Open Economy

Intermediate Macroeconomics - UCLA - Econ 102

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Section 1

Introduction

Introduction

- Theoretical analysis: I favored the "Keynesian cross" version of Keynesian economics. (as opposed to say, IS-LM, or the Mundell-Fleming model)
- This deck of slides will justify why I teach this particular version of the Keynesian model. I believe that it's what explains the data best.
- It also corresponds much more to Keynes' original ideas I believe.
- Although some implications of this type of thinking are close to mercantilism (e.g. Hobson) - which have been historically opposed to free trade.

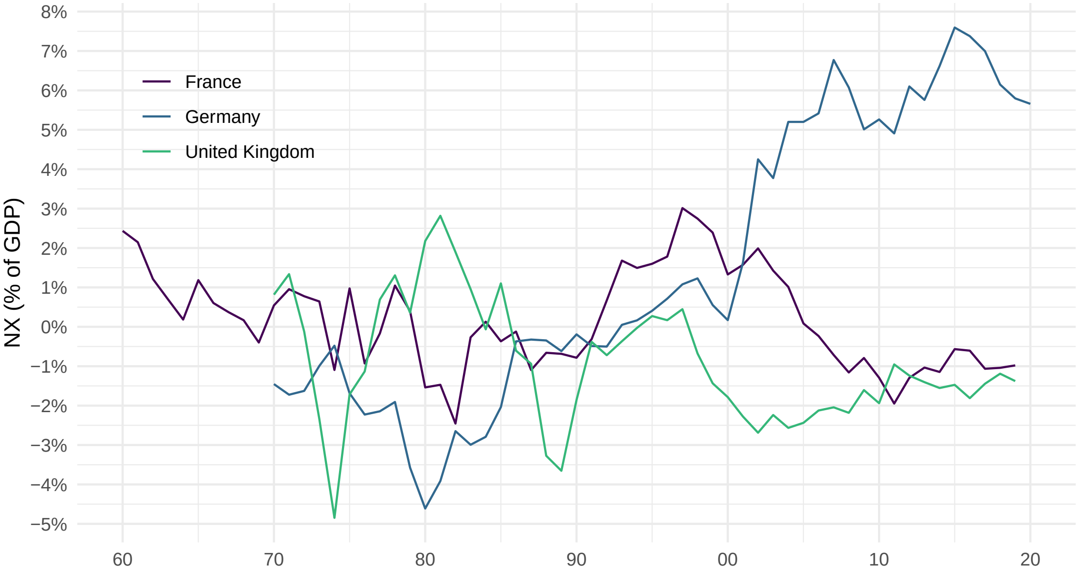
Section 2

Data

Exchange Rates

Location	Year	$1 =	USD	EUR
Argentina	2019	48.148 ARS	$0.021	0.019€
Australia	2019	1.439 AUD	$0.695	0.621€
Austria	2019	0.893 EUR	$1.119	1€
Belgium	2019	0.893 EUR	$1.119	1€
Bulgaria	2019	1.747 BGN	$0.572	0.419€
Brazil	2019	3.927 BRL	$0.255	0.227€
Canada	2019	1.327 CAD	$0.754	0.673€
Switzerland	2019	0.994 CHF	$1.006	0.899€
Chile	2019	702.897 CLP	$0.001	0.001€

Current Accounts



Current Accounts

Current Account ($ Bn)	2007	2010	2013	2016	2019
Euro area	$ 134 Bn	$ 99 Bn	$ 370 Bn	$ 454 Bn	$ 428 Bn
Germany	$ 232 Bn	$ 180 Bn	$ 219 Bn	$ 256 Bn	$ 219 Bn
China	$ 308 Bn	$ 223 Bn	$ 235 Bn	$ 256 Bn	$ 132 Bn
Russian Federation	$ 107 Bn	$ 121 Bn	$ 122 Bn	$ 66 Bn	$ 129 Bn
Singapore	$ 57 Bn	$ 63 Bn	$ 71 Bn	$ 83 Bn	$ 106 Bn
Netherlands	$ 71 Bn	$ 70 Bn	$ 93 Bn	$ 80 Bn	$ 95 Bn
Switzerland	$ 50 Bn	$ 63 Bn	$ 76 Bn	$ 74 Bn	$ 84 Bn
Saudi Arabia	$ 104 Bn	$ 88 Bn	$ 158 Bn	$ 3 Bn	$ 67 Bn
Italy	$ -8 Bn	$ -39 Bn	$ 52 Bn	$ 61 Bn	$ 66 Bn
Korea, Republic of	$ 19 Bn	$ 34 Bn	$ 74 Bn	$ 99 Bn	$ 53 Bn

