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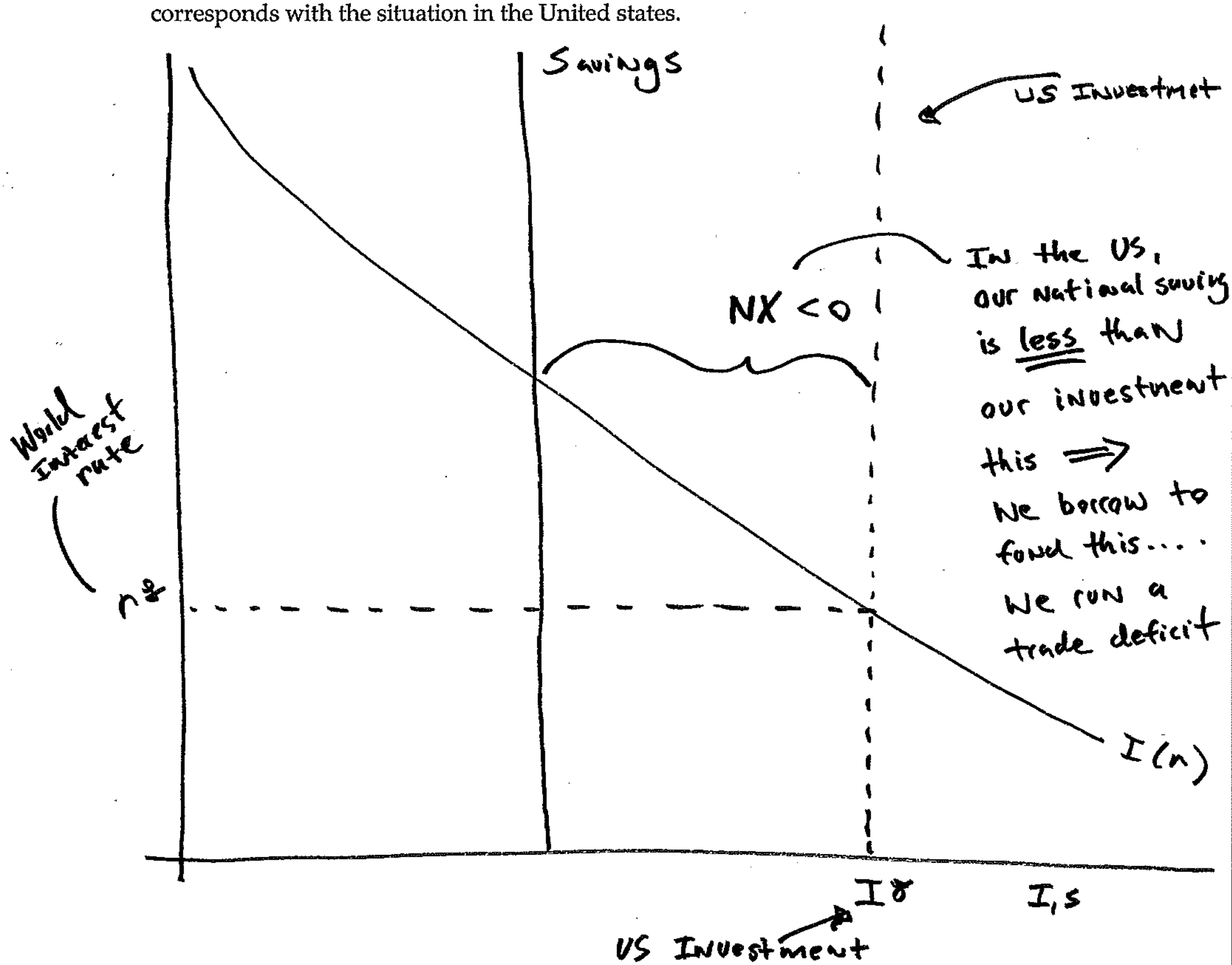
Revisiting Trump's Economic Plan

Recall from Midterm 1: Donald J. Trump's Presidential platform outlines a substantial tax decrease by reducing tax rates for a large majority of Americans. This tax reduction will be off-set by a substantial reduction in government spending. That is Trump's tax plan is deficit neutral.

Let's revisit this plan in the context of the small-open economy model discussed in Chapter 6-1 and 6-2 of Mankiw.

1. First, the United States is currently running a trade deficit, that is net exports are negative. Carefully illustrate savings, investment, net exports, and the world real interest rate that corresponds with the situation in the United states.



