International Economics: Lecture 23

Intertemporal Approach to CAB

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Three approaches to Current Account Balance (CAB)

- *Elasticities approach*:

  How exchange rate must change for the CAB to improve.
- *Absorption approach*:

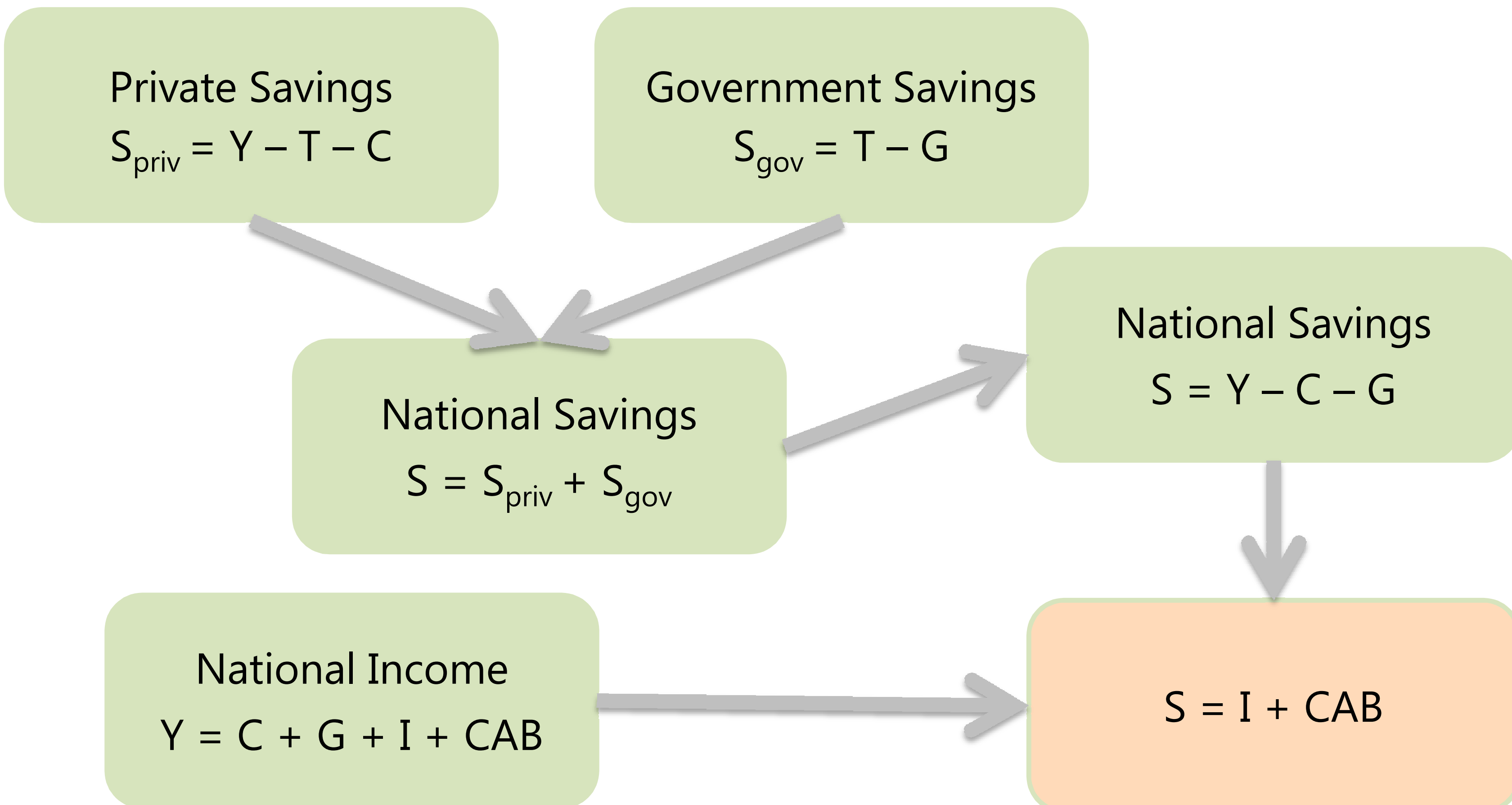
  How domestic spending must change relative to domestic income for the CAB to improve.
- *Intertemporal approach*:

  How domestic savings must change relative to domestic investments for the CAB to improve.