Net International Investment Positions

Net International Investment Position ($ Bn)	2007	2010	2013	2016	2019
Japan	$ 2195 Bn	$ 3150 Bn	$ 3093 Bn	$ 2879 Bn	$ 3270 Bn
Germany	$ 693 Bn	$ 884 Bn	$ 1344 Bn	$ 1697 Bn	$ 2785 Bn
China	$ 952 Bn	$ 1478 Bn	$ 1818 Bn	$ 1985 Bn	$ 2300 Bn
Hong Kong, China	$ 492 Bn	$ 665 Bn	$ 758 Bn	$ 1154 Bn	$ 1579 Bn
Norway	$ 226 Bn	$ 385 Bn	$ 641 Bn	$ 736 Bn	$ 996 Bn
Netherlands	$ -138 Bn	$ 89 Bn	$ 279 Bn	$ 457 Bn	$ 819 Bn
Singapore	$ 418 Bn	$ 512 Bn	$ 606 Bn	$ 717 Bn	$ 777 Bn
Canada	$ -185 Bn	$ -303 Bn	$ -25 Bn	$ 304 Bn	$ 750 Bn
Saudi Arabia	$ 380 Bn	$ 479 Bn	$ 763 Bn	$ 597 Bn	$ 671 Bn
Switzerland	$ 657 Bn	$ 744 Bn	$ 627 Bn	$ 609 Bn	$ 625 Bn

