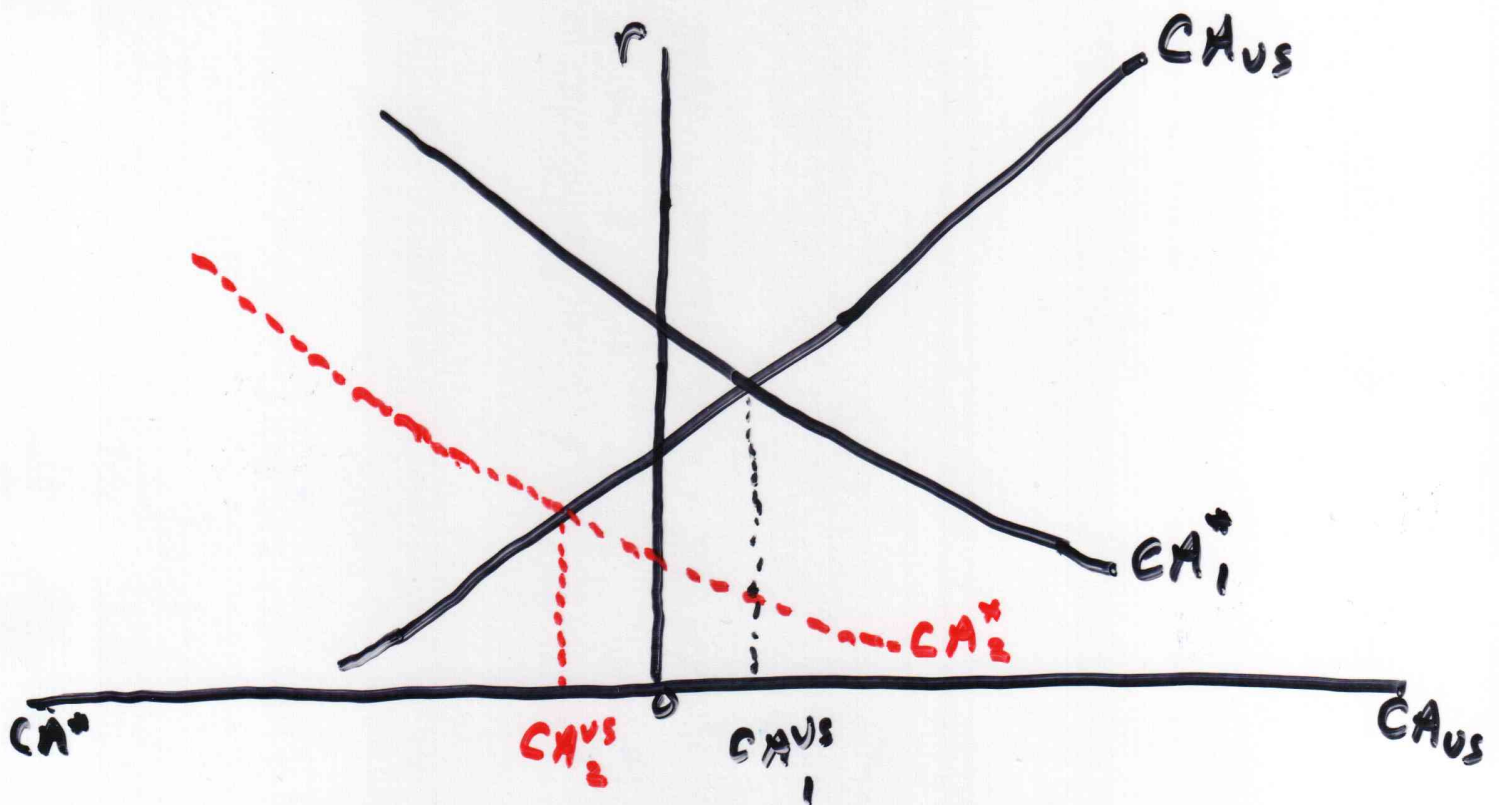


Topics for Today

- 1.) Alternative Interpretations of the Emergence of CA deficits in the U.S. during the 1980s.
- 2.) The "Twin Deficits"