  - Investments and savings are intertemporal decisions, as an economic agent saves or invests if expects to be alive in the next period.
  - By saving one postpones current consumption, expecting to consume more later.
  - By investing one expects to produce and thus to consumer more later.

CAB = Investments – Savings

T = taxes. Y = national income. C = private consumption.
G - gov. expenditures



Goods market equilibrium

C^{pl} = planned consumption

I^{pl} = planned investments

S^{pl} = planned savings

- *Planned spending equals production*

  $Y = C^{pl} + I^{pl} + G + CAB$

- *Planned investments equal savings*

  $S^{pl} = I^{pl} + CAB$

$$CAB = S^{pl} - I^{pl}$$

CAB is the difference between desired savings and investments.

If investments exceed national savings, then current account is in deficit.

Small open economy and world real interest rate

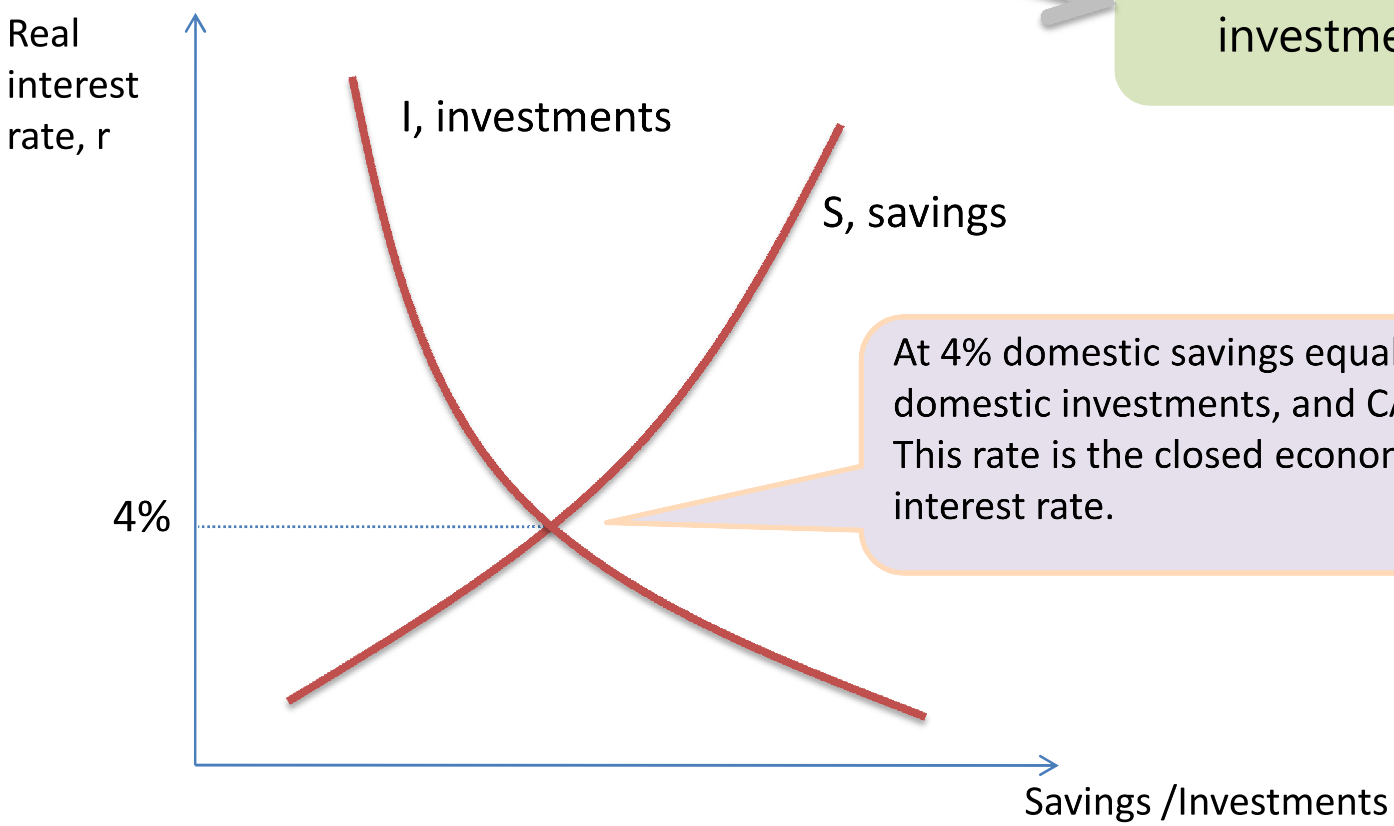
- *Small open economy* = an economy that is so small compared to world that has no effect on world prices, incomes or interest rates. The country is thus a price taker in world markets.
  The *economy is open* in the sense, that has perfect access to the international capital market.
- *World real interest rate* = the rate that prevails in the international capital market, where savings are being conveyed to those who wish to use it for investments.
  - Small open economy may borrow or lend in international capital markets as much as it wants.

