Osher Lifelong Learning Institute, Winter 2022

Contemporary Economic Policy

Southern Maine University
January-February, 2023

Jon Haveman, Ph.D.
National Economic Education Delegation

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Course Outline

- **Contemporary Economic Policy**
  - Week 1 (1/10): Trade and Globalization (Alan Deardorff, Univ. Michigan**)**
  - **Week 2 (1/17): Trade Deficits and Exchange Rates (Alan Deardorff**
  - Week 3 (1/24): US Economic Update (Geoffrey Woglom, Amherst College)
  - Week 4 (1/31): Monetary Economics (Geoffrey Woglom)
  - Week 5 (2/7): The Black-White Wealth Gap(Jon Haveman, NEED)
  - Week 6 (2/14): Autonomous Vehicles (Jon Haveman)

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Submitting Questions

- **Please submit questions of clarification in the chat.**
  - I will try to handle them as they come up.
- **We will do a verbal Q&A once the material has been presented.**
- **Slides will be available from the NEED website tomorrow (https://needelegation.org/delivered_presentations.php)**

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Trade Deficits and Exchange Rates

Alan Deardorff
University of Michigan

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Trade Deficits and Exchange Rates

Alan V. Deardorff
University of Michigan

Presentation to Southern Maine University
January 17, 2023

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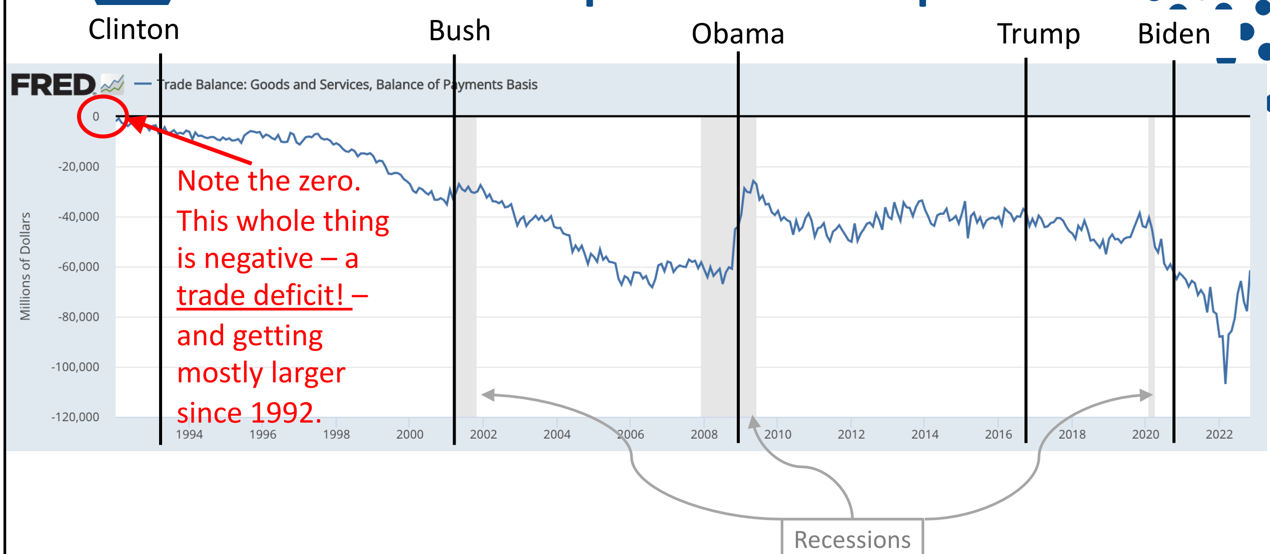
US Trade Balance = Exports minus Imports



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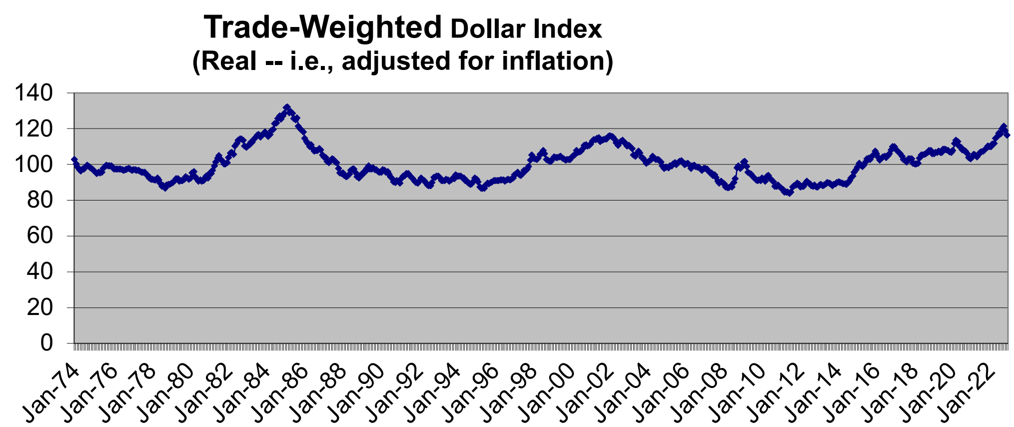
US Exchange Rate



Source: Federal Reserve

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Outline

- **The trade deficit**
  - How it's defined
  - How it has changed over time, US and other
  - What it means and does not mean
- **Exchange rates**
  - What they are
  - How they are determined
  - How they have changed over time, US and other
  - How they matter
  - Currency manipulation (if time allows)

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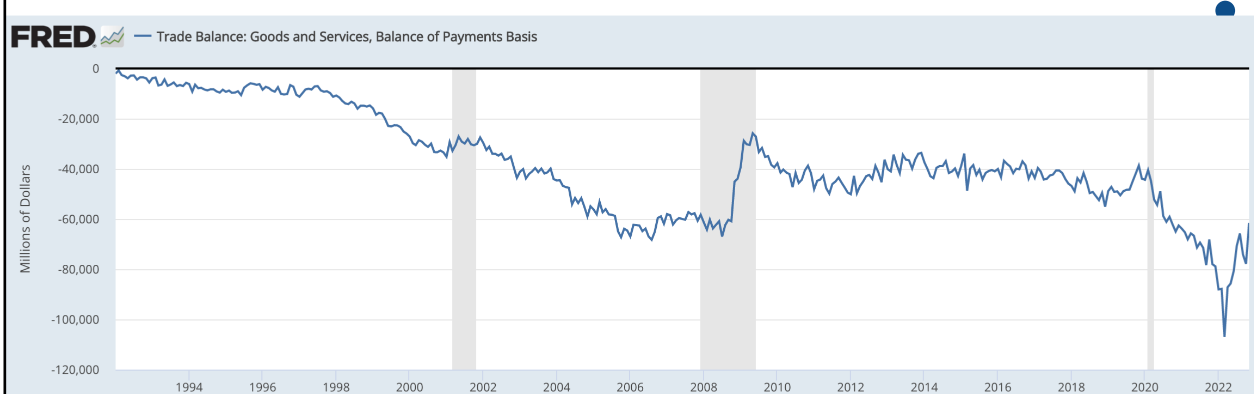
Trade Deficit

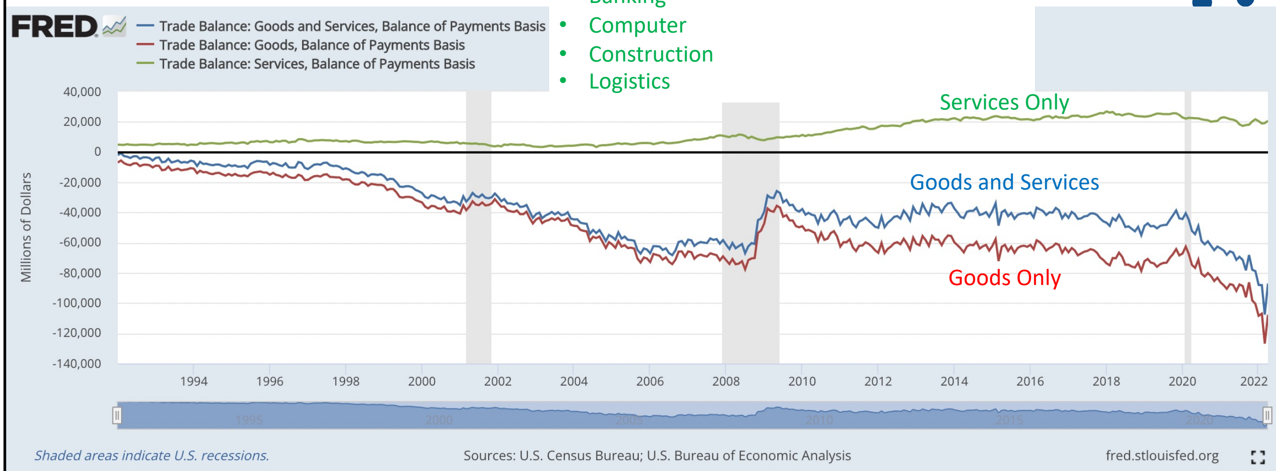
- **The trade balance**
  - Defined as Exports minus Imports, X–M
  - May be reported for goods only, or for goods and services
- **When trade balance is negative, that's a trade deficit**
  - Thus trade deficit is Imports minus Exports, M–X
- **The US:**
  - Has had a deficit for many decades
  - It has grown substantially in recent years
  - Has had a surplus for trade in services
- **Another measure: "The Current Account Balance"**
  - This is the trade balance plus:
    - International income flows (interest, dividends, profits, wages)
    - International transfer payments (e.g., remittances, aid)
  - Not very different from the trade balance

