Saving and Investment in the Open Economy, Part 2

Agenda
- Globalization and the U.S. Economy
- Saving and Investment in Large Open Economies (LOE)
- The U.S. Current Account Deficit
- Fiscal Policy and the Current Account
  - The Twin Deficits

Globalization and the U.S. economy
- World’s economies have become increasingly interdependent, with more international trade, finance and investment.

Globalization and the U.S. economy
- Exports and imports have grown significantly as a percent of GDP over the past 50 years and particularly over the last 20 years.
Globalization and the U.S. economy

- U.S. investments abroad and foreigners’ investments in U.S. have also grown significantly as a percent of U.S. GDP over past 20 years.
  - The U.S. is now the world’s largest international debtor.

Globalization and the U.S. economy

- Costs of globalization for the U.S.:
  - U.S. imports increase.
    - This displaces some domestic production and jobs.
    - This increases competitive pressures and reduces profit margins in import-competing sectors.
  - U.S. foreign direct investment might displace domestic investment.
    - If so, this reduces domestic production and jobs.
Globalization and the U.S. economy

• Benefits of globalization for the U.S.:
  - U.S. imports increase.
    • This may mean a wider variety of goods and services.
    • Prices of imported goods and services and prices of goods and services in import-competing sectors decline.
    • Generates production and jobs in import-complementary sectors.

• Benefits of globalization for the U.S.:
  - U.S. exports increase.
    • Domestic production and employment expand in the export and export-complementary sectors.
    • This increases pricing power and profit margins in these sectors.
  - Foreign direct investment in the U.S. increases domestic investment.
    • This increases domestic production and jobs.

Globalization and the U.S. economy

• Recently, big changes in the business services industry.
  - The most visible sub-sector has been call centers.
    • Substantial offshoring has resulted in domestic job losses.
  - However, the U.S. is the world leader in exporting business services.
    • Far more is done in U.S. and sold abroad than vice versa.
  - U.S. benefits more than it "loses" from such activity.

International trade in business services

[Graph showing international trade in business services from 1996 to 2010, with U.S. exports increasing significantly over the period.]
Saving and Investment in LOE

• A large open economy, LOE, is an economy that is large enough to affect the world real interest rate.
  
➢ Suppose there are just 2 economies in the world.
  
  • The home or domestic economy.
    - Saving = S, investment = I.
  
  • The foreign economy, representing the rest of the world.
    - Saving = S_{For}, investment = I_{For}.

Saving and Investment in LOE

• The world real interest rate, \( r^w \), will adjust to equilibrate desired international lending by one country with desired international borrowing by the other.

➢ The equilibrium world real interest rate is determined such that a current account surplus in one country is equal in magnitude to the current account deficit in the other.

Determination of \( r^w \) with two LOEs

• Economic shocks in a LOE:
  
➢ Anything that increases desired national saving, or
  • Output rises, future output falls, G falls, etc.

➢ Anything that increases desired investment.
  • \( MPK^r \) rises, \( \tau \) falls, etc.
An increase in $S^d$ with LOEs

• Economic shocks in a LOE:
  ➢ An increase in desired saving in one LOE will:
    • Reduce that country’s current account balance,
    • Reduce that country’s net foreign lending, and
      – Or increase that country’s net foreign borrowing.
    • Cause the world real interest rate to decline.

An increase in $I^d$ with LOEs

• Economic shocks in a LOE:
  ➢ An increase in desired investment in a LOE will:
    • Increase that country’s current account balance,
    • Increase that country’s net foreign lending, and
      – Or decrease that country’s net foreign borrowing.
    • Cause the world real interest rate to rise.
The U.S. current account deficit

- The current account deficit has deteriorated significantly over the past 20 years.
  - Why has the current account deteriorated so much?
  - Is a huge current account deficit sustainable?
  - If not, what will happen to cause it to adjust?

The U.S. current account deficit

- Why has the U.S. current account deficit deteriorated so much?
  - Weaker growth in foreign demand.
  - Better international investment opportunities.
  - Higher oil prices.
  - Increased saving by developing countries.

The U.S. current account balance

- Lower foreign demand:
  - Economic growth in Japan and Europe has been much weaker than in the U.S. since the early 1990s.
    - People there are saving more, investing in the U.S. more, but buying fewer U.S. goods.
The U.S. current account deficit

• Better international investment opportunities:
  ➢ U.S. investors are diversifying their investments internationally.
  ➢ Foreign investors are investing heavily in the U.S.

Net international ownership of assets

The U.S. current account deficit

• Higher oil prices:
  ➢ U.S. imports much of its oil consumption.
    • Doubling of oil prices recently led to decline in current account balance of over 1% of GDP.

Petroleum net exports
The U.S. current account deficit

- Increased saving by developing countries:
  - Many developing nations changed from being international borrowers to being international lenders.
  - They want to invest in safe places like U.S., rather than borrowing and getting into financial crises.

- Is a huge current account deficit sustainable?
  - Most economist do not think so.

- If not, what will happen to cause it to adjust?
  - A decline in the foreign exchange value of the dollar will increase import prices and decrease export prices.
  - This will lead to lower imports and higher exports and reduce current account deficit.

Fiscal policy and the current account

- Are budget deficits and current account deficits necessarily related?
  - This is the “twin deficits” argument.

- Are budget deficits and current account deficits necessarily related?
  - This depends on the response of national saving.
  - An increase in the government budget deficit raises the current account deficit only if it reduces desired national saving.
Fiscal policy and the current account

• The budget deficit and national saving:
  ➢ A deficit caused by increased government purchases:
    • If Ricardian equivalence holds, $S_d$ won’t change.
      – The budget balance declines but $S_d$ and the current account balance do not change; there are no “twin” deficits.
    • If Ricardian equivalence does not hold, $S_d$ will fall.
      – The budget balance declines, $S_d$ declines, and the current account declines; “twin” deficits exist.

• “Twin deficits” in the U.S.:
  ➢ The deficits appear to be twins in the 1980s and early 1990s, moving closely together.
  ➢ In late 1990s, the U.S. government ran surpluses, while the current account deficit got larger.
  ➢ At other times (during World Wars I and II, and during 1975), government budget deficits also grew while the current account balance increased.
Fiscal policy and the current account

• “Twin deficits” in other countries:
  - In Germany, budget deficits and current account deficits broadly moved together.
  - In Canada and Italy, there were large budget deficits without significant current account deficits in the mid-1980s.