Savings /Investments vs. Real interest rate

Higher real interest rate *leads to*

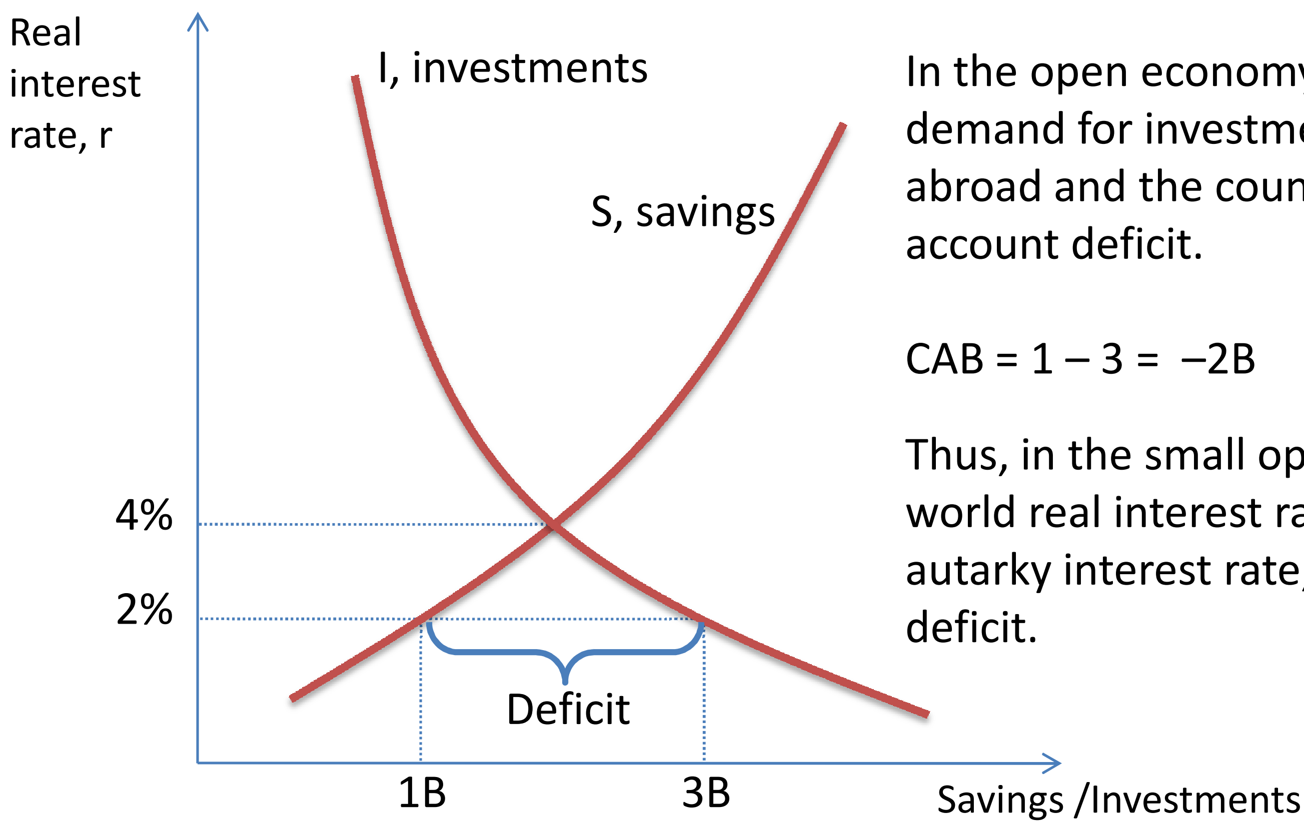
... higher level of savings

... lower level of investments



At 4% domestic savings equal domestic investments, and CAB = 0. This rate is the closed economy real interest rate.