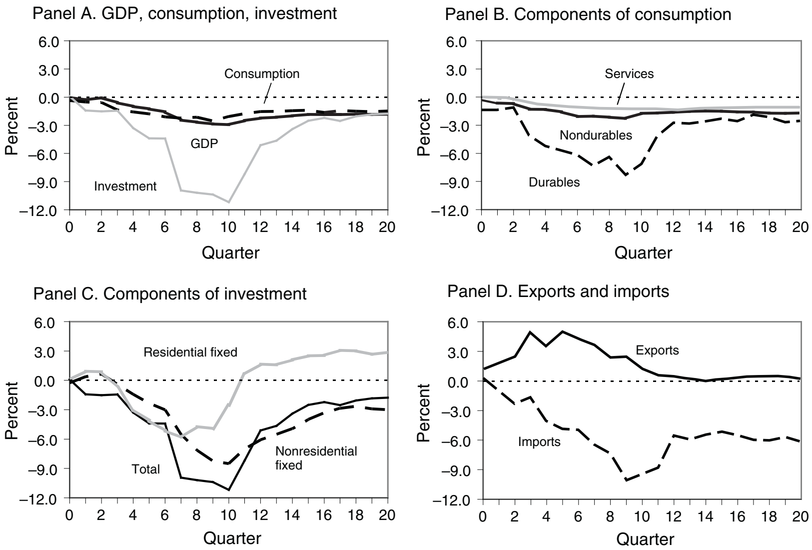
Section 3

Effets of Fiscal Policy on Current Accounts

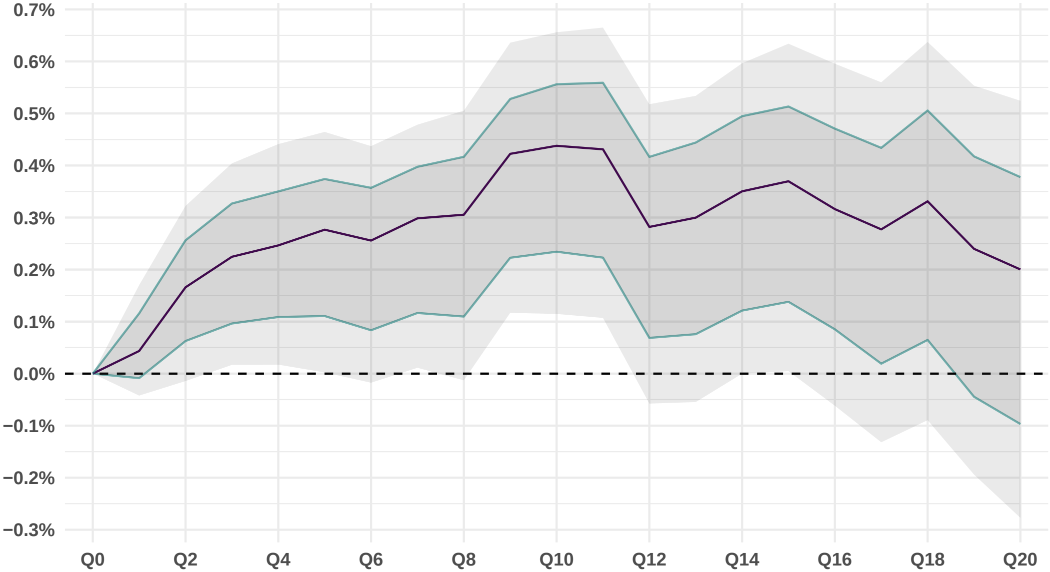
Idea

- An Empirical method is used to isolate "fiscal shocks" using the narrative record.
- I trace out the cumulative response to a 1% of GDP increase in taxes. (so a recessionary shock)
- According to the model we've seen, it should lead to: lower investment, lower consumption, lower imports, and unchanged exports.
- I will show you data coming from multiple different studies: Romer and Romer (2010) on the United States, Cloyne (2013) on the United Kingdom, Guajardo et al. (2014) on a sample of OECD Economies.