US Trade Balance: Goods and Services



US Trade Balances

Examples of services trade:
- Professional (legal, engineering, accounting)
- Banking
- Computer
- Construction
- Logistics



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Trade Deficit

- **For the World as a Whole**
  - Since one country's imports are another's exports
    - ↳ The sum of all deficits and surpluses must be zero
- **Therefore US deficit implies rest of world has surplus**
- **But many countries have deficits**

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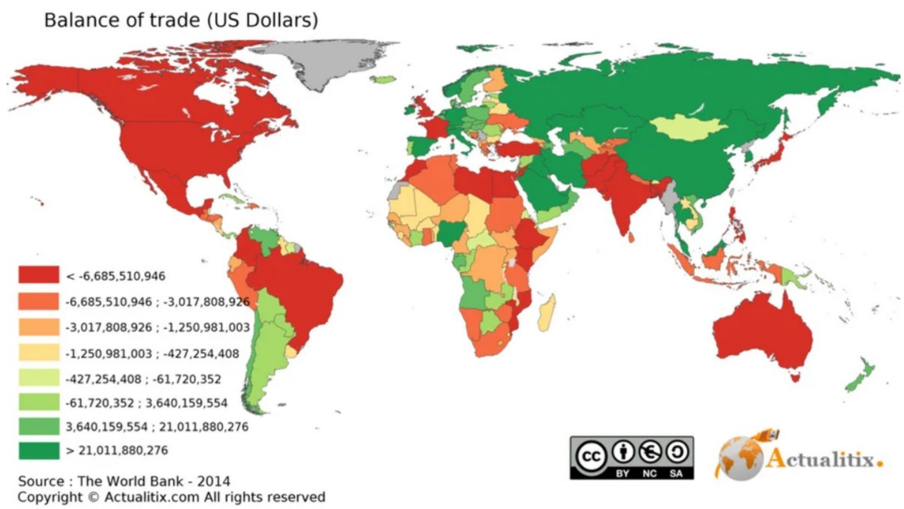
World Map: Balance of trade (US Dollars)



Source:
Reddit

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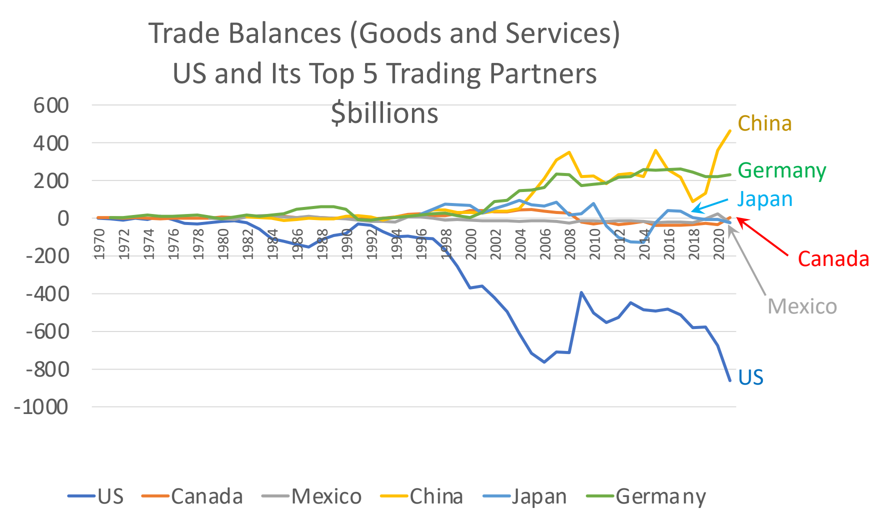
Trade Balances Over Time



Source:
IMF
International
Financial
Statistics

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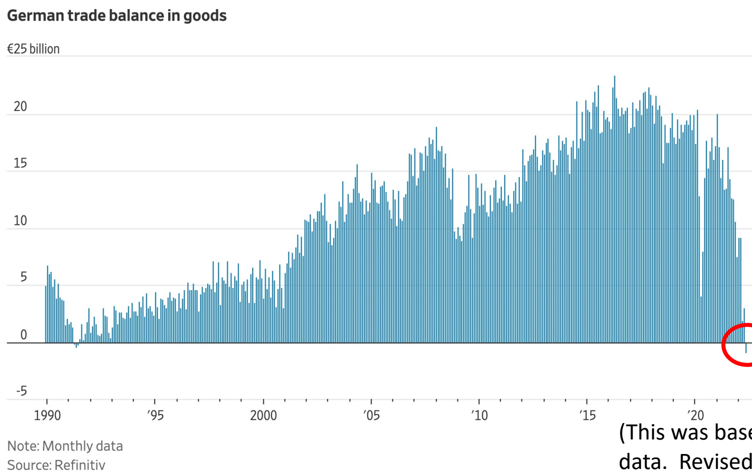
Trade Balances Over Time

But note the recent data for Germany:



Negative for first time since 1991

Source:
WSJ, 7/11/22

(This was based on preliminary data. Revised data a month later showed a small surplus.)

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Trade Deficit

- **What a trade deficit means**
  - Imports > Exports
  - The gap must be paid for somehow. By
    - Capital inflows (borrowing, sale of stocks & bonds)
    - Sale of property (real estate, companies)
    - Gifts from foreigners (not relevant for US)
    - Others willing to hold more or our currency (very relevant for US)
  - What explains the gap? Look at GDP (Gross Domestic Product), which measures both production and income in a country:

$$GDP = C + I + G + X - M$$

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What a Trade Deficit Means

Production

$$GDP = C + I + G + X - M$$

Consumption = Household spending

Investment = Business spending on equipment and inventories (not inputs)

Government = Purchases by government at all levels

Exports

Imports (Subtracted because C, I, and G all include imports)

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What a Trade Deficit Means

$$\overbrace{GDP}^{\text{Income}} = \overbrace{C + I + G}^{\text{Expenditure}} + \overbrace{X - M}^{\text{Trade Balance}}$$

OR:

$$\overbrace{X - M}^{\text{Trade Balance}} = \overbrace{GDP}^{\text{Income}} - \overbrace{(C + I + G)}^{\text{Expenditure}}$$

- **Therefore**
  - Trade Surplus = Income minus Expenditure
  - Trade Deficit = Expenditure minus Income
- **Running a trade deficit means we are spending <u>more</u> than our income**

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What a Trade Deficit Means

- **For another interpretation, subtract net taxes from both sides**

$$T = \text{Net Taxes} = \text{Taxes} - \text{Transfers}$$

$$GDP - T = C + I + G - T + X - M$$

$$\underbrace{\underbrace{(GDP - T - C)}_{\text{Private Saving}} + \underbrace{(T - G)}_{\text{Gov't Saving}}}_{\text{Total Saving}} - \underbrace{I}_{\text{Investment}} = \underbrace{(X - M)}_{\text{Trade Balance}}$$

$$\boxed{\text{Trade Balance = Saving minus Investment}}$$

What a Trade Deficit Means

Trade Balance = Saving minus Investment

- **Therefore**
  - If a country is saving more than needed to finance domestic investment, it will, by definition, run a trade surplus
  - If a country is saving less than needed to finance domestic investment, it will, by definition, run a trade deficit
- **That gap is also, as before, the difference between total income and total expenditure**
- **It therefore also appears as**
  - Net borrowing and lending
  - Plus net acquisition or sales of assets

What a Trade Deficit Does NOT Mean

- **There are several very popular interpretations of trade deficits that are simply <u>NOT</u> valid, even though many politicians believe them:**
  - That foreign trade barriers are hurting our exports
  - That other countries are engaged in unfair trade
  - That our firms are not competitive
  - That we are losing jobs to other countries
  - That we need to restrict trade
- **To understand why these are wrong, think about whether they could change**
  - Expenditure relative to income, or
  - Saving relative to investment
- **Possible exception: If we are in recession and these may change income**
  - But note that the trade deficit typically <u>falls</u> during recession, <u>due to</u> recession reducing expenditure