$CAB = S^{pl} - I^{pl} < 0$: Deficit



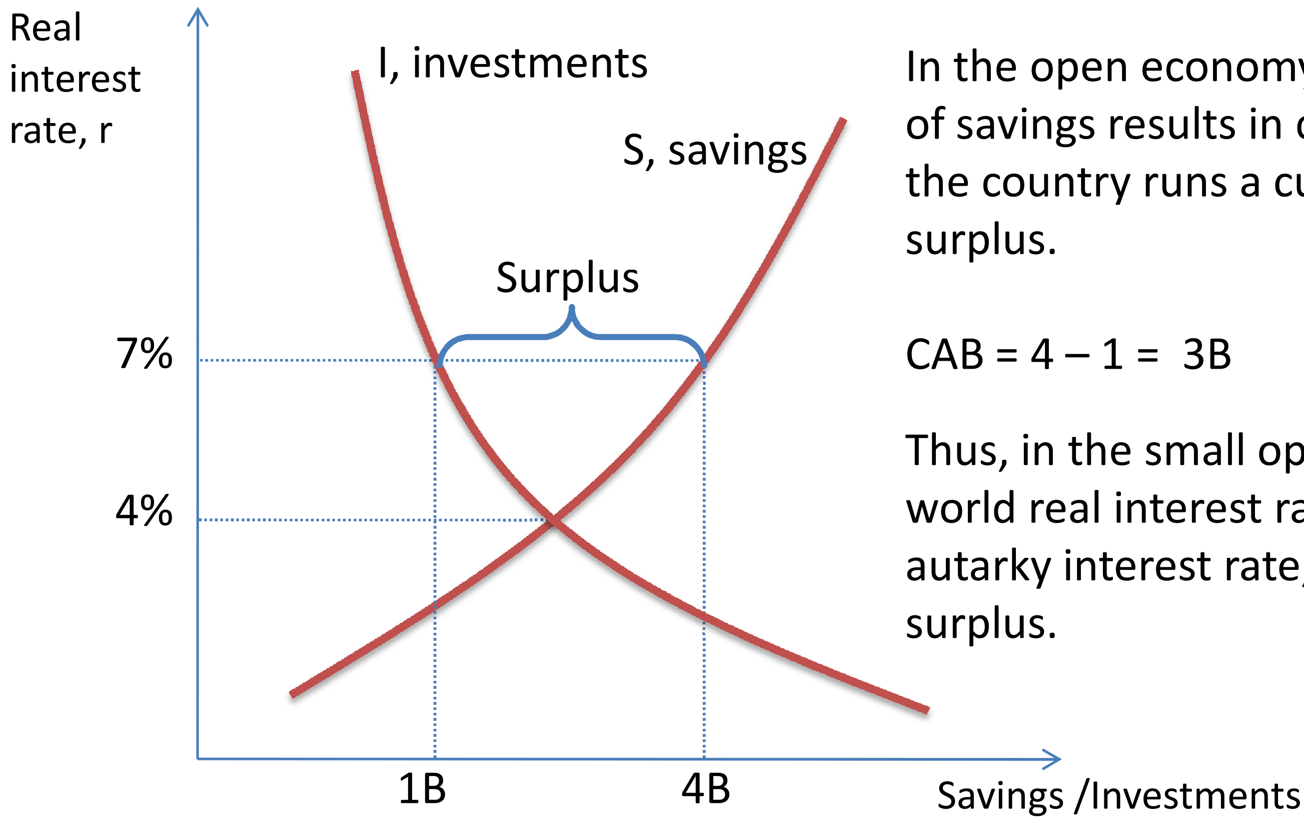
At 2% planned domestic investments exceed savings.

In the open economy the excess demand for investments is met from abroad and the country runs a current account deficit.

CAB = 1 – 3 = –2B

Thus, in the small open economy, when world real interest rate is below the autarky interest rate, the CAB is in deficit.

$CAB = S^{pl} - I^{pl} > 0$: Surplus



At 7% planned domestic savings exceed investments.

In the open economy the excess supply of savings results in capital outflow and the country runs a current account surplus.

CAB = 4 – 1 = 3B

Thus, in the small open economy, when world real interest rate is above the autarky interest rate, the CAB is in surplus.

The poorest 20% of Danes are more joyful than the richest Greeks.

Source: Economist