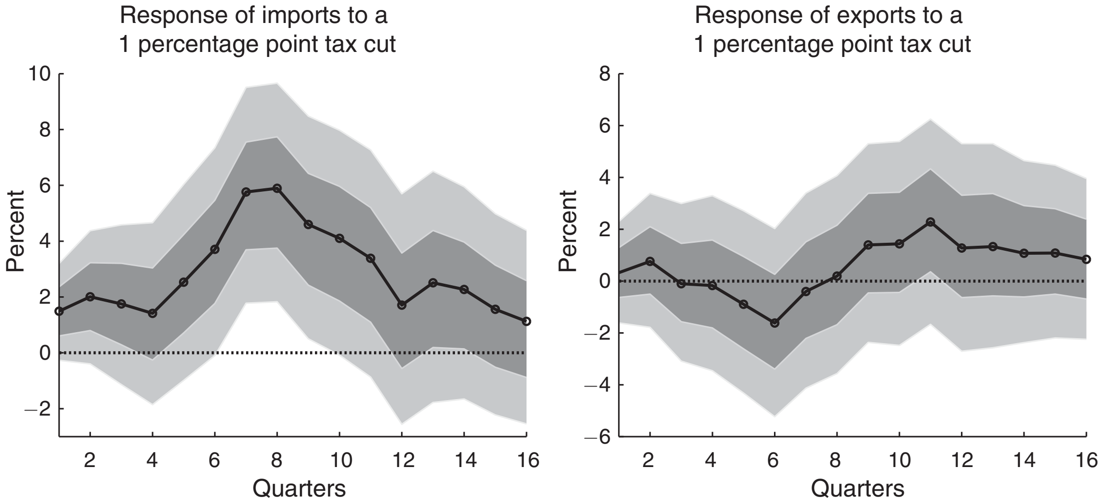
Romer, Romer (2010) - Paper



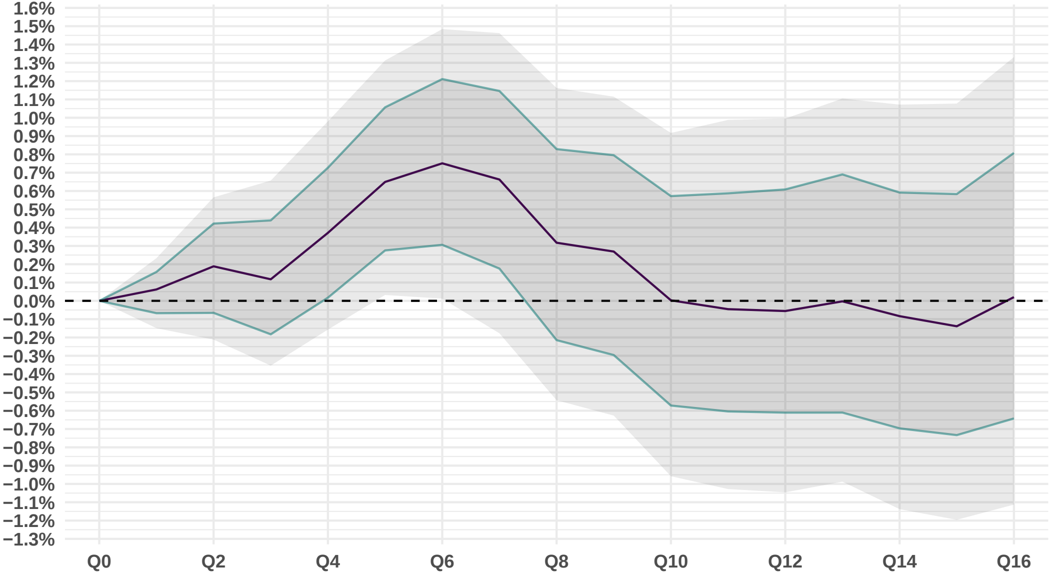
Romer, Romer (2010) - Replication



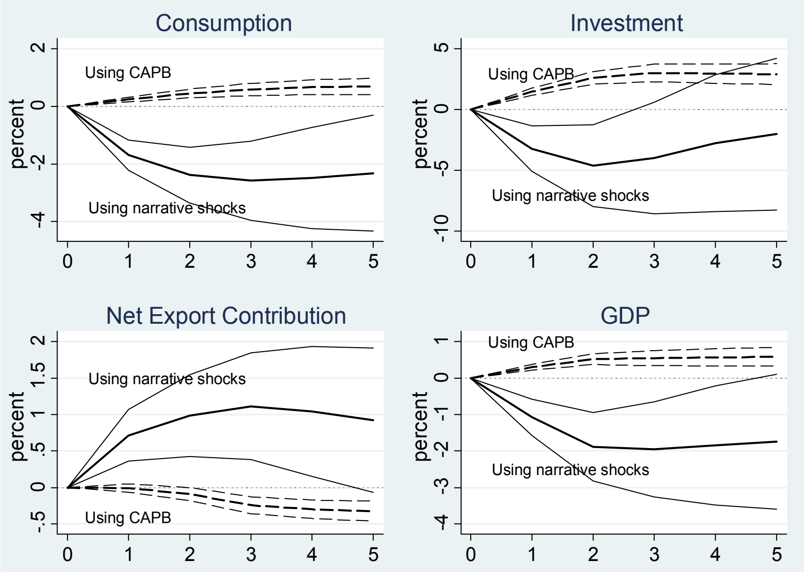
Cloyne (2013) - Paper