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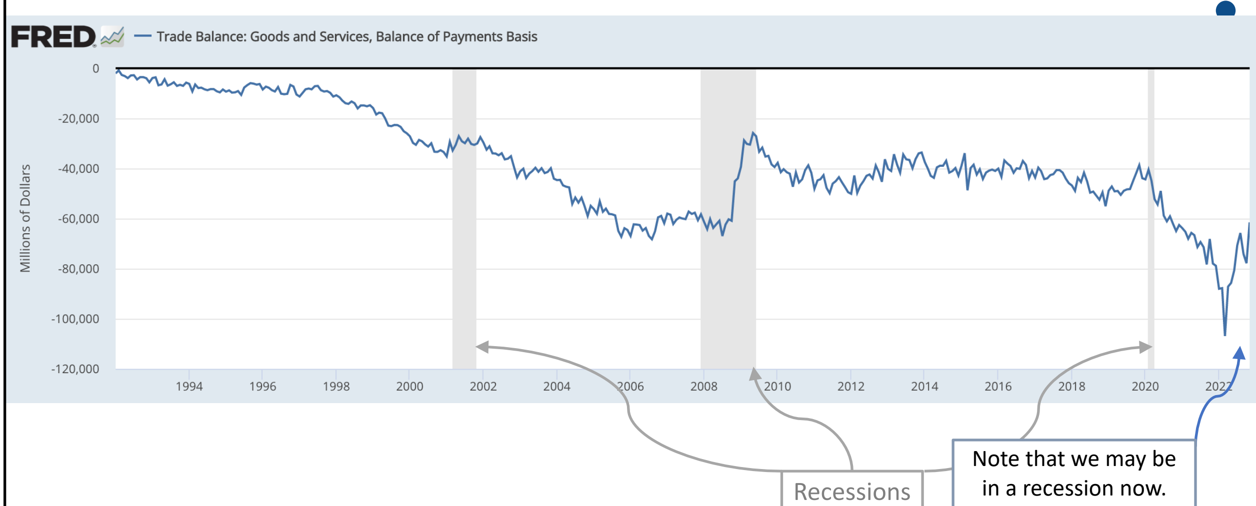
US Trade Balance: Goods and Services



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US Trade Deficit

- **The US trade deficit means that the US is spending more than its income. How much?**
  - $861 billion in 2021, according to the IMF
  - How does that compare to US GDP? GDP was $23 trillion.
  - So US trade deficit was about 3.7% of US GDP
  - Collectively, we and our government are spending almost 4% above our income.
  - How does that compare to other countries?

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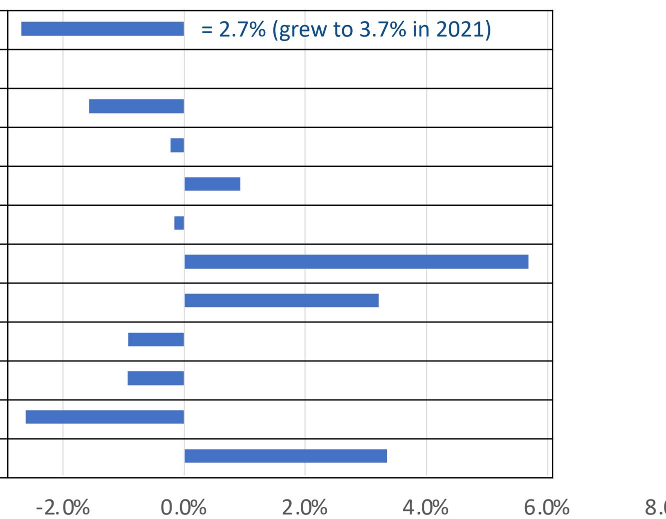
Trade Balance / GDP of US and It's Top Ten Trading Partners, 2019

	Trade w US
US	= 2.7% (grew to 3.7% in 2021)
	$ billions
Canada	619.0
Mexico	617.7
China	579.1
Japan	221.6
Germany	189.7
S. Korea	136.8
UK	133.2
France	97.2
India	94.3
Italy	82.5



Source:
IMF
International Financial Statistics

Trade balance includes goods and services

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Trade Balance / GDP
Sample countries, 2019

Singapore	36.9 %
Ireland	12.4%
Switzerland	9.8%
Germany	5.7%
China	0.9%
Japan	–0.2%
US	–2.7%
Romania	–4.1%
Ukraine	–8.1%
Philippines	–9.6%
Haiti	–24.5%
Guyana	–62.2%

Source:
IMF
International Financial Statistics

Trade balance includes goods and services

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US Trade Deficit

- **Is it a problem?**
  - Yes, if others are unwilling to lend to us or to hold our assets (& our money)
  - But US, at least for now, has both a strong currency and a strong economy
    - Others trust assets in the US more than others
    - They also rely on US dollars for transactions and reserves
    - We have an "Exorbitant Privilege" because of the US dollar's role in the world economy (said by Valery Giscard d'Estaing in the 1960s) when most currencies were pegged to dollars, but still valid today)

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US Trade Deficit

- **Is it a problem?**
  - It does mean that US net debt to foreigners grows every year.
  - What if other countries decide to dump their dollar assets? Their value would plummet and they would lose. (But runs on currencies, like runs on banks, do happen.)
  - US net international investment position recently reached –$18 trillion!

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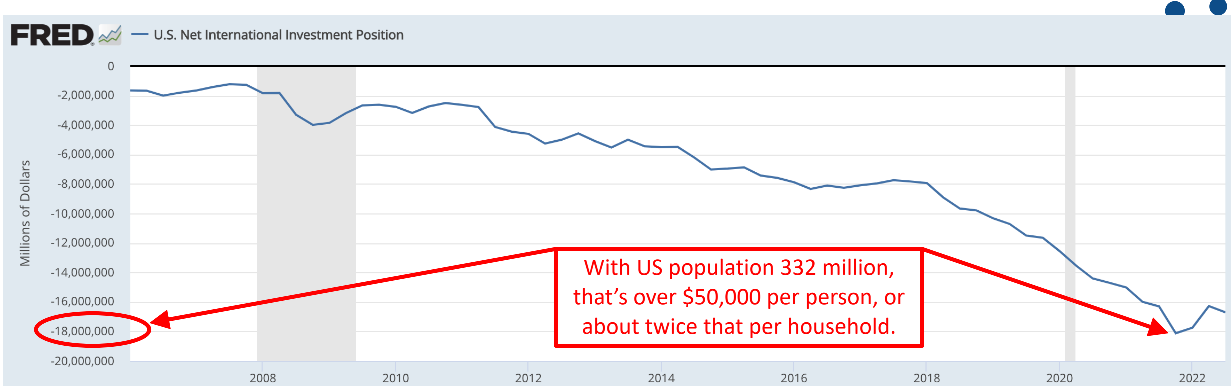
US Net International Investment Position



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US Trade Deficit

- **Is it a problem?**
  - Yes, in my view, but <u>not</u> because it might hurt us. Because it takes advantage of others.
  - The US, one of the richest countries in the world, is
    - Spending more than its income
    - Being funded, in part, by much poorer countries
  - We are enjoying
    - More goods and services than we produce
    - Produced by often lower-wage and poorer workers abroad
    - Without, at least in the foreseeable future, paying for them
  - That just feels wrong to me,
    - Especially if others are financing us not by choice but because they have no other option.