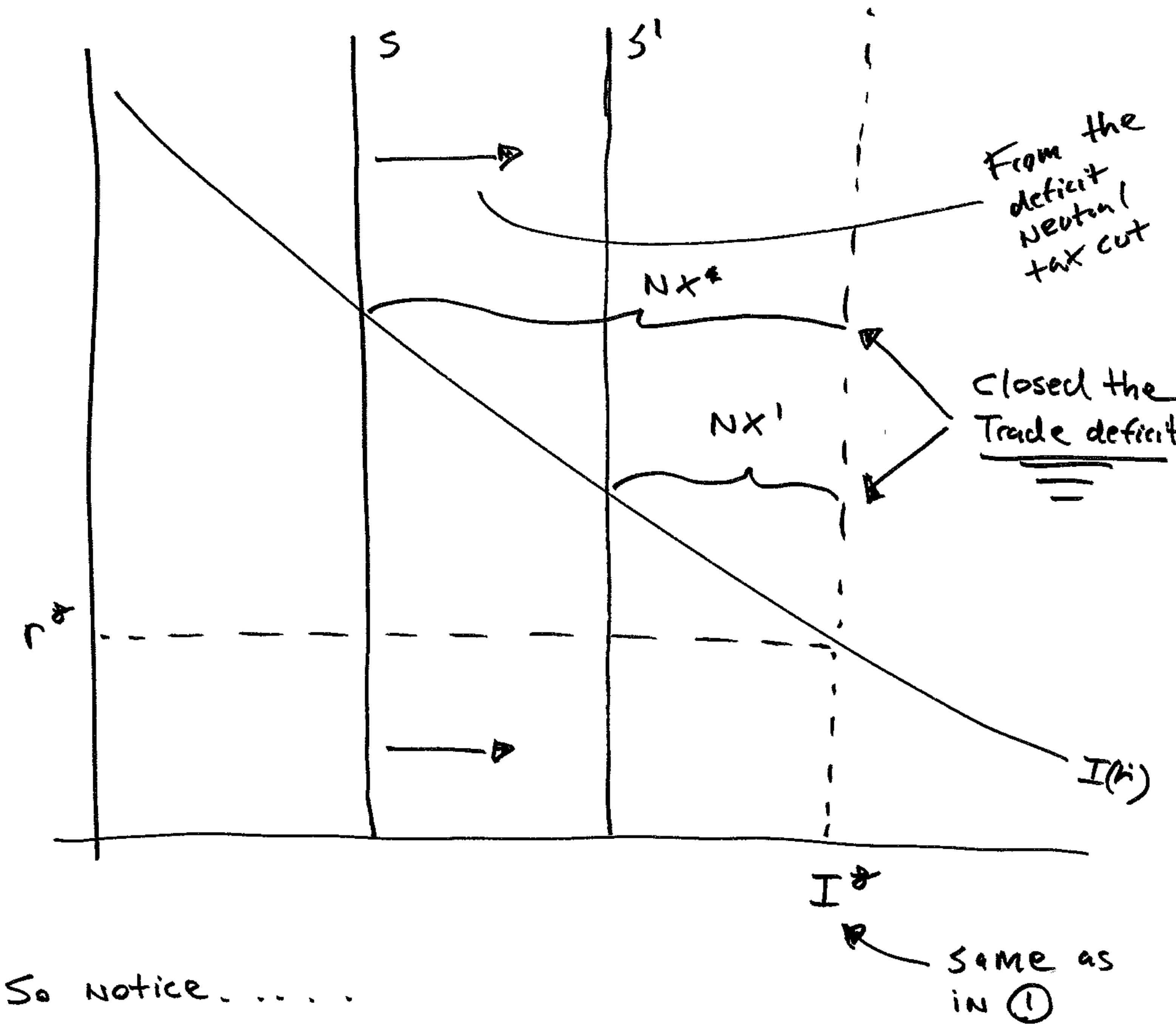
2. Describe how Trump's plan will affect: National savings, investment, net-exports, real GDP, and the real interest rate.

National Savings:

$$S = \underbrace{Y - T - \beta(Y - T)}_{\text{Private Savings}} + \underbrace{T - G}_{\text{Public Savings}}$$

Because Trump's Plan is deficit netural, this has NO affect on Public Savings. But the reduction in tax burden on Consumers leads to an increase in Private savings. This means National Savings $\uparrow$

Now we can use our Open-Economy Loanable Funds Eq. to see what happens for other stuff...



So notice.....

Investment : No Change. Why Investment is pinned down by the world interest rate, i.e. free movement of capital implys that we just invest according to the world rate that we face.

Net Exports: Increase ↑, or trade deficit is reduced....

So recall...

$$S - I = NX$$

And the current US situation is that $S < I$ or $NX < 0$.

So an increase in National savings, <u>closes the gap</u> betwen our domestic ability to finance investment and our investment needs. This implies we will not need to borrow from abroad (or at least as much) and, inturn, this implies our trade defict shrinks.

Real GDP: No change....

$Y = F(K, L)$, K and L are Fixed, thus no change in production no change in GDP.

Real Interest rate r^*: The assumption is we are a small open economy, thus our actions <u>do not</u> affect r.

3. A colleague argues that Trump's economic plan will ``Make America Great Again'' by stimulating investment which leads to capital formation and, thus, raises real GDP in in the future. Is this argument consistent with your analysis in 2. Why or why not?

No its not. The key difference is the closed vs. open economy assumption.

In a closed economy, investment must equal savings. Why? The only way to finance the investments, must come through the savings ~ no other way to do it. Thus, any change in natinal savings has a direct impact on inestment.

In a open economy, this is not the case. Investment is determined by the world interest rate... then if savings are not sufficent, we borrow. If we have to much savings, we lend. Savings is disconnected from Investment, Thus while Trump's plan will affect savings, net exports ... it will not affect investment, future capital, future GDP.