Cloyne (2013) - Replication



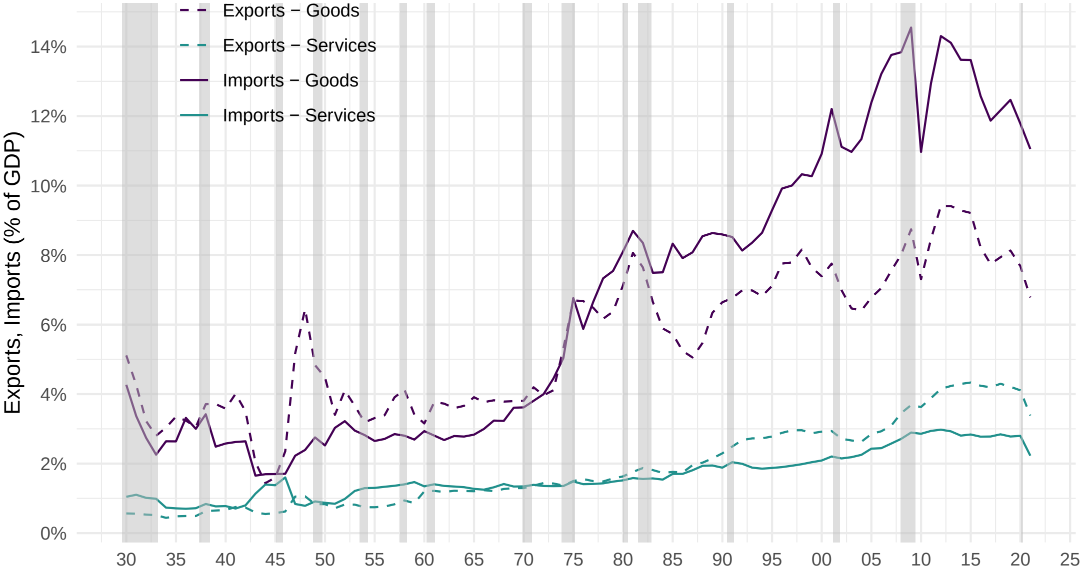
Guajardo et al. (2014)



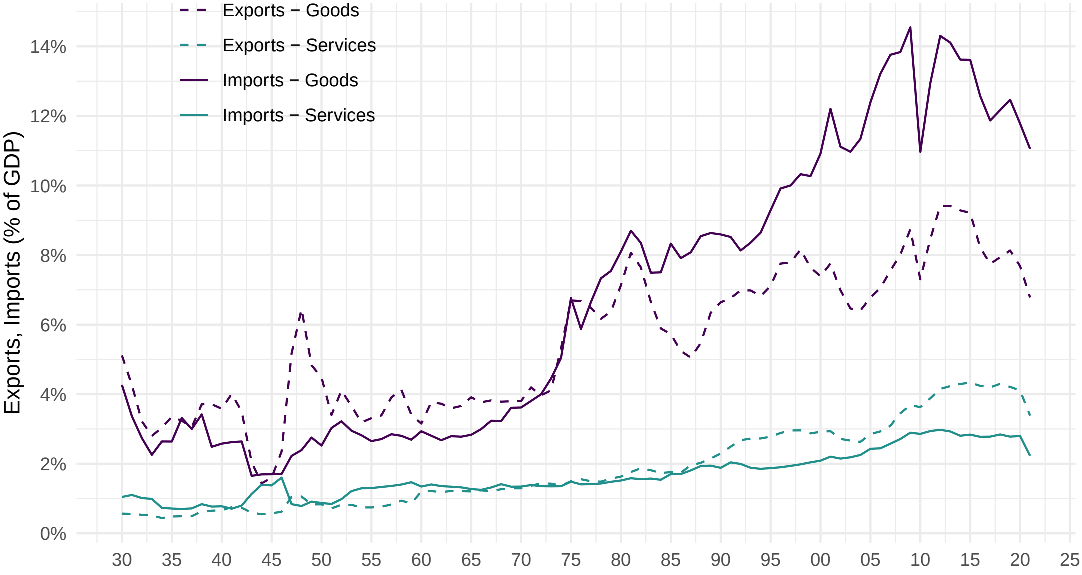
Section 4

Some U.S. Data

Exports, Imports (% of GDP)