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US Trade Deficit

- **Could an increase in the trade deficit ever hurt us?**
  - Yes, if we are in a recession.
  - Then by demanding foreign goods and services instead of our own, we support jobs abroad instead of at home
  - That is when using trade policy and/or exchange-rate policy to promote demand and higher employment at home seems to make sense.
    - But it helps us only at the expense of others, if they are also in recession
    - And it is likely to cause retaliation, cancelling all or more than any benefit

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Trade Deficits and Exchange Rates

- **Do exchange rates matter for trade deficits?**
  - Yes.
  - If your currency falls in value, it makes
    - Exports cheaper
    - Imports more expensive
    - Lowers real income and therefore expenditure
    - Result: Trade balance ”improves”
      - Deficit shrinks, or
      - Surplus grows
  - Example of the opposite, dollar appreciation: Volker policy in 1980-81
    - Raised US interest rates
      - ↳ Attracted capital from abroad
        - ↳Caused the US dollar to rise in value by about 50%
          - ↳Hurt US exports, helped imports, and increased the US trade deficit

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Pause

- **Pause for**
  - Questions
  - 5-Minute Break
- **Next: Exchange Rates**

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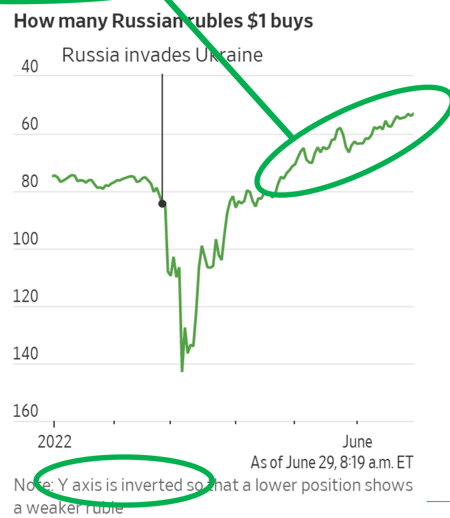
Exchange Rates

- **What they are**
  - The price of one currency in terms of another
  - Thus, for example
    - The number of dollars you pay for one euro: $/€
    - Or, the number or euros you'll get for one dollar: €/$
  - Rates reported in data are from transactions between major banks
  - Rates you see in banks, stores, and currency exchanges will be worse for you
    - To cover cost and make profit for them

Exchange Rates Can Be Confusing

- **Confusing in how they are reported**
  - Hard to know what is up and what is down
    - i.e., "The Japanese yen rose today from 152 to 144" (10/21/22)
    - Makes sense because the numbers are understood to be ¥/$, not $/¥, so the change from 152 to 144 is in fact a rise in the value of the yen
  - Yen is reported that way because alternative would be
    - "The Japanese yen rose today from $0.0066 to $0.0069"
  - For currencies worth much less than $1, scales often show currency/$
    - Graphs of rates over time may be drawn on an "inverted scale"
    - Or alternatively, "strength" may appear as a drop on the graph

Russia's Surprising Economic Headache: A Strong Ruble



Wall Street Journal
June 29, 2022

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Russia's rouble is now stronger than before the war

Rouble v US dollar

Trading View

The Conversation
June 13, 2022

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Exchange Rates Can Be Confusing

- **Confusing in the names for currencies**
  - Different names or spellings for the same currency
    - Russia: ruble vs. rouble (see above)
    - China: yuan vs. renminbi
    - UK: pound vs. sterling
  - Different countries with the same-named currency
    - Dollar: Australia, Canada, Hong Kong, US, …
    - Peso: Argentina, Chile, Colombia, Mexico
    - Pound: Egypt, Lebanon, UK
  - Different-named currencies use the same symbol
    - ￥: Japan's yen, China's yuan

What Determines Exchange Rates

- **Exchange rates are determined in markets**
- **Thus they respond to changes in demand and supply**

What Determines Exchange Rates

- **Main sources of <u>demand</u> for our country's currency**

  Increases that cause our currency to rise (or "appreciate"):
  - Exports, i.e., foreign purchases of our
    - Goods
    - Services
  - "Capital inflows," i.e., foreign purchases of our
    - Stocks
    - Bonds
    - Currency

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What Determines Exchange Rates

- **Main sources of <u>supply</u> of our country's currency**

  Increases that cause our currency to fall (or "depreciate"):
  - Imports, i.e., our purchases of foreign
    - Goods
    - Services
  - "Capital outflows," i.e., our purchases of foreign
    - Stocks
    - Bonds
    - Currencies

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What Determines Exchange Rates

- **So changes that cause our currency, the $, to rise in value:**
  - More US exports and/or less US imports
  - Rise in US interest rates and or fall in foreign interest rates
  - New expectation that dollar will rise
    - Causes wealth holders to buy more $ assets
  - Other central banks choose to hold more $ in reserves
- **Opposites of above cause the $ to fall**

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What Determines Exchange Rates

- **Historic Roles of Governments and Central Banks**
  - Define the value of currency in terms of gold or silver
    - The Gold Standard of the 19th and early 20th century
  - Intervene in markets to "peg" their currency to another
    - The Dollar Standard of 1945-1973
      - Most currencies were pegged to the US $
      - Other central Banks bought and sold dollars to achieve this.
  - Let major currencies "float" since 1973
    - Many weaker countries still intervene in markets, buying or selling to
      - Peg to another currency
      - Reduce currency fluctuations
    - A few intervene in markets to "manipulate" their currencies
      - Reduce their value to encourage exports

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How Have Exchange Rates Changed

- **We'll look at**
  - US dollar
  - France, Germany, Italy, and Euro Area's euro
  - Canadian dollar
  - Mexican peso
  - British pound
  - Japanese yen
  - Chinese renminbi

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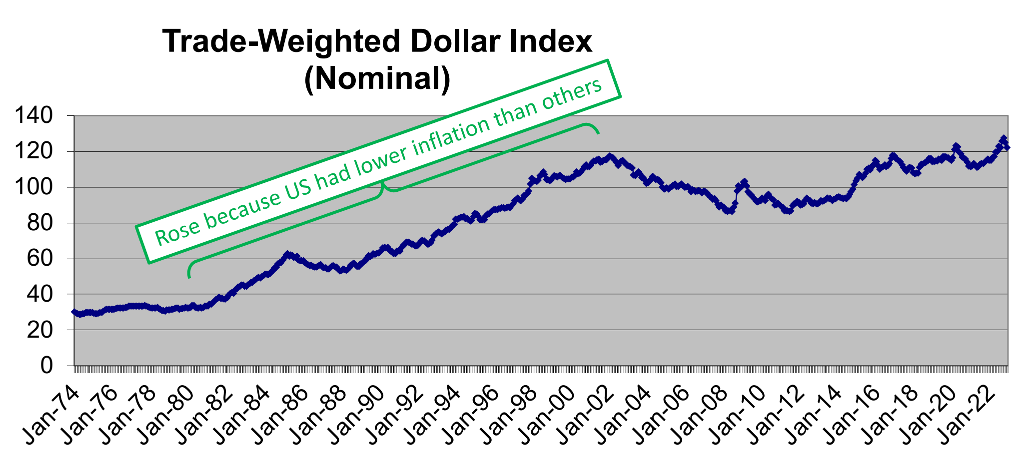
US Exchange Rate



Source: Federal Reserve

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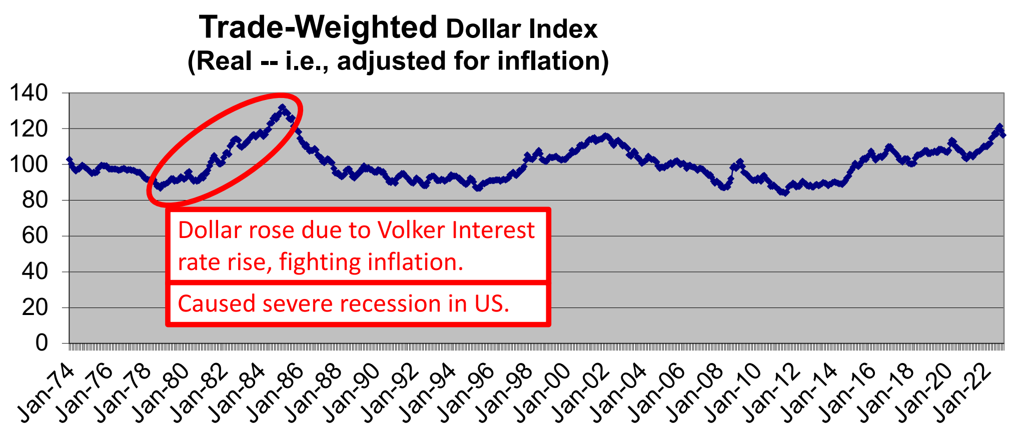
US Exchange Rate



Source: Federal Reserve

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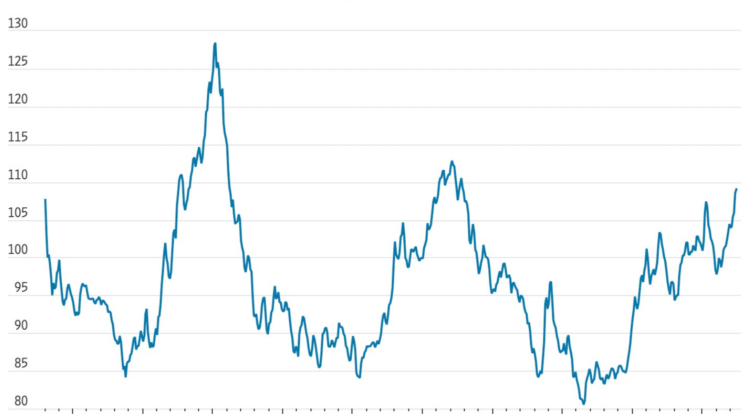
US Exchange Rate

