows how to use the Tools for Economic Policy.

R. A. Mundell [3, 70-79] provides a short-term solution, which brings Tools for monetary and fiscal policies, as well as Emphasis the importance of capital movements. Revenue growth too, the policy of increasing the demand for money, which in turn will provide a good service to fiscal policy. As a rule of fiscal expansion leads to an increase in the interest rate, the monetary expansion, including capital inflows, the balance of the current account deficit. In general, in terms of income, changes in fiscal policy have little impact on the balance of payments, rather than monetary policy.

Domestic economic policy and the exchange rate. Open economy is an important topic for discussion domestic economic policy tools for effective governance. Especially interesting is the impact of international capital flows and flexible exchange rates on monetary and fiscal policy. Closed economy macroeconomic analysis process used in the so-called IS-LM Model, which was first presented in 1937 and the Nobel Prize Laureate economist John Hicks [4] and later found in the R. Stern's [5] and V. Argy's [6] works. This model is also well described by J. Sax and F. Lapen's book "Macroeconomics - a global vision" [7, 396-456].

This model is given in the diagram (chart -2), the curve connects the combination of interest rate and income, in order to protect the goods and services on demand-supply ratio:
$$Y = C + I + G + X - M$$
where Y is income, C consumption, I investment, G government expenditure, X export and M imports.

Chart 2. Equilibrium in the open IS-LM model
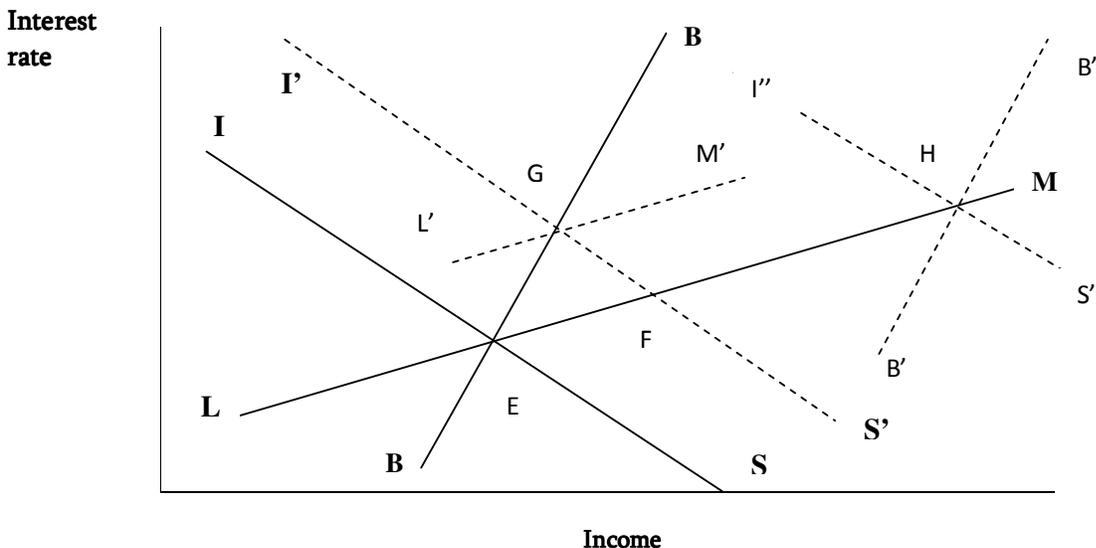
The IS curve slopes downwards because lower interest rates stimulate higher investment and require higher income/output to equate supply and demand. If the exchange rate falls, exports rise and/or imports fall; hence, with constant interest rates, demand rise and the IS curve moves outward. Similarly, expansionary fiscal policy shifts IS outwards.

The LM curve plots combinations of I and Y that ensure equilibrium in the money market. The supply of money is assumed exogenous in nominal terms, but the demand depends on both interest rate and income. Income affects demand positively through the transactions demand: The more income, the more money you can spend. Interest rates have a negative effect by affecting the costs of holding cash: the higher the interest rate, the more the interest forgone by holding money instead of bonds. Hence a higher income must be offset by a higher rate of interest if demand is to equal a given supply and so LM slopes up. Money demand also depends on price. Income and interest rates determine the real demand for cash and this must be multiplied by the price level to find the nominal demand to be equated with the nominal supply. When prices raise, LM shifts up and to the left because, with given nominal supply, real demand must fall if equality is to continue.

