LECTURE TEN - PART SEVEN

The U.S.'s Chronic Trade Deficit

- How does the U.S. maintain a chronic trade deficit under a flexible exchange rate system?
- Shouldn't there be a natural adjustment of the U.S. balance of payments due to market forces?
- After all, U.S. trade deficits should lead to a surplus of dollars in foreign exchange markets and thereby drive down the dollar's value.

The Adjustment Mechanism Hasn't Worked

- This, in turn, should lower the price of the country's exports, increase the price of its imports, and restore balance to U.S. trade flows.
- But such an adjustment process has not worked particularly well in curbing the chronic trade deficits of the United States.
- The question is why, and the answer lies in first understanding the nature of the U.S. trade deficit.

Chronic Budget Deficits

- The first reason for persistent U.S. trade deficits is the large, chronic budget deficits that began in the 1980s.
- The need for the government to finance these budget deficits drove up interest rates, strengthened the dollar, made exports more expensive and imports cheaper, and sent the trade deficit spiraling upward.

A Declining Savings Rate

- A declining savings rate in the U.S. has also been a major contributing factor to the trade deficit problem in this sense.
- As the U.S. savings rate has fallen, the investment rate has remained fairly stable or even increased.
- This has been possible because foreign investment has filled the savings-investment gap.

One Result

- U.S. citizens have been able to save less while consuming more and at least part of that increased consumption has been on imported goods.
- In this sense, the U.S. capital surplus may not only result from the trade deficit but also help cause it.

An Interesting Point

- These causes of the U.S. trade deficit are each driven by U.S. domestic fiscal and monetary policies.
- We must understand how domestic fiscal and monetary policies in a global economy can affect not just the domestic country's trade balance.

Key Point
Domestic fiscal and monetary policies can affect the rates of growth and unemployment in the domestic country's trading partners!

The Punch Line

- Any imbalances in either capital or trade flows in one country will affect all trading partners.
- The U.S. trade deficits and capital surpluses are are global problems as well.
- The best way to understand this important point is to illustrate the transmission mechanisms through which domestic fiscal and monetary policies affect the global economy.

The Multiplier Link

- Suppose that America's GDP falls.
- This might happen as a result of contractionary fiscal policy to slow inflation.
- Alternatively, it may simply be that demand in the private sector is weak.

The Chain of Causality

- Regardless of the reason, the result is the same, and it is illustrated in the chain of causality in this figure:

$$Y_A \downarrow \rightarrow Im_A \downarrow \rightarrow Ex_E \downarrow \rightarrow Y_E \downarrow$$

Key Point
America's contractionary policy can lead to a contraction in other economies like that of Europe!!!!

The Multiplier Link & Global Coordination of Fiscal Policies

- It's increasingly important for countries to coordinate their fiscal policies!
- Example: Suppose that America wants to reduce its trade deficit with Japan.
- One way to do this might be for the U.S. to adopt a more contractionary fiscal policy.
- Such a policy might not be politically acceptable on the home front if the U.S. economy is in recession.

The Multiplier Link

- Alternatively, the U.S. might encourage Japan to adopt a more expansionary fiscal policy.
- This would stimulate Japanese demand for U.S. imports and strengthen the yen relative to the dollar.
- This is the kind of request an American President might make to the Japanese Prime Minister at a bilateral trade summit.

Japan Might Agree

- If Japan is in a recession with low inflation, it might agree to the fiscal expansion.
- However, if Japan is at or near full employment, it may simply refuse any fiscal stimulus for fear of igniting inflation.

Monetary Policy In A Global Economy

- What happens in Europe when America raises its interest rates through contractionary monetary policy?

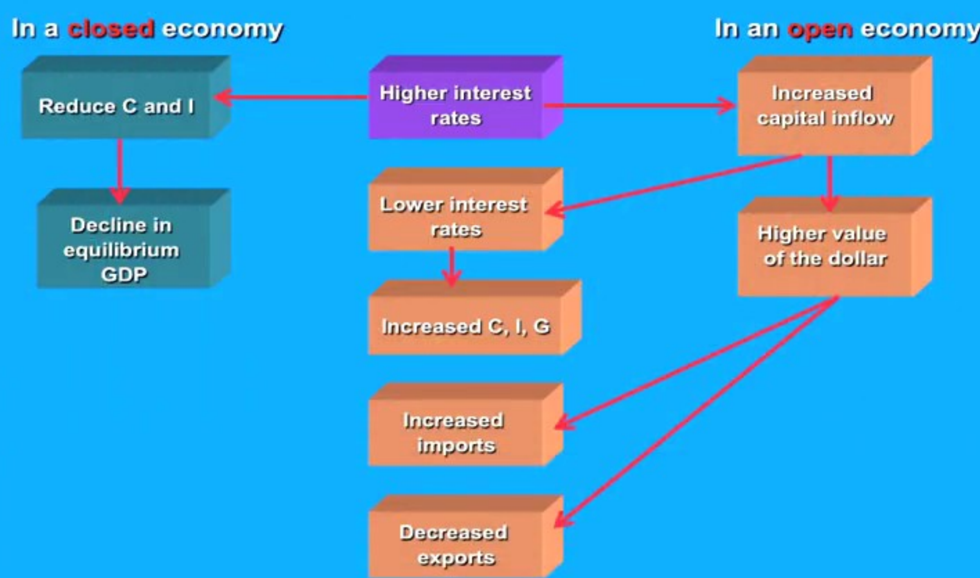
$$r_A \uparrow \rightarrow \begin{cases} e_S \uparrow \rightarrow Ex_E \uparrow \rightarrow Y_E \uparrow \\ r_E \uparrow \rightarrow I_E \downarrow \rightarrow Y_E \downarrow \end{cases}$$

The Monetary Link

Key Point

The overall impact of monetary policy and the monetary link on domestic GDP is ambiguous and will depend on the particular situation.

The Impact Of A Cut In The Money Supply



The Bottom Line

- The net impact of the contractionary monetary policy on domestic GDP is theoretically ambiguous and depends on the individual case.
- This example illustrates the critical importance of globally coordinating fiscal & monetary policy.
- Coming up in Part Eight: A real world example featuring Germany.