A True Strong Dollar Policy

Inflation-adjusted index of dollar value, trade-weighted



Note: Monthly data. Based on trade in goods until 2020, then goods and services.
Source: Federal Reserve via Refinitiv

Source: WSJ, 7/11/22

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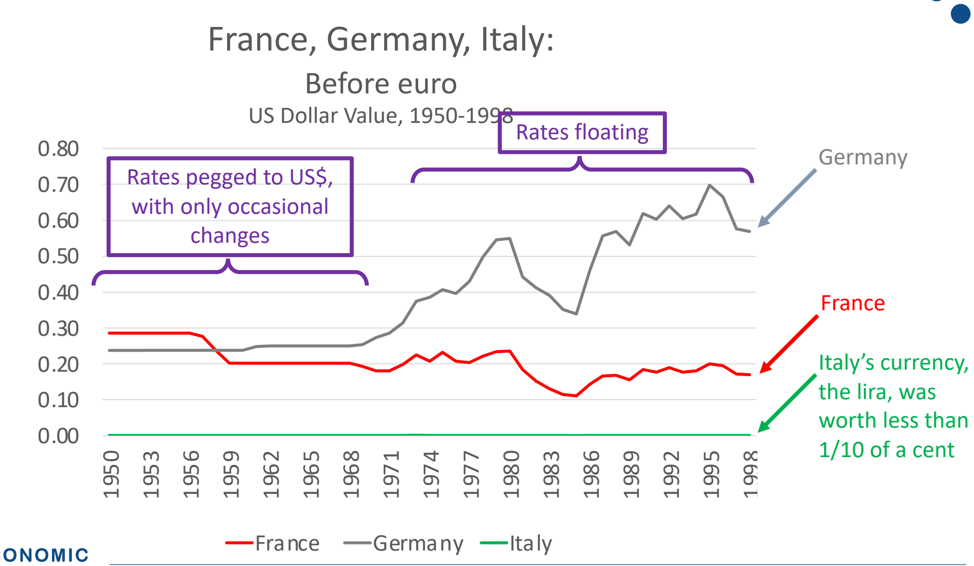
Dollar Value of Other Currencies



Source:
IMF
International Financial Statistics

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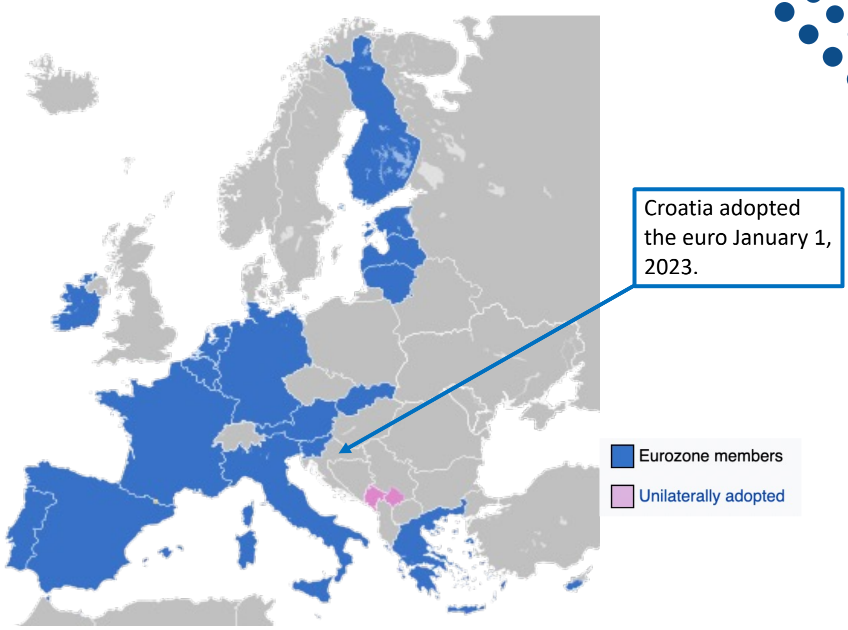
Euro Area



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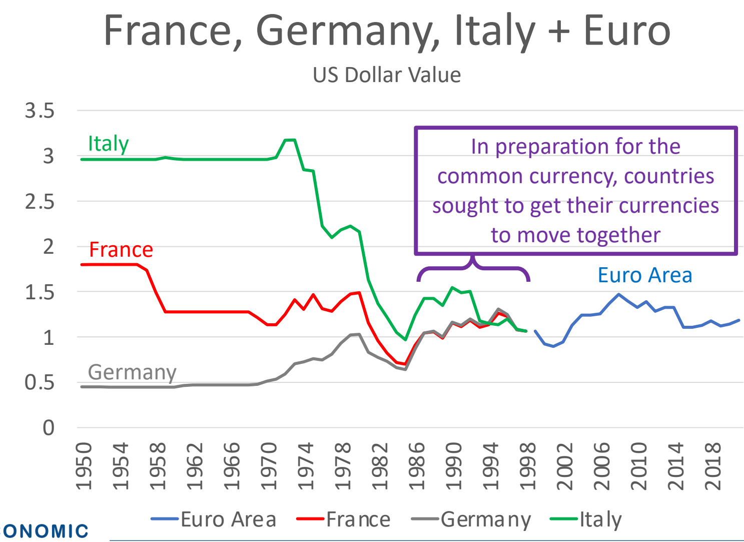
Dollar Value of Other Currencies

Rates here are scaled up to match value of euro in 1998.



Source: IMF *International Financial Statistics*

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Dollar Value of Other Currencies

Euro Falls to Equal the U.S. Dollar for the First Time in 20 Years

The New York Times
July 14, 2022

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Dollar Value of Other Currencies

Euro

X-rates.com
Jan 15, 2023

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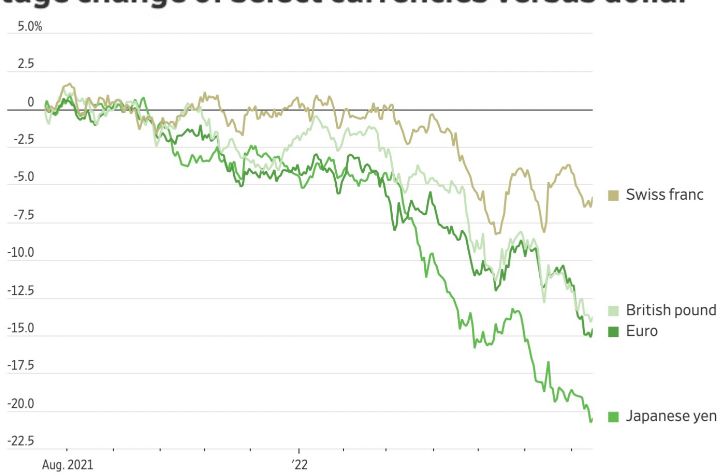
Dollar Value of Other Currencies

Percentage change of select currencies versus dollar

THE WALL STREET JOURNAL.
July 18, 2022



Source: Tullett Prebon

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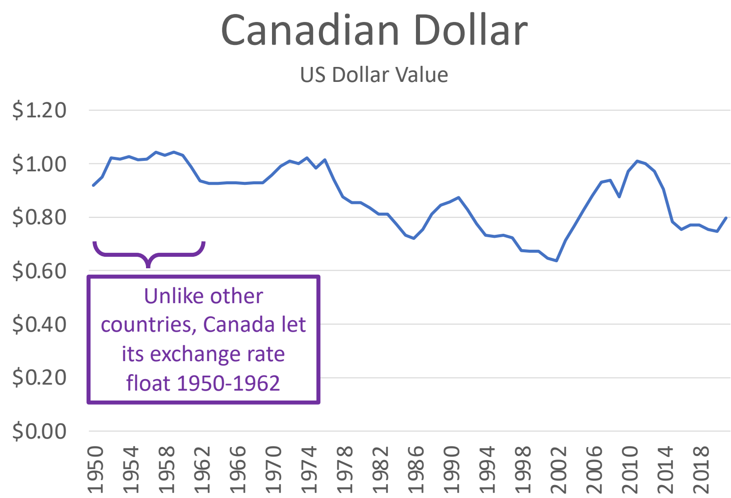
Dollar Value of Other Currencies



Source: IMF *International Financial Statistics*

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Dollar Value of Other Currencies