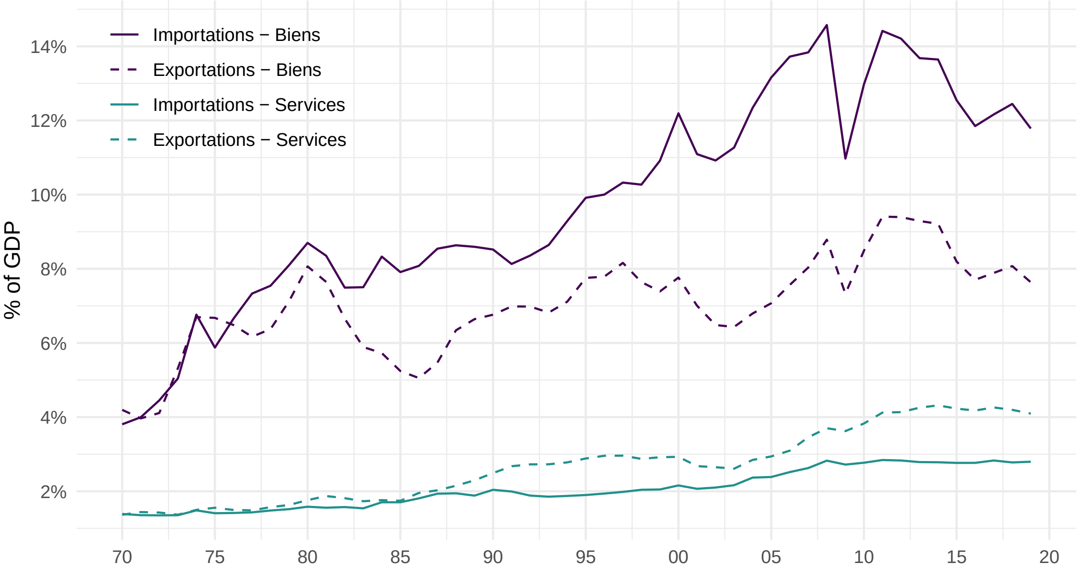


Exports, Imports, Goods and Services (% of GDP)



Net Exports (% of GDP)

Exports in Goods and Services (Source: OECD)



Section 5

Quotes from Keynes

Open economy

Four main sources of information:

- Chapter 10 in The General Theory.
- Proposals for a Revenue Tariff - March 7, 1931.
- On the Eve of Gold Suspension - Sept 10, 1931.
- Chapter 23 in The General Theory. (Keyes (1936))

Keyes (1936) - Chapter 10

(iii) In an open system with foreign-trade relations, some part of the multiplier of the increased investment will accrue to the benefit of employment in foreign countries, since a proportion of the increased consumption will diminish our own country's favourable foreign balance; so that, if we consider only the effect on domestic employment as distinct from world employment, we must diminish the full figure of the multiplier. On the other hand our own country may recover a portion of this leakage through favourable repercussions due to the action of the multiplier in the foreign country in increasing its economic activity.

Keyes (1931) - Proposals for a Revenue Tariff

To decrease the cost of output by reducing wages and curtailing Budget services may indeed increase foreign demand for our goods (unless, which is quite likely, it encourages a similar policy of contraction abroad), but it will probably diminish the domestic demand. The advantages to employers of a *general* reduction of wages are, therefore, not so great as they look. Each employer sees the advantage to himself of a reduction of the wages which he himself pays, I am of the opinion that a policy of expansion, though desirable, is not safe or practicable to-day, unless it is accompanied by other measures which would neutralise its dangers. Let me remind the reader what these dangers are. There is the burden on the trade balance, the burden on the Budget, and the effect on confidence. If the policy of expansion were to

Keyes (1931) - On the Eve of Gold Suspension

of francs and dollars. But they cannot suppose that we can depend permanently on foreign loans. The rest of the problem is primarily concerned with improving our current balance of trade on income account. This is what the Cabinet ought to be thinking about.

There are only two possible lines of attack on this. The one (which is the milder measure open to us) consists in direct measures to restrict imports (and, if possible, subsidise exports); the other is a reduction of all money wages within the country. We may have to attempt both in the end, if we refuse to devaluate.

The Prime Minister has said that it is like the war over again, and many people believe him. But this is exactly the opposite of the truth. During the war it was useful to refrain from any avoidable expenditure because this would release resources for the insatiable demands of military operations. What are we releasing resources for to-day? To stand at street corners and draw the dole.

When we already have a great amount of unemployment and unused resources of every description, economy is only useful from the national point of view *in so far as it diminishes our consumption of imported goods*. For the rest, its fruits are entirely wasted in unemployment, business losses, and reduced savings. But it is an extraordinarily indirect and wasteful way of reducing imports.

23

Notes on Mercantilism, The Usury Laws, Stamped Money and Theories Of Under-Consumption

I

For some two hundred years both economic theorists and practical men did not doubt that there is a peculiar advantage to a country in a favourable balance of trade, and grave danger in an unfavourable balance, particularly if it results in an efflux of the precious metals. But for the past one hundred years there has been a remarkable divergence of opinion.