The BB plots level of interest rates and income consistent with external balance, recognizing both capital and current accounts. Higher income worsens the current account and so must be offset along BB by a rise in interest rates. The slope of BB depends on the degree of capital mobility, which in turn depends on the degree of substitutability between foreign and domestic assets in desired portfolios and on the extent of transaction costs. If the assets remain the same or a series of transactions prices extremely high and the BB curve is vertical, which means that it depends only on the current account of balance. Thus, given income, is quite independent of the rate of interest. On the other hand, when transaction costs are minimal, BB is horizontal and any deviations between the world and domestic interest rates causes capital to flow or outflow.

The intersection of LM and IS defines internal equilibrium, but we can have full equilibrium only if all three curve intersect at one point. If not, we assume that domestic equilibrium is maintained and that there is balance of payment disequilibrium. Above and left of BB there is a surplus and below and right a deficit. The simplicity of the analysis we assume an expression, because of economic processes requires a comprehensive approach. However, this approach is quite popular in among macro-economists.

The Mundell-Fleming analysis. Fleming [8, 369-379], and then Mundell [9, 475-485] considered the effectiveness of monetary and fiscal policy as controllers of income. They think that monetary policy will be effective only under flexible exchange rates and that fiscal policy was effective only under fixed rates. This is a neo-Keynesian one and the nature of their results is simply explored in the LM-IS framework.

Chart 3. Monetary and fiscal policy with capital mobility
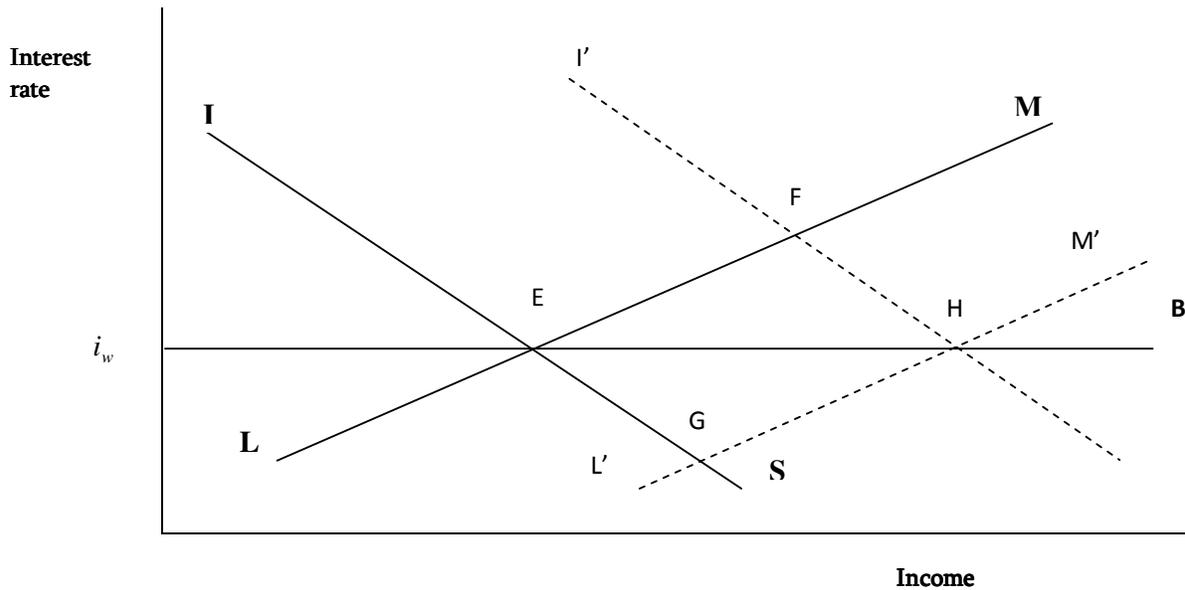
Perfect capital mobility makes the BB horizontal at the ruling world rate of interest. Any other interest rate would lead to an infinite inflow or outflow of capital, preventing equilibrium. Starting from complete equilibrium at E (chart-3.), imagine fiscal expansion, shifting IS to I'S'. The potential domestic equilibrium would be at F, with a higher interest rate and income. High interest rates will cause a huge amount of capital inflows (Balance of payments surplus), which in turn will expand the money supply and push out the LM curve. Only when LM had reached the L'M ' would equilibrium be re-established in all three markets. At the new equilibrium, incomes would have risen and the balance of payments would show a current account deficit, which is financed by a capital account surplus. Higher income generates higher imports, which shall be reimbursed at the cost of borrowed capital.

