6
Introducing the Open Economy

6.1 A coherent framework

This chapter extends the closed economy framework developed in previous chapters to describe two economies which trade merchandise with one another. Our methodology differs from the usual textbook approach, according to which models of individual closed economies are eventually ‘opened’, but which give no consideration to what other countries must be held to be doing and how a full set of interactions between all countries might be characterized. The excuse is that the open economy under study is presumed to be small compared to the rest of the world, so that the feedback effects can be assumed to negligible. But then not much can be said about the US economy, the size of which surely guarantees large feedback effects on the rest of the world, nor about the European community or the block of Asian countries including Japan. This partial equilibrium approach is the more surprising because international trade theory is usually treated within a relatively sophisticated two-country and two-good framework. We shall discuss open economy macro-economics using models of an economic system which, taken as a whole, is closed, with all flows and all stocks fully accounted for wherever they arise.¹

One devastating feature of one-country-open-macro is that in the array of asset demand functions, which will be developed later in this book, the demand for overseas assets must be treated net; yet net overseas assets may move from positive to negative, making it impossible to construct a sensible array of asset demand functions. What is required, here again, is a

¹ This method is put forward in particular in Godley (1999b). It was first adumbrated in Tobin and De Macedo (1980), and later developed in Allen and Kenen (1980), Kenen (1985), and Branson and Henderson (1985), although all of this work, in our view, falls short of solving a dynamic model which evolves through time with multiple feedbacks.
systemic approach, methodologically identical with the closed economy models already presented.\(^2\)

Our open-economy models will evolve organically in stages from model \(PC\) in Chapter 4. We start off with the very same (closed) economy described by model \(PC\), and then imagine how the economies of two component regions, which together make up the total, interact with one another and with the government. This will be Model \(REG\). In subsequent sections we deal with a two-country system, each with its own currency. This will be Model \(OPEN\).

### 6.2 The matrices of a two-region economy

We introduce open-economy macroeconomics by splitting a closed economy into two parts, the ‘North’ and the ‘South’ but retaining a single government, a single fiscal and monetary system and (of course) a single currency. The economy described here is the very same economy as in Model \(PC\); we just disaggregate it into two regions, which will be differentiated by adding the \(S\) superscript sign to symbols describing one (the ‘South’) and \(N\) to describe the other (the ‘North’).

Table 6.1 shows the balance sheet of this two-region economy. Table 6.1 is no different from Table 4.1, except that households have been subdivided into two groups, the households living in the North and those in the South. \(V_g\) represents the net wealth of the federal government and it takes on a negative value, since the government has no asset and only a liability, represented by \(B\). As a consequence \(V_g\) describes total net wealth acquired by the households of both regions.

\(^2\) See also Gray and Gray (1988–89: 241) for the advantages of adopting a flow-of-funds matrix for the world, thus identifying the ‘constraints and interdependencies which must characterize the international financial system’ and transforming ‘balance-of-payments analysis from a partial to a general framework’.