The majority of statesmen and practical men in most countries, and nearly half of them even in Great Britain, the home of the opposite view, have remained faithful to the ancient doctrine; whereas almost all economic theorists have held that anxiety concerning such matters is absolutely groundless except on a very short view, since the mechanism of foreign trade is self-adjusting and attempts to interfere with it are not only futile, but greatly impoverish those who practise them because they forfeit the advantages of the international division of labour. It will be convenient, in accordance with tradition, to designate the older opinion as *mercantilism* and the newer as *free trade*, though these terms, since each of them has both a broader and a narrower signification, must be interpreted with reference to the context.

Keynes: Protectionist Policies?

- In terms of the model we wrote: the idea is to influence m_1: the propensity to import. Why? Because when you do a stimulus, you stimulate other countries too. By introducing a tariff, you may make other countries' traded goods more expensive, and favor your own ones.
- Of course, the problem is that it distorts trade, and can lead to crony capitalism (as some specific firms ask to be exempted from tariffs).
- An alternative way to influence m_1 is to do a devaluation: if prices do not move immediately in response, then you also make your own products more competitive by doing so. (as I said we've abstracted from exchange rate considerations)

Hobson - Imperialism

the distribution of wealth. If a tendency to distribute income or consuming power according to needs were operative, it is evident that consumption would rise with every rise of producing power, for human needs are illimitable, and there could be no excess of saving. But it is quite otherwise in a state of economic society where distribution has no fixed relation to needs, but is determined by other conditions which assign to some people a consuming power vastly in excess of needs or possible uses, while others are destitute of consuming power enough to satisfy even the full demands of physical efficiency. The following illustration may serve to make the issue clear. "The

There is no necessity to open up new foreign markets; the home markets are capable of indefinite expansion. Whatever is produced in England can be consumed in England, provided that the "income," or power to demand commodities, is properly distributed. This only appears untrue because of the unnatural and unwholesome specialisation to which this country has been subjected, based upon a bad distribution of economic resources, which has induced an overgrowth of certain manufacturing trades for the express purpose of effecting foreign sales. If the industrial revolution had taken

The struggle for markets, the greater eagerness of producers to sell than of consumers to buy, is the crowning proof of a false economy of distribution. Imperialism is the fruit of this false economy; "social reform" is its remedy. The primary purpose of "social reform," using the term in its economic signification, is to raise the wholesome standard of private and public consumption for a nation, so as to enable the nation to live up to

Where the distribution of incomes is such as to enable all classes of the nation to convert their felt wants into an effective demand for commodities, there can be no over-production, no under-employment of capital and labour, and no necessity to fight for foreign markets.

The most convincing condemnation of the current economy is conveyed in the difficulty which producers everywhere experience in finding consumers for their products: a fact attested by the prodigious growth of classes of agents and middlemen, the multiplication of every sort of advertising, and the general increase of the distributive classes. Under a sound economy the

[1] "Poverty: A Study of Town Life."

Section 6

Surplus or Debtor Countries ?

A question of balance

62 **Finance and economics** **The Economist** August 25th 2018

Free exchange | A question of balance

What a rising current-account surplus means for the euro area

GREECE'S third bail-out programme came to an end on August 20th. A look at the causes of the country's near-decade of crisis illustrates how external imbalances can reflect underlying troubles. Gaps in public finances, as well as investments in property, were financed by borrowing from Germany and other northern European countries. Wages and costs were pushed up, making exports less competitive—within the euro zone, there can be no currency devaluation—and further widening Greece's current-account deficit. When foreign lending seized up, the government needed bailing out and the banks crumbled. Portugal (chiefly because of its public finances), Spain and Ireland (blame private-sector housing bubbles) have similar tales to tell.

cle alone. Growth in the zone relies too much on that of its largest trading partners, including America; worthy investment projects at home—in German infrastructure, say—go unfulfilled.