In the case of monetary expansion LM shifts out to L'M', implying domestic equilibrium G. This entails a large foreign deficit (capital flowing out because of the fall in interest rates) and this serves to drag L'M' back. Only when it has reached LM again does the process stop. Thus, under a fixed exchange rate the government cannot control the money supply, monetary policy is therefore vain and useless.

Turning to flexible exchange rates and start again from E and let fiscal policy shift IS to I'S'. Again we have a potential domestic equilibrium at F, but now the capital inflow appreciates the currency and brings I'S' back towards IS as exports fall and imports rise. The final equilibrium is reached again, the point E, where the balance of payments current account deficit is balanced capital account surplus. On the other hand, monetary policy is very effective and necessary for the same reason. Expanding the money supply to shift LM to L'M' produces payments deficit and depression. This shifts IS out to I'S' and produces equilibrium at H, where income has risen and a current surplus is balanced by capital deficit. hence, shifting from fixed to flexible exchange rates completely reverse the comparative advantages of monetary and fiscal policy. Under fixed rates government is pursuing a monetary policy, but under flexible rates we still find some use of fiscal policy.

Rational Expectations. Mundell - Fleming analysis assumes that people will never expect any changes in the currency exchange rate from its present position. Under fixed-rate system this may be reasonable, but not under flexible rates. Anticipated changes in the exchange rate alter the relationship between the

domestic and the foreign rates of interest. If appreciation is expected, the domestic interest rate will have to fall below the world rate if capital flows are to be avoided.

Expectations can be formulated as a model, which includes wealth and price effects of exchange rate formation. Under flexible exchange rates, but without expectation monetary policy shifts the economy from E to H.

Chart 4. Monetary policy with flexible rates and rational expectation

Interest rate

i_w

i_{w-r}

I′   I   M   M′   E   H   B   L   I″   M″   J   B'   L′   S   L″   S″   S′

Income
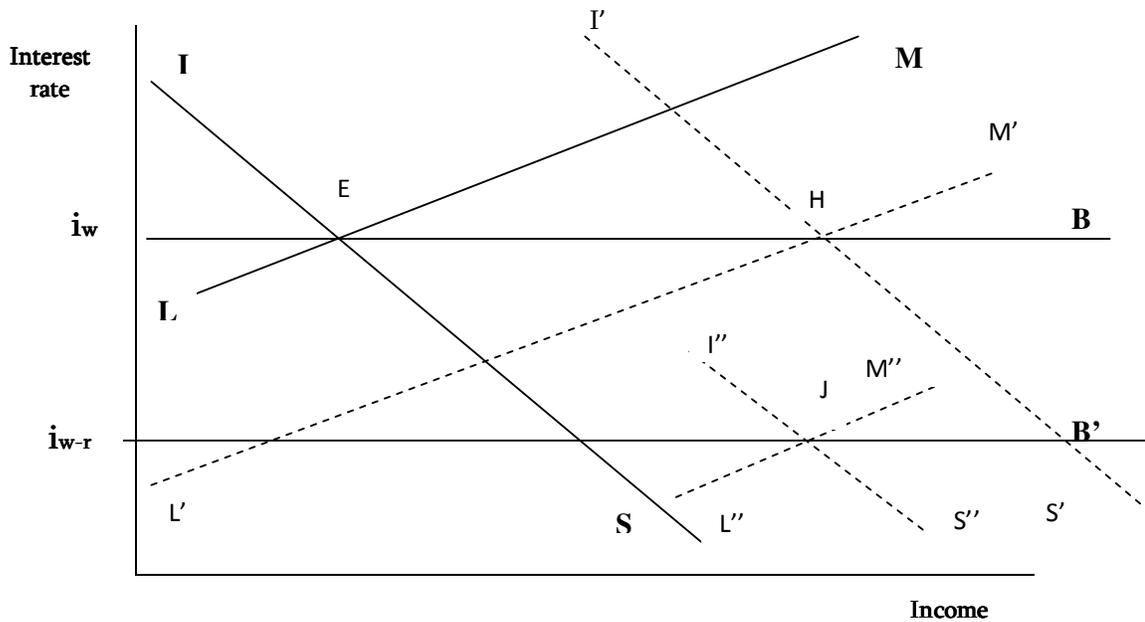
At the H the exchange rate has depreciated and there is a current account surplus. Over time, these conditions can raise the level of the exchange rate, which will restore the old balance. Assume that it is known in advance and expected increases future prices of national currency. People will start to buy domestic currency to avoid losses and earnings, so H cannot be considered even a temporary equilibrium. Indeed, until the economy reaches the H point, people would have started buying in anticipation, with the result that, under rational expectations, the ex mood changes, change rate will not fall as far as without expectations.

