Macro Policy in a Global Setting

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Chapter Goals

- Discuss why there is a significant debate about what U.S. international goals should be
- Describe the paths through which monetary policy affects the trade balance
- Explain the paths through which fiscal policy affects the trade balance

Chapter Goals

- Summarize the reasons why governments try to coordinate their monetary and fiscal policies
- State the potential problem of internationalizing a country's debt
- Explain how restoring U.S. competitiveness will likely affect U.S. policy in the future

Ambiguous International Goals of Macroeconomic Policy

- There is general agreement about the domestic goals of macroeconomic policy: We want low inflation, high growth, and low unemployment
- The international goal of U.S. macro policy is to maintain the U.S. position in the world economy, but there is debate about how to achieve that goal
  - Do we want a high or a low exchange rate?
  - Do we want a balance of trade surplus or a trade deficit?
  - Should we even pay attention to the balance of trade?

The Exchange Rate Goal

Depending on the state of the economy, there are arguments for both high and low exchange rates

Advantages of high exchange rates:

- Foreign currencies are cheaper, so imports are cheaper
- Competition from cheaper imports keeps U.S. inflation low

Disadvantages of high exchange rates:

- Imports increase and exports decrease causing a trade deficit
- Trade deficits can have a contractionary effect on the economy

The Trade Balance Goal

- The trade balance is the difference between a country's exports and imports
- Running a trade deficit is good in the short run but presents problems in the long run
  - In the short run, imports exceed exports, so we're consuming more than we could if we didn't run a deficit
  - If a country runs a trade deficit year after year, eventually the long run will arrive and the country will run out of assets to sell

The Trade Balance

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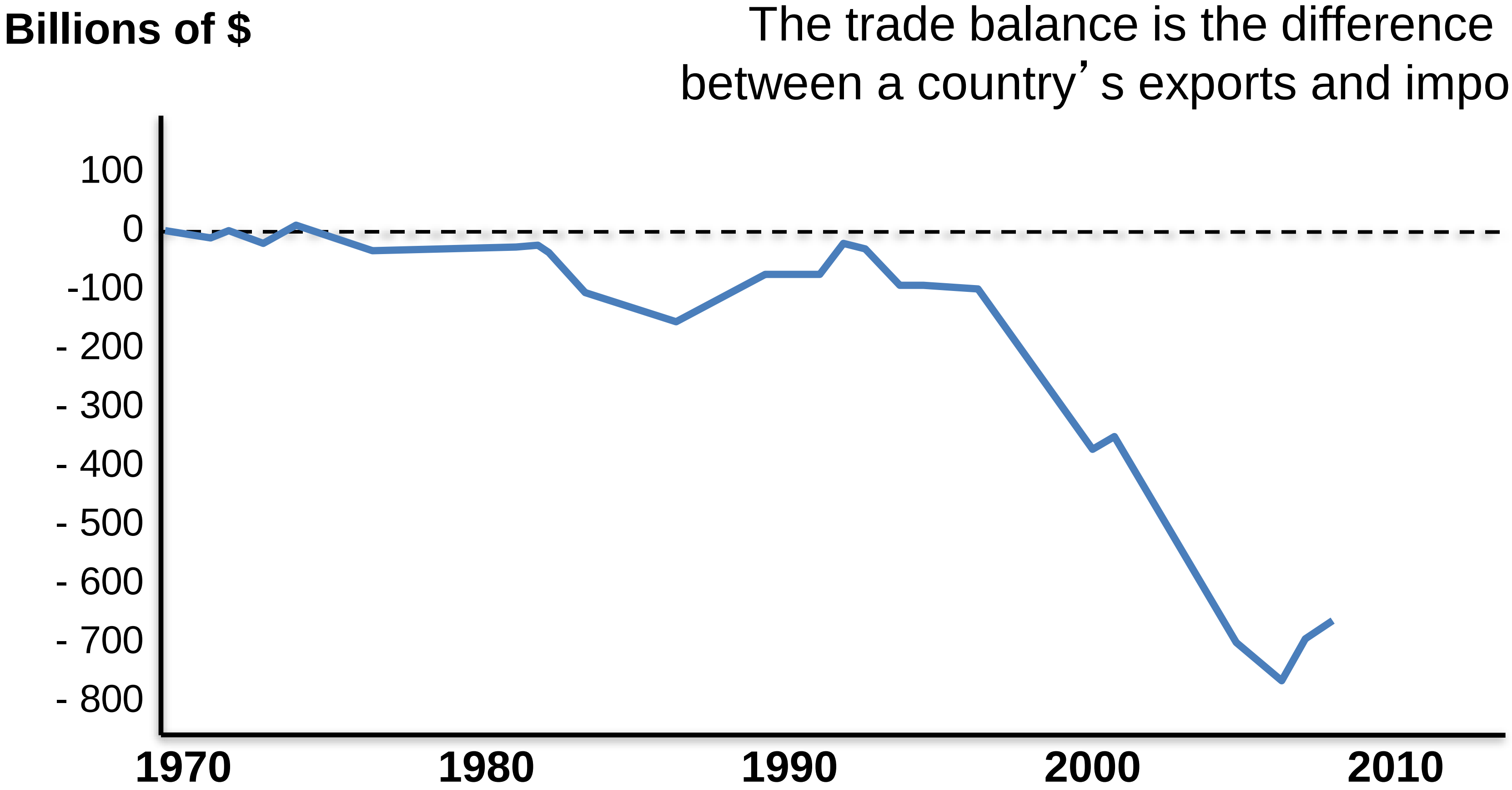