Surpluses also have political consequences outside the bloc. President Donald Trump sees Europe as a "foe" because of its bilateral trade surplus with America. He has slapped tariffs on European steel and aluminium, and threatened them on cars; the European Union has retaliated. The two sides are negotiating, but trade tensions are likely to keep simmering.

Internal strife

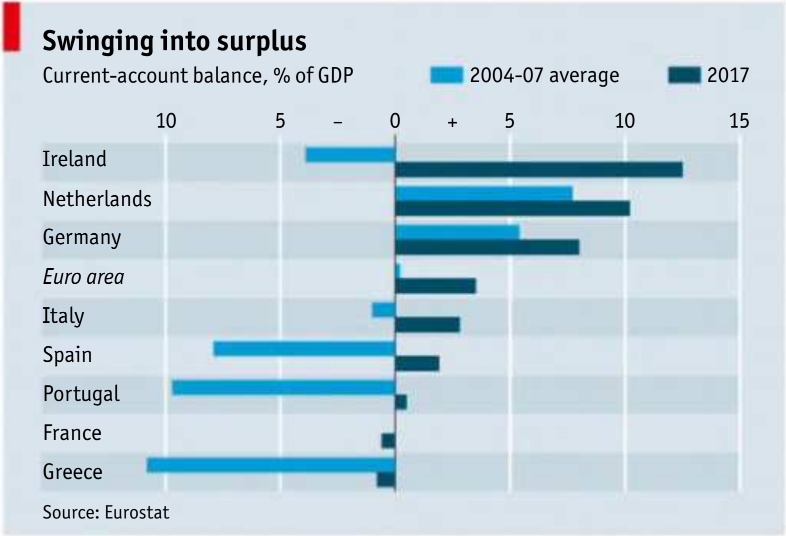
The current-account deficits in the euro zone's crisis countries

Compulsory for the debtor, voluntary for the creditor

John Maynard Keynes recognised the risk of such asymmetry in the 1940s: "The process of adjustment is compulsory for the debtor and voluntary for the creditor. If the creditor does not choose to make, or allow, his share of the adjustment, he suffers no inconvenience." Keynes wanted to tax countries that hoarded trade surpluses. In 2011 the European Commission set up a "macroeconomic-imbalance procedure" to tackle the problem. But the process appears to place less weight on surpluses than on deficits and lacks the means to enforce its recommendations.

Another way of dealing with imbalances would be to encourage greater risk-sharing through fiscal and (deeper) banking union. The euro zone would become more like America, where inter-state imbalances are not even recorded. But that too seems politically infeasible. The euro area's long slog will carry on, and debtor countries will bear the burden. ■

Graph



Swinging into surplus
Current-account balance, % of GDP
2004-07 average
2017
10
5
–
0
+
5
10
15
Ireland
Netherlands
Germany
Euro area
Italy
Spain
Portugal
France
Greece
Source: Eurostat

Compulsory for the debtor, voluntary for the creditor

It is characteristic of a freely convertible international standard that it throws the main burden of adjustment on the country which is in the debtor position on the international balance of payments, – that is on the country which is (in this context) by hypothesis the weaker and above all the smaller in comparison with the other side of the scales which (for this purpose) is the rest of the world.

Take the classical theory that the unlimited free flow of gold automatically brings about adjustments of price-levels and [27] activity between the debtor country and the recipient creditor, which will eventually reverse the pressure. It is usual to-day to object to this theory that it is too dependent on a crude and now abandoned quantity theory of money and that it ignores the lack of elasticity in the social structure of wages and prices. But even to the extent

Compulsory for the debtor, voluntary for the creditor

And besides this, the process of adjustment is *compulsory* for the debtor and *voluntary* for the creditor. If the creditor does not choose to make, or allow, his share of the adjustment, he suffers no inconvenience. For whilst a country's reserve cannot fall below zero, there is no ceiling which sets an upper limit. The same is true if international loans are to be the means of adjustment. The debtor *must* borrow; the creditor is under no such compulsion.

There is a further consequence, having very great importance, of the main burden of adjustment being on the debtor country which is *small* compared with the world at large; namely, that most of the means of adjustment open to the debtor country are liable to have an adverse effect on its terms of trade. (The best argument in favour of the expedient of tariffs is that it is free from