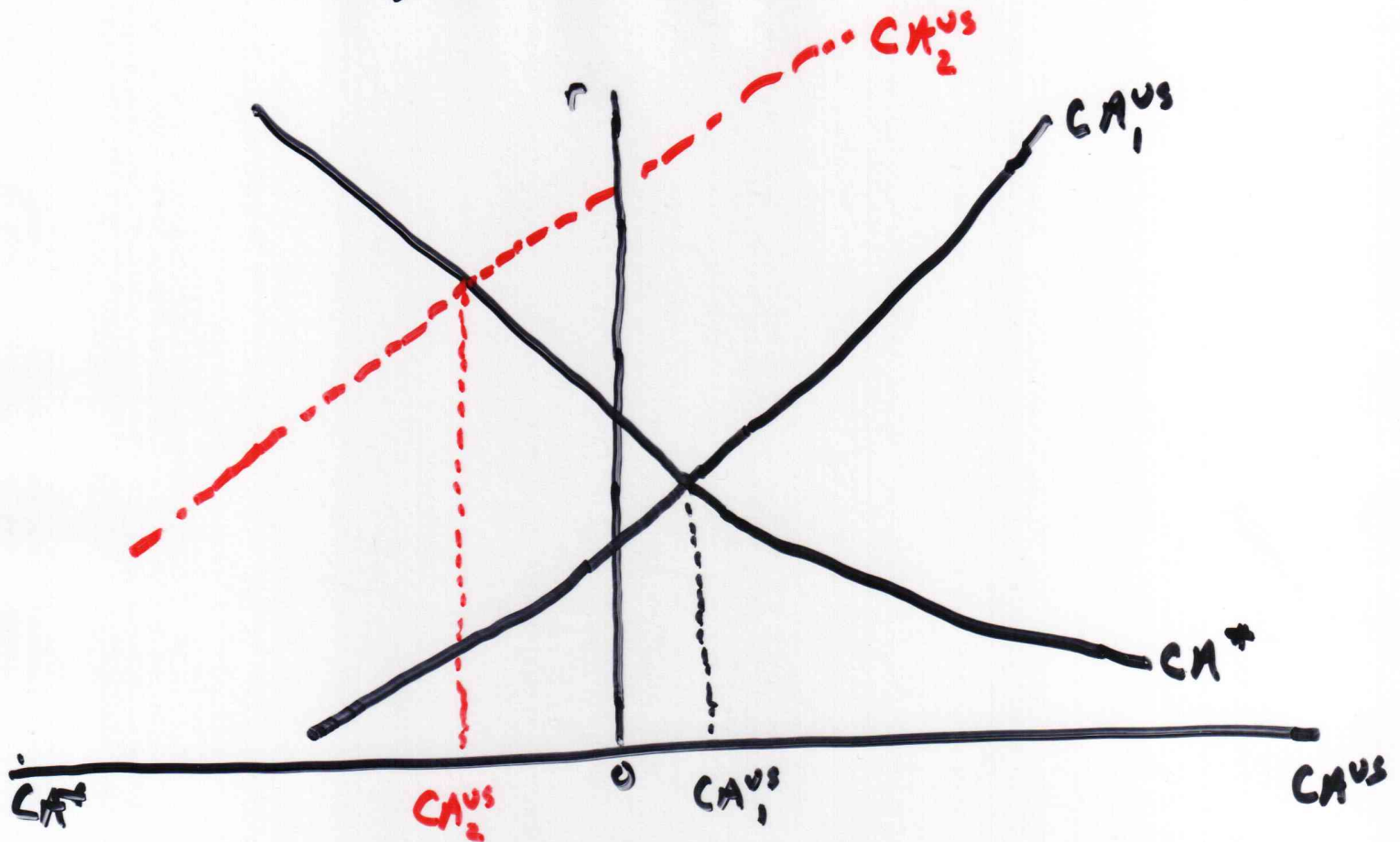
The Emergence of U.S. Current Acct. Deficits