International versus Domestic Goals

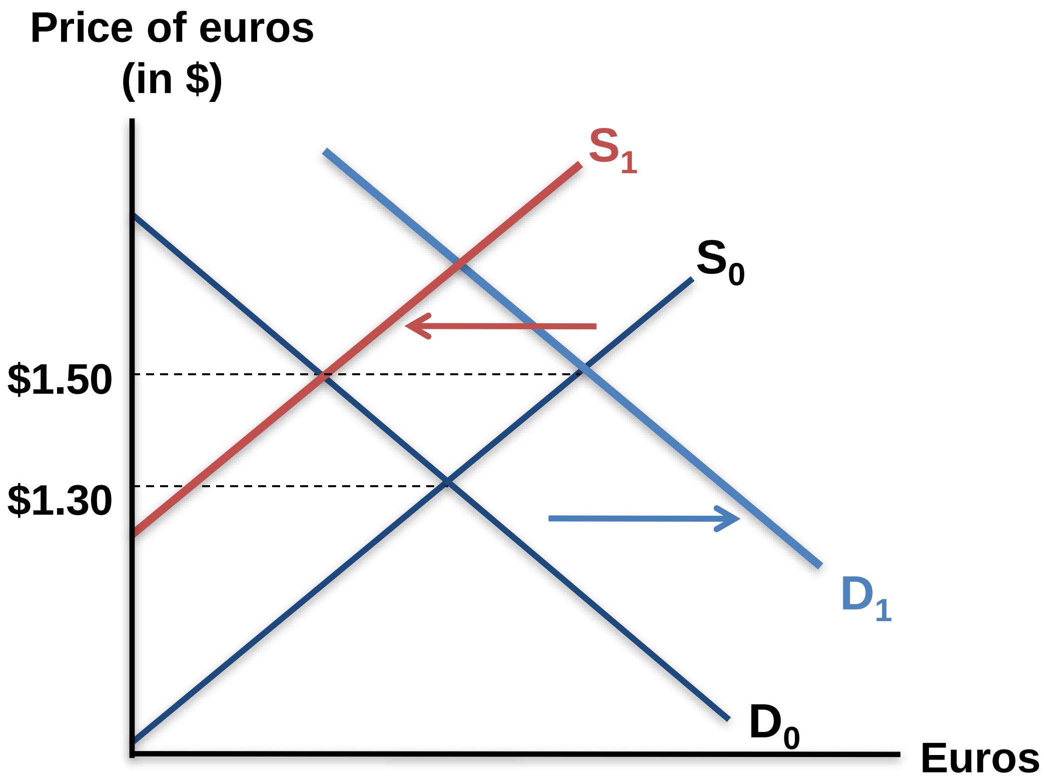
- Domestic goals generally dominate the international goals because:
    - Domestic goals (inflation, unemployment, and growth) affect citizens directly
    - There is general agreement as to what domestic goals are
- Often a country responds to an international goal only when the international community forces it to do so