The anticipation appreciation (r) also has another effect. By raising return on domestic bonds it reduces the domestic rate of interest consistent with capital equilibrium from i_w to (i_{w-r}). This fall below the external balance curve B to B' curve. For equilibrium under rational expectations, I"S" and L"M" must intersect at this lower rate of interest at J. Later, in the absence of information, we cannot change the place of J exactly. It depends on the expected rapid price rise, thus it depends on whether the expected diminish the causes of the decline. As before, the wealth effect on the economy gradually returns back from the J point. As the price increases will have less of an expectation that B 'is gradually returned to the B-century. This also means that the interest rate should be increased and become equal to the world level.

Assets and the exchange rate. If in the past we have considered the impact of the goods and money on the formation of foreign exchange rate. We must also take into account the impact of the assets on the formation of exchange rate. Assets as the wealth of the local currency, as well as Treasury bonds , which is released by the local government or received from abroad. Savings in the three types of wealth (goods, money, treasury bonds) depends on two factors: The profit rate of return and risk factors. Usually it is possible to reduce the risk through a diversified portfolio. Concentration of one type of asset can get more profit, but such a choice may be wrong, in anticipation of the big losses. Therefore, the reduction of the risk factors reducing the rate of return on profit. The placement of the various types of assets in wealth, overcome by creating a diversified portfolio. Convert assets into cash without loss or their

liquidity, determines their attractiveness. The risk and rate of return on assets placed in the form of wealth. Some assets may be in luxury goods, whose share of the portfolio increases with the increase in wealth. On the other hand, if the wealth is growing, we want to transform there in assets. Increasing attractiveness of assets at the present time, it generates demand in the future. Third, wealth is experiencing revaluation as well: When depression occurs, it immediately leads to an increase in the value of foreign assets in local markets. Fourth, if the wealth is flowing from one country to another, and these countries have different requirements for assets, then the demand is change for different assets. We take the total wealth, the profit rate of return and risk rate, residents are investing money in various types of assets and create an investment portfolio. Thus, we can estimate the demand for assets. Exchange rate is involved in some form of shares trading. First of all, assets portfolio optimization may require changes in the current account, and this is usually achieved by changes in an exchange rate. For example, we know that foreign investment and the current account surplus - is one way to accumulate wealth; if the government does not rule out the actual release additional capital and loan commitments, this will be the only way. If income growth is increase the wealth or stimulating demand for foreign assets, it may be noted devaluation of the exchange rate and has helped us achieve current account surplus. On the other hand, the high value of foreign assets means more profits abroad. After accumulation of funds, the necessity of achieving a positive balance of foreign trade to be raised in order to balance the current account, which means the exchange rate increases. Expected changes in the exchange rate will also increase the return, so it will have an impact on asset markets. On their side, the balance of the stock market will have an impact on the current exchange rate.

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