- We can use our "large country" analysis from last time to study an important issue - Why did the U.S. suddenly begin running large CA deficits in the early 1980s?
- Our model suggests 2 possibilities:
 - 1.) Foreign saving increased, or foreign investment declined, which shifted CA^* to the left:



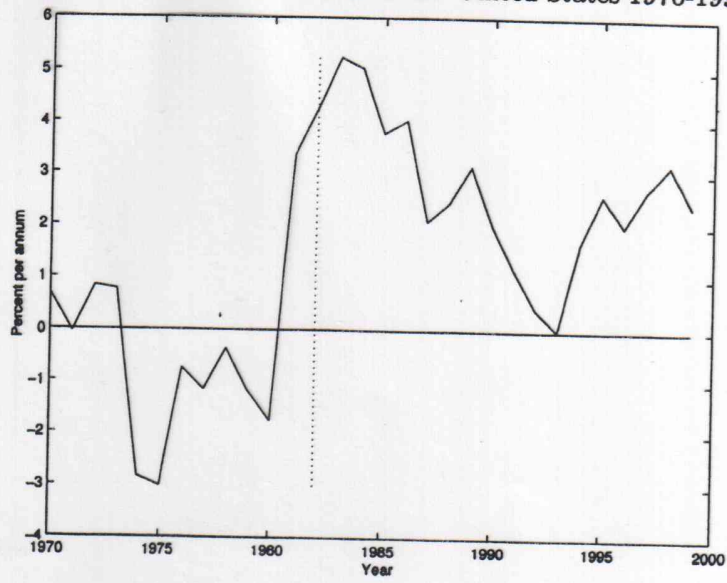
(Note: This story resurfaced recently, to explain the widening of the U.S. CA deficit during the early 2000s, i.e., Bernanke's "savings glut" hypothesis).

2.) U.S. saving declined, or U.S. investment increased, which shifted CA^{US} to the left:



How can we distinguish between these two hypotheses?