Balancing the Exchange Rate Goal with Domestic Goals

- In principle, the government can control the exchange rate with monetary policy
- The problem with doing so is that monetary policy also affects the domestic economy
  - Expansionary monetary policy will push the exchange rate down
  - Contractionary monetary policy will push the exchange rate up and may decrease domestic income and jobs
- In order to achieve a certain exchange rate, a country may have to sacrifice domestic goals

Targeting an Exchange Rate with Monetary and Fiscal Policy

To increase the exchange rate value of the euro, the European Central Bank (ECB) could:

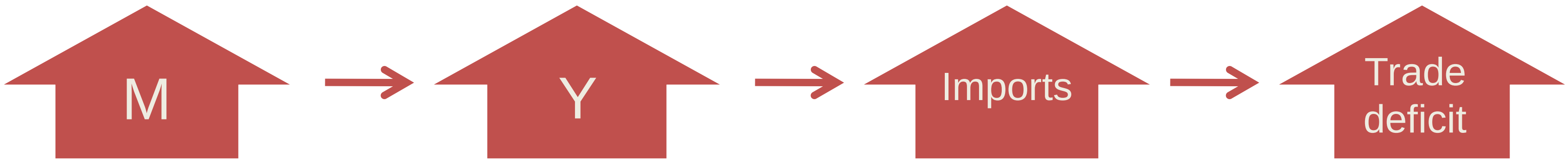


Run contractionary monetary policy to increase interest rates and increase the private demand for euros

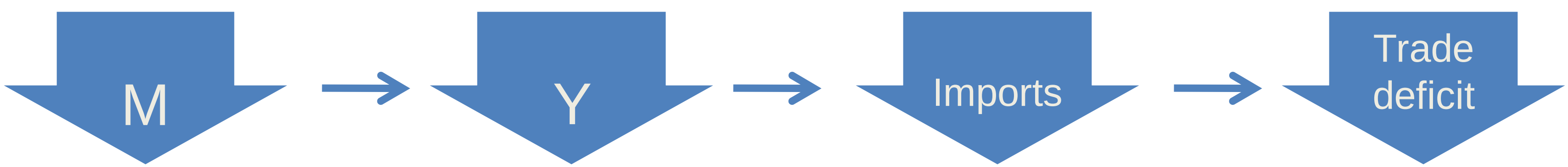
Or induce a recession and decrease the private supply of euros