Canadian dollar

X-rates.com
Jan 15, 2023

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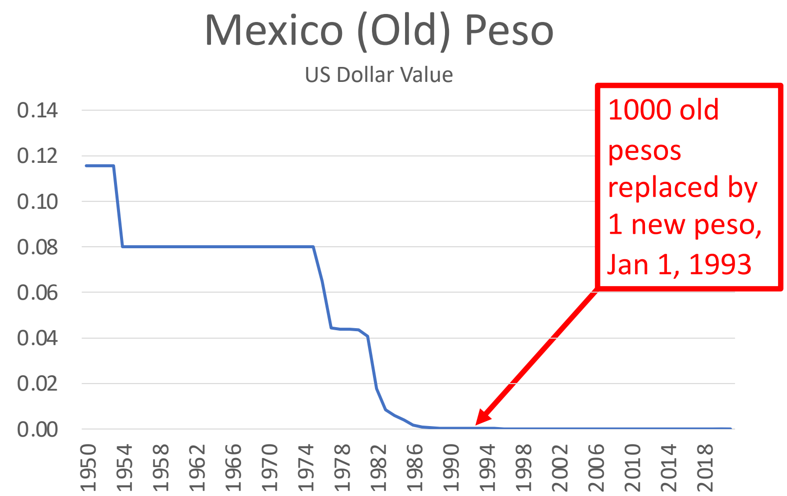
Dollar Value of Other Currencies



Source:
IMF
International Financial Statistics

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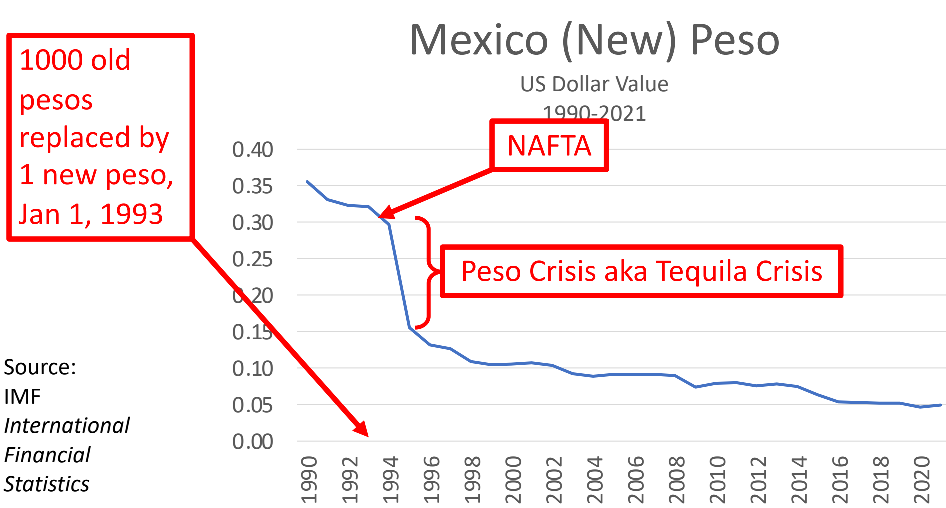
Dollar Value of Other Currencies



Source:
IMF
International Financial Statistics

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Dollar Value of Other Currencies

Mexican peso

X-rates.com
Jan 15, 2023

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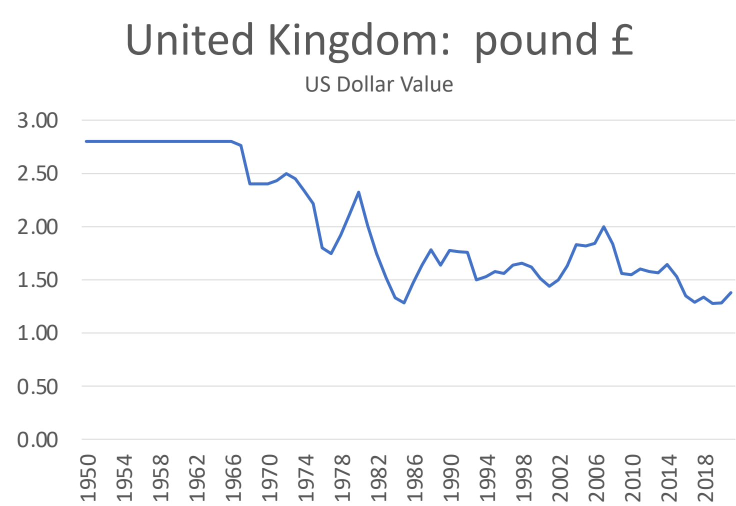
Dollar Value of Other Currencies



Source:
IMF
International Financial Statistics

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Dollar Value of Other Currencies

UK
pound

X-rates.com
Jan 15, 2023

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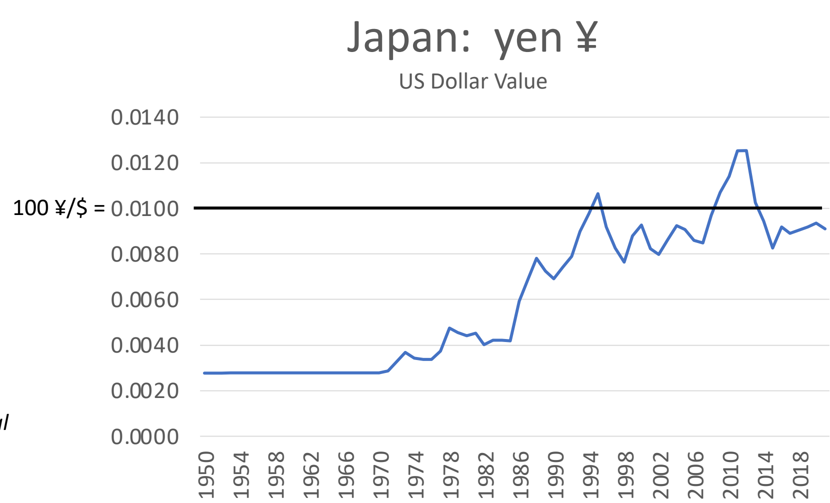
Dollar Value of Other Currencies



Source:
IMF
International Financial Statistics

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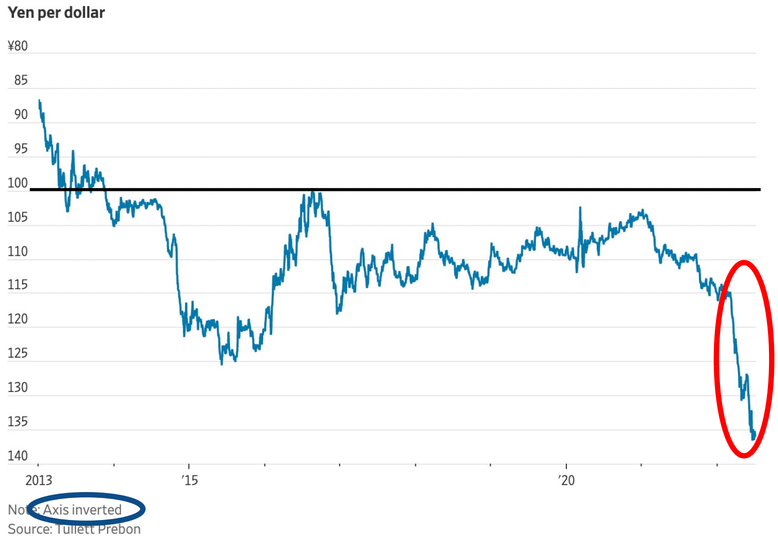
Dollar Value of Other Currencies



Recent drop since March 1, 2022

Source: WSJ, 7/11/22

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Dollar Value of Other Currencies

Japanese yen

X-rates.com
Jan 115, 2023

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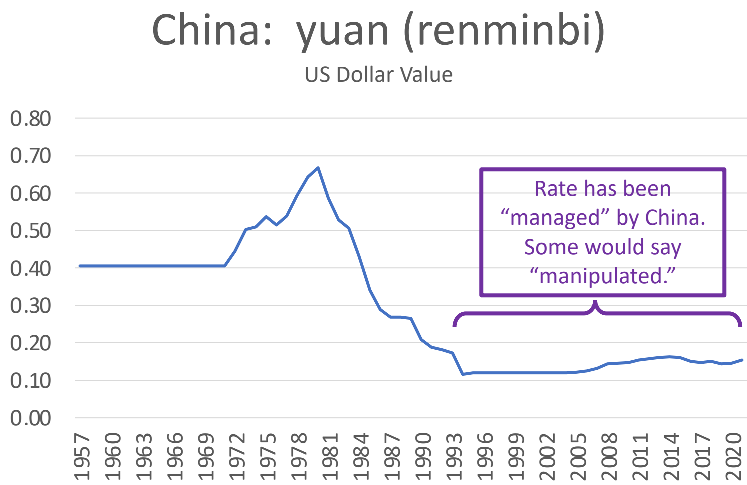
Dollar Value of Other Currencies



