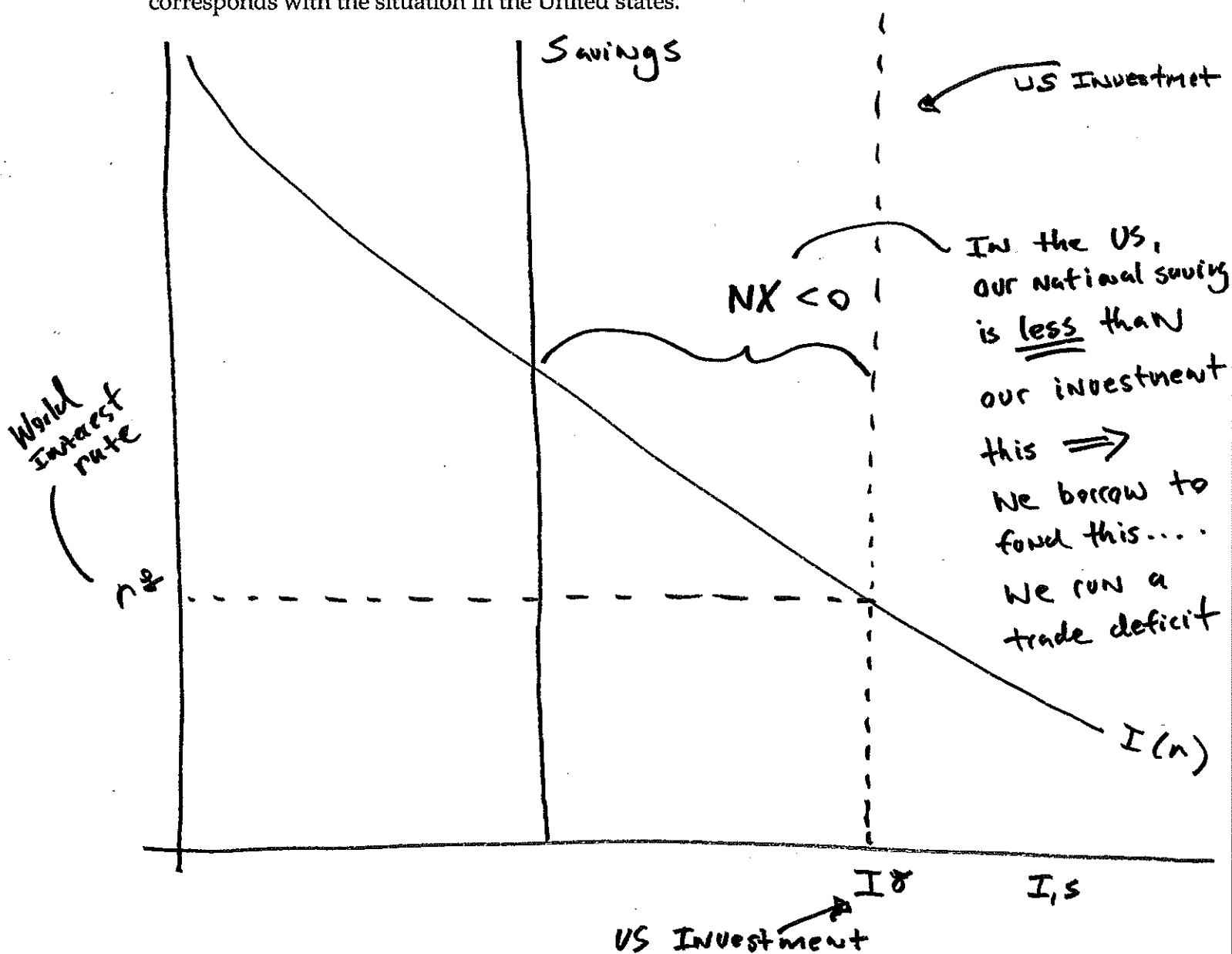


## Revisiting Trump's Economic Plan

**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.



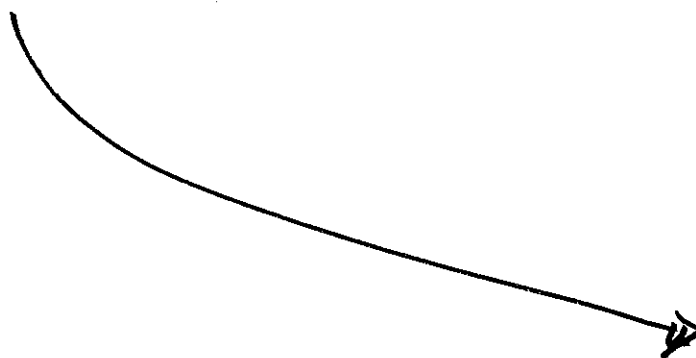
2. Describe how Trump's plan will affect: National savings, investment, net-exports, real GDP, and the real interest rate.