Monetary Policy’s Effect on the Trade Balance

Expansionary monetary policy makes the trade deficit larger

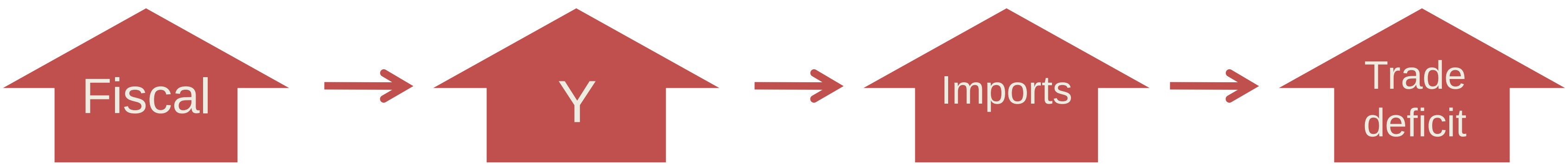


Contractionary monetary policy makes the trade deficit smaller

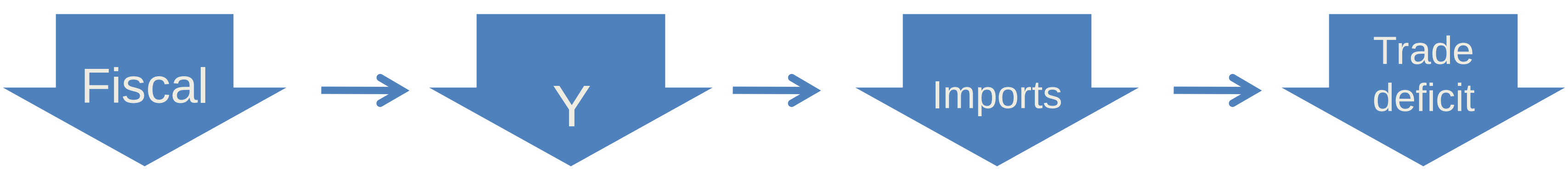


Fiscal Policy's Effect on the Trade Balance

- Expansionary fiscal policy makes the trade deficit larger



- Contractionary fiscal policy makes the trade deficit smaller



International Phenomena and Domestic Goals

- International phenomena change and have significant influences on the domestic economy
- If other countries stop buying U.S. assets that are financing the large trade deficit, the dollar exchange rate will fall
- In the short run, the fall in the dollar will increase the prices of imports, creating inflation in the U.S
- In the long run, the fall in the exchange rate will improve the competitiveness of the U.S. and increase exports

International Goals and Policy Alternatives

International Goal	Policy Alternatives
Lower exchange rate	• Contractionary foreign monetary policy • Expansionary domestic monetary policy
Lower trade deficit	• Contractionary domestic fiscal policy • Expansionary foreign fiscal policy • Contractionary domestic monetary policy • Expansionary foreign monetary policy

International Monetary and Fiscal Coordination

- Governments try to coordinate their monetary and fiscal policies because their economies are interdependent
    - If one country's trade balance is in surplus, another country's is in deficit
- **Policy coordination** is the integration of a country's policies to take account of their global effects
- Each nation will likely do what is best for the world economy as long as it is also best for itself

Crowding Out and International Considerations

- Crowding out that may result from financing the debt can be avoided if the debt is **internationalized** when foreigners buy the debt at the existing interest rate
- Internationalizing the debt may be a short-run solution, but it can create long-run problems
- Foreign ownership of a country's debt means the country must pay interest to those foreigners and the debt will eventually have to be repaid or refinanced

International Issues and Macro Policy

- The more globally connected a country is, the less flexibility it has with monetary and fiscal policy
- A country can respond to international pressure faster if it has flexible exchange rates
- An alternative to using monetary and fiscal policy to meet international goals is trade policy designed to affect the level of exports and imports
- Macro policy is short-run policy, which must be conducted within a longer-range setting of the country's overall **competitiveness** which is the ability of a country to sell its goods to other countries

Restoring International Trade Balance to the U.S. Economy

- The large demand for U.S. assets has allowed the U.S. to lose its comparative advantage in the production of many goods and services and run a trade deficit.
- As long as other countries are willing to accept U.S. currency or U.S. assets in payment for goods they produce, the U.S. can continue to run a trade deficit at the current exchange rate

Restoring International Trade Balance to the U.S. Economy

- At some point foreigners will likely stop wanting to accumulate more U.S. currency or assets and the dollar will depreciate
- The dollar will continue to depreciate especially relative to the Indian rupee and the Chinese yuan until the U.S. regains a comparative advantage in enough goods to create a balance in the balance of payments

Chapter Summary

- The international goals of a country are often in dispute
- Domestic goals generally dominate international goals, but countries often respond to an international goal when forced to do so by other countries
- Expansionary monetary policy, through its effect on income, tends to increase its trade deficit
- Contractionary fiscal policy tends to decrease a country's trade deficit

Chapter Summary

- For every effect that macro policies have on a country's exchange rate and trade balance, there is an equal and opposite effect on foreign countries' exchange rates and trade balances
- Therefore, countries try to coordinate their policies
- International financial inflows can reduce crowding out

Chapter Summary

- Internationalizing a country's debt means that at some time in the future the country must consume less than it produces
- The U.S. has lost its competitiveness in the production of many goods
- Unless foreigners continue to demand U.S. assets, the U.S. trade deficit will put downward pressure on the dollar and U.S. policymakers will face implementing contractionary policies and/or trade restrictions