Source:
IMF
International Financial Statistics

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Dollar Value of Other Currencies

Chinese yuan

X-rates.com
Jan 15, 2023

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How Exchange Rates Matter

- **Effects of an exchange rate depreciation**
    - (fall in value of the country's currency)
  - Trade
    - Exports become less expensive and quantity likely rises
    - Imports become more expensive and quantity likely falls
    - Trade balance likely improves (surplus ↗ or deficit ↘)
  - Macroeconomic
    - Raises domestic prices of imports and thus inflation
    - If at full employment, real income falls, causing less spending
    - If in recession, increased demand for products increases employment

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How Exchange Rates Matter

- **More effects of an exchange rate depreciation**
    - (fall in value of the country's currency)
  - Domestic value of foreign assets and debts rises
    - Net creditors gain, net debtors lose
      - Effect on interest/dividend payments is opposite
    - Those who have borrowed abroad to finance investment at home lose
      - May go bankrupt
- **Effects of expectation of exchange rate depreciation**
  - Holders of assets in domestic currency try to sell and move abroad
    - ↳ This speculative attack causes greater depreciation
  - Example from 1997 Asian Crisis

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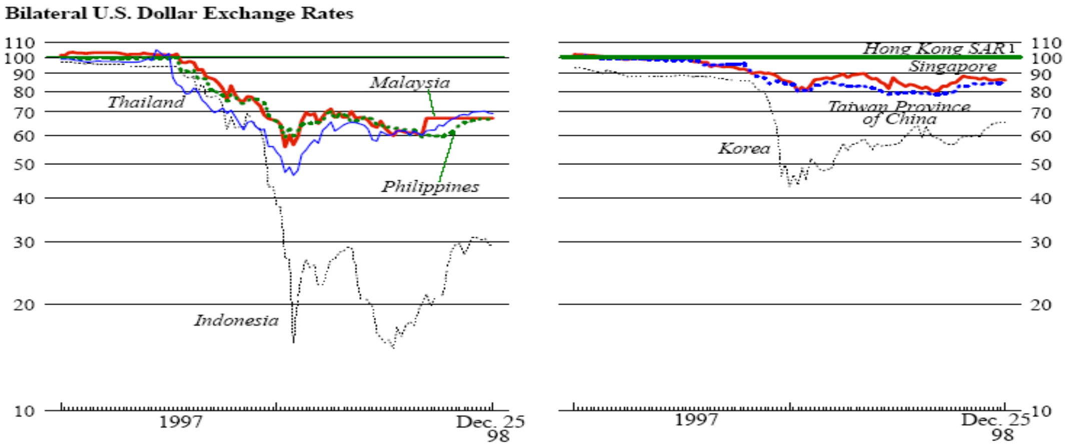
The Asian Crisis of 1997



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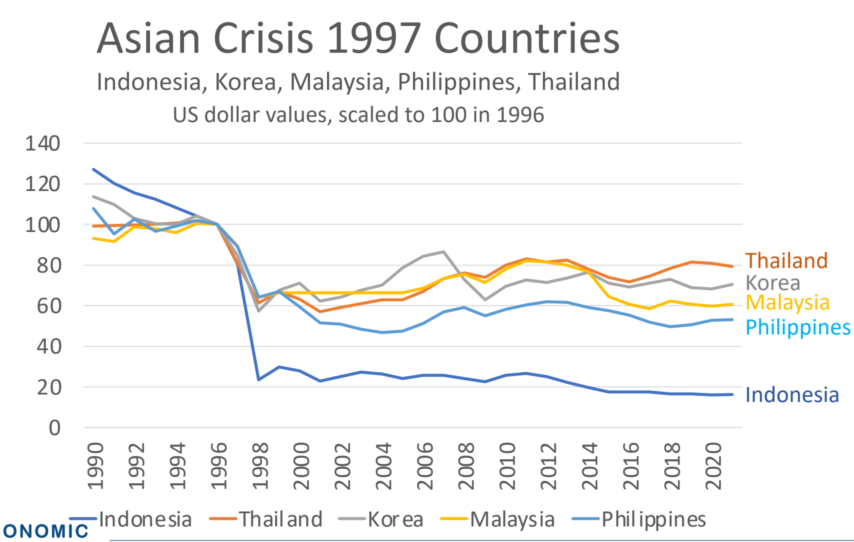
The Asian Crisis of 1997



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Currency Manipulation

- **Currency Manipulation**
  - Defined as
    - Intervention in the exchange market by Central Bank or Government
    - In order to push down, or keep down, the value of the currency
  - Presumed purposes: To…
    - Increase exports
    - “Gain unfair advantage” in international trade and competitiveness
    - Stimulate the domestic economy
    - Accumulate foreign assets

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Currency Manipulation

- **US Official Definition of Currency Manipulation**
  - US Treasury issues report on currency manipulation twice each year
  - Criteria for manipulation
    1. Persistent net official purchases of foreign currency
       (more than 2 percent of GDP)
    2. A material trade (current account) surplus
       (more than 2 percent of GDP)
    3. A significant bilateral trade surplus with the United States
       (more than $20 billion per year)

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Currency Manipulation

- **US Treasury Report June 10, 2022**
  - "No major U.S. trading partner during 2021 manipulated the rate of exchange between its currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade."
  - "Switzerland meets all three criteria … over the four quarters through December 2021, and therefore Treasury is conducting enhanced analysis of Switzerland's macroeconomic and exchange rate policies in this Report.
  - 12 economies are on "Monitoring List": China, Japan, Korea, Germany, Italy, India, Malaysia, Singapore, Thailand, Taiwan, Vietnam, and Mexico
- **Look at data for two: Switzerland and China**

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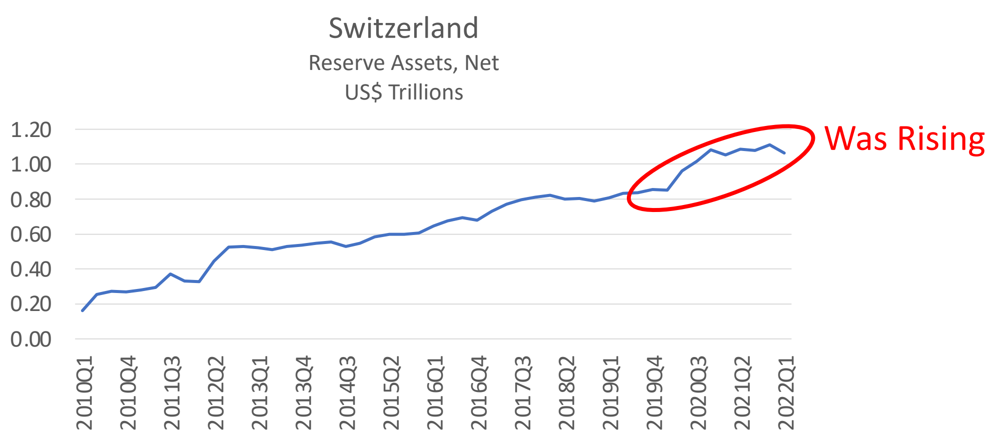
Currency Manipulation

Manipulation Criteria: Net Official Purchases of Foreign Currency (Reserves)



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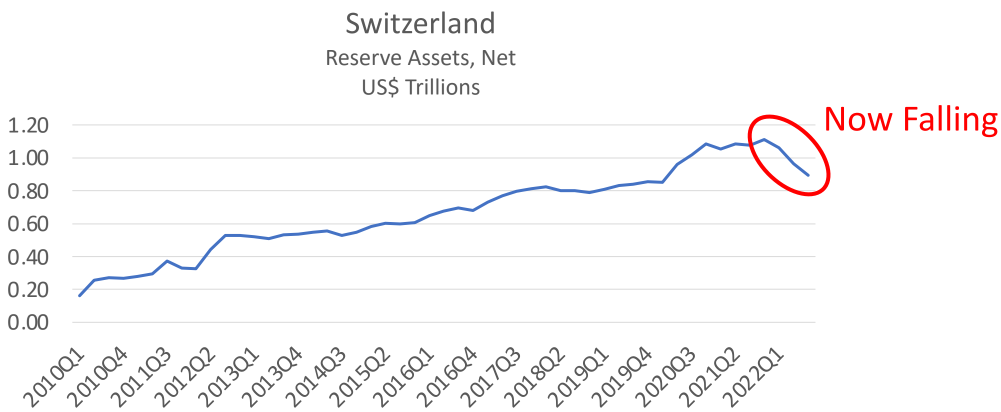
Currency Manipulation

Manipulation Criteria: Net Official Purchases of Foreign Currency (Reserves)