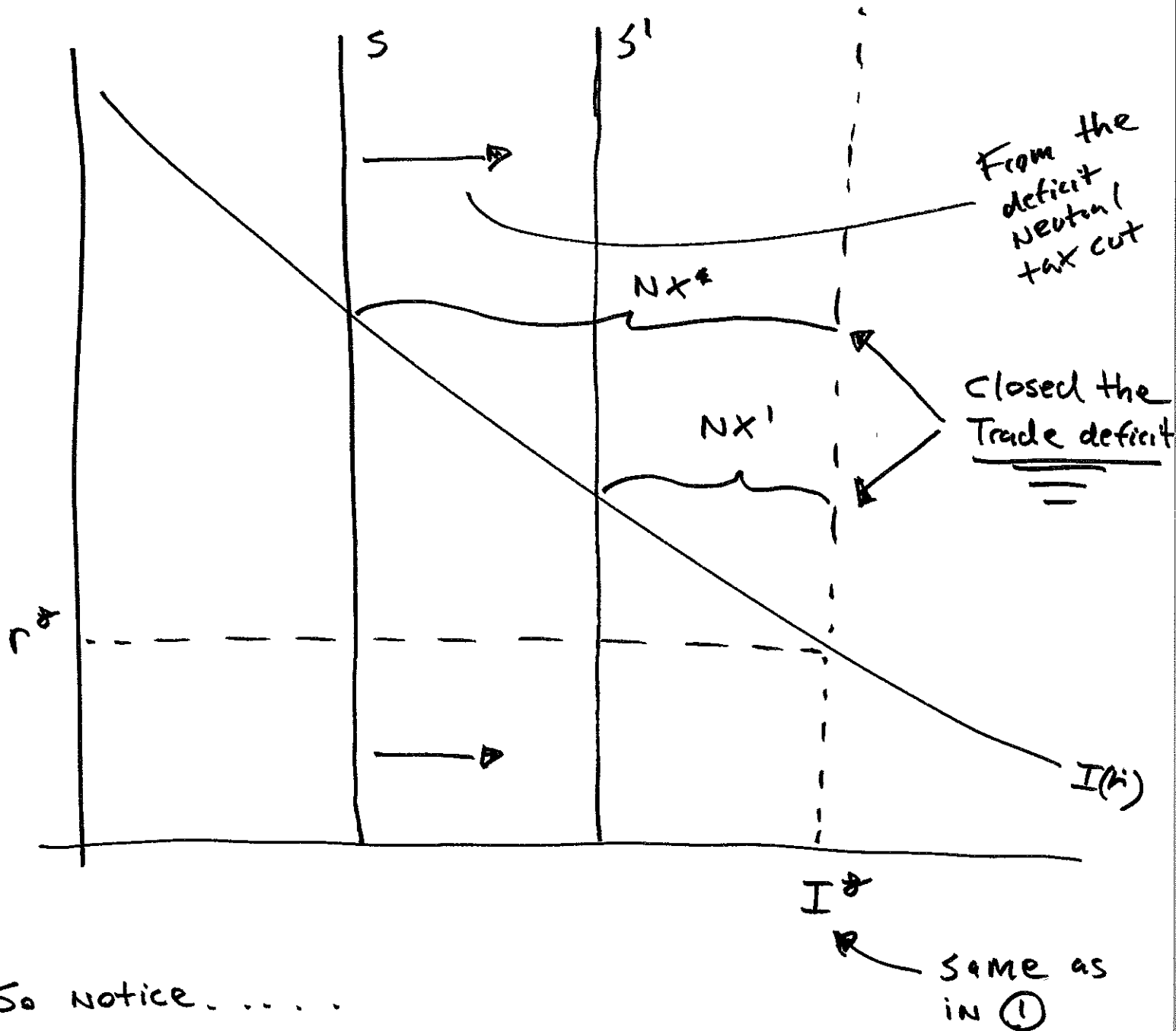
National Savings:

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

Because Trump's Plan is deficit neutral, this has NO effect 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 Eg. 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 implies that we just invest according to the world rate that we face.

Net Exports: Increase  $\uparrow$ , 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 <sup>national</sup> savings, closes the gap between 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, internal, this implies our trade deficit shrinks.

Real GDP: NO change....

$$Y = F(K, L), \text{ K and L are}$$

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 do not 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 the future. Is this argument consistent with your analysis in 2. Why or why not?

No it's 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 national savings has a direct impact on investment.

In a open economy, this is not the case. Investment is determined by the world interest rate... then if savings are not sufficient, we borrow. If we have too 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.