Figure 5.3: Real interest rates in the United States 1970-1999



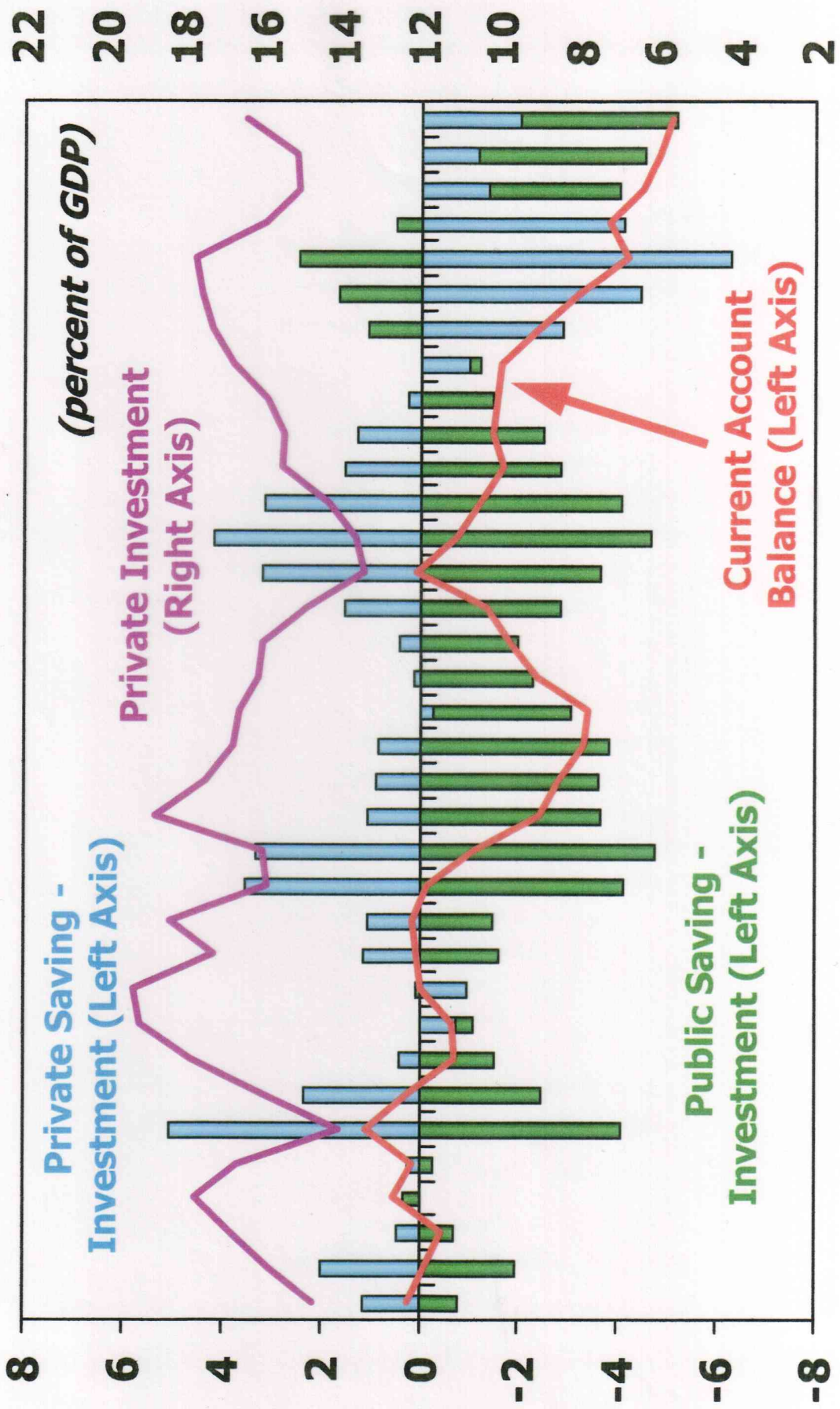
Source: Economic Report of the President, 2000. Note: The real interest rate is measured as the difference between the 3-month Treasury bill rate and consumer price inflation. (Thus, this is an *ex post* real interest rate.)

- Concluding that the U.S. CA deficits were likely caused by a decline in U.S. saving or an increase in U.S. investment is a useful first step. But it leads to the next question - which was it, $S \downarrow$ or $I \uparrow$?

1979 - 82	-	rising fiscal deficits
82 - 84	-	rising investment
84 - 90	-	declining private saving & persistent fiscal deficits
92 - 2000	-	rising investment
2000 - now	-	rising fiscal deficits

- The problem with this sort of analysis is that it does not explain why these variables are changing. I , S_p , and S_g are jointly endogenous variables, which react to each other. To attribute causality to these changes we need a theory. In particular, we need to incorporate the government into our model.

Figure 6: US Current Account and Saving-Investment



70 72 74 76 78 80 82 84 86 88 90 92 94 96 98 00 02 04

The "Twin Deficits"

$$Y = C + I + G + NX$$

$$\begin{aligned} \text{GNP} = Y + \text{NFP} &= C + I + G + (NX + \text{NFP}) \\ &= C + I + G + \text{CA} \rightarrow \text{current acct.} \end{aligned}$$

$$\text{GNP} - T - C = I + (G - T) + \text{CA}$$

$$\text{Define } S_g = T - G \quad \left. \vphantom{\text{Define}} \right\} \text{govt. saving}$$

$$S_p + S_g = I + \text{CA}$$

$$-\text{CA} = -S_g + (I - S_p)$$

$$\text{Current Acct. Deficit} = \text{Govt. Budget Deficit} + \underline{\underline{(I - S_p)}}$$