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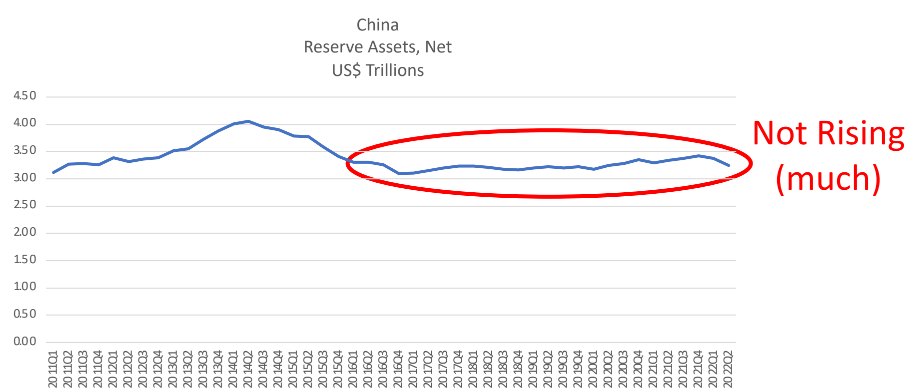
Currency Manipulation

Manipulation Criteria: Net Official Purchases of Foreign Currency (Reserves)



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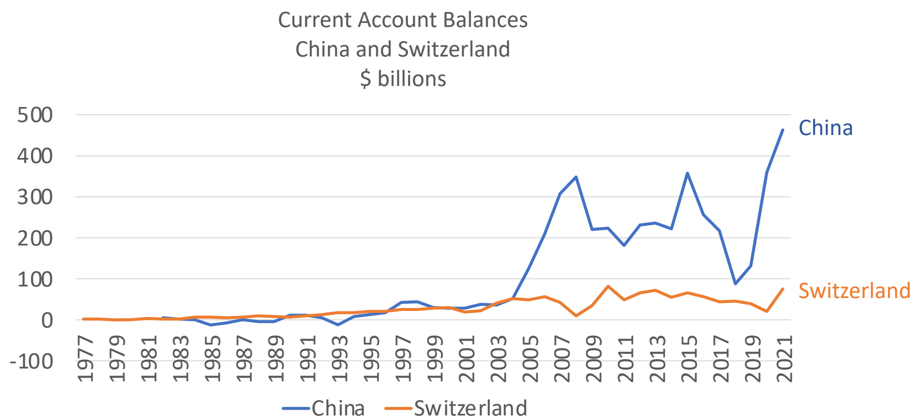
Currency Manipulation

Manipulation Criteria: Current Account Surpluses



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Currency Manipulation

Manipulation Criteria: US Bilateral Deficits

US Bilateral Trade Deficits larger than $20 billion	
China	-923.2
Mexico	-365.8
Japan	-236.5
Germany	-104.9
Vietnam	-70.1
Ireland	-58.8
Italy	-58.5
Canada	-53.0
Malaysia	-33.7
Switzerland	-33.3
India	-28.4
Korea, Rep.	-25.5
Thailand	-24.7

US Bilateral Trade Surpluses larger than $20 billion	
Netherlands	20.3
Hong Kong, China	25.9

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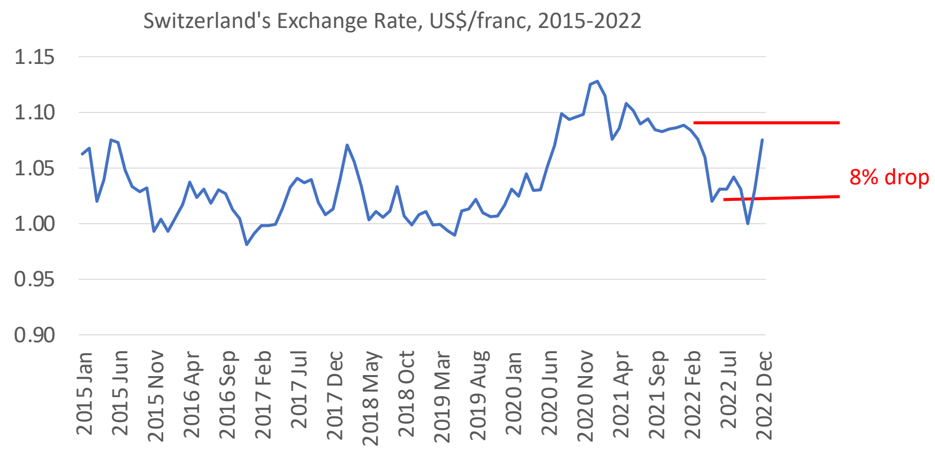
Currency Manipulation

Not Manipulation Criteria:
Exchange Rates



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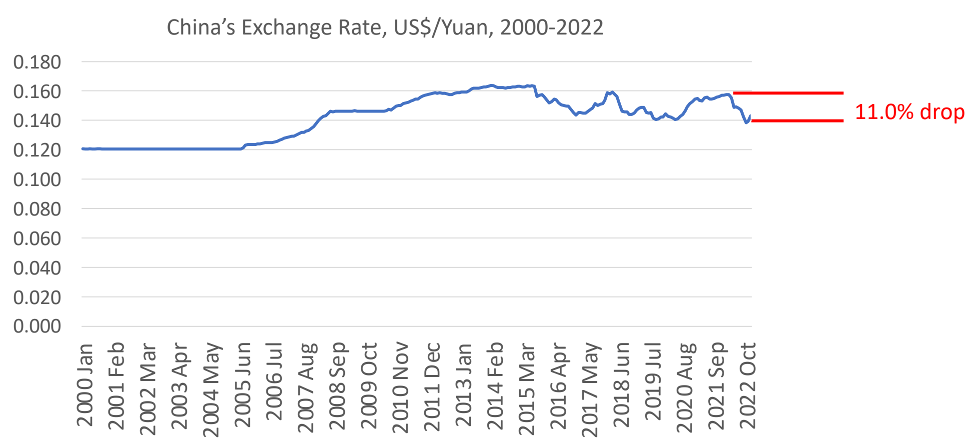
Currency Manipulation

Not Manipulation Criteria:
Exchange Rates



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Currency Manipulation

- **US Treasury Report November, 2022**
  - "[The U.S.] Treasury has concluded that no major trading partner of the United States engaged in [currency manipulation] during the relevant period."
  - "Switzerland once again exceeded the thresholds for all three criteria..."
  - "Italy, India, Mexico, Thailand, and Vietnam have been removed from the Monitoring List in this Report, having met only one out of three criteria for two consecutive Reports.."
  - "In this Report, the Monitoring List comprises China, Japan, Korea, Germany, Malaysia, Singapore, and Taiwan." (7 countries)
  - "China's failure to publish foreign exchange intervention and broader lack of transparency around key features of its exchange rate mechanism make it an outlier among major economies and warrants Treasury's close monitoring."

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Next Week

Economic Update

Jeoffrey Woglom
Amherst College

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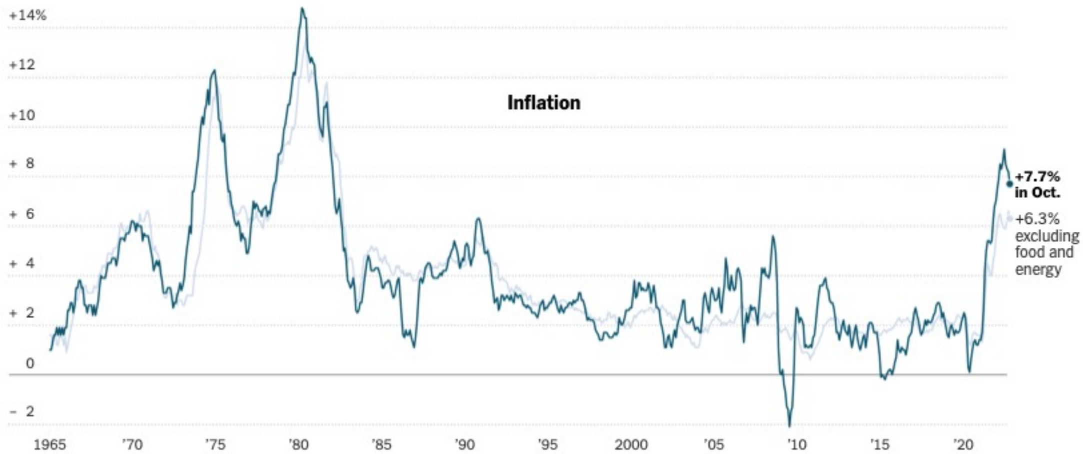
Economic Update



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Source: NYTimes.com

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Thank you!

Any Questions?

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