

ECO 209 Macroeconomic Theory and Policy

Case Study No. 4

Case Study No. 4 on ***Why Trade Deficits Matter*** will be discussed in class during the week of November 27. The required short-readings have been posted on the course website. Read these articles and come to class ready for the discussion. The following questions will help you in your preparation:

- 1) Why did Krugman consider in early 2006 that Americans were living beyond their means?
- 2) We have seen in class that private domestic savings can be used to finance domestic investment, government deficits, and net exports. Were U.S. private savings fully financing domestic investment plus the government deficit at that time?
- 3) What were foreign savings actually financing in the U.S. at that time? And at the present time?
- 4) What might have triggered the surge in U.S. consumption expenditure in the mid-2000s? How does this situation compare to U.S. consumption expenditure today?
- 5) Should a country always borrow from abroad to cover a balance of trade deficit?
- 6) Does the U.S. borrow from abroad to cover a deficit in the current account? Or does the U.S. have a deficit in the current account because it borrows too much from abroad?
- 7) Why did Krugman consider that the “borrowing binge” of the first half of the 2000s was unsustainable? Was he right in his predictions about the exchange rate and the housing market?
- 8) What did he mean by a “soft landing” of the economy? What policies should be implemented to cause a soft landing? What was, in his view, the most likely outcome? Was he right?
- 9) Regarding excessive external borrowing, what is more worrisome: government or private sector borrowing? Which one can default more easily: governments or the private sector? Can the U.S. or Canadian government default on their debt? And Greece or Argentina?

- 10) Is the U.S. trade deficit due to “bad” trade agreements (e.g., NAFTA) or “unfair” trading practices (e.g., China)? Would pulling out of NAFTA or slapping tariffs on Chinese goods reduce its trade deficit?
- 11) Did the trade deficit with Mexico and China cause the U.S. rate of unemployment to increase? What impact did it have on the U.S. labour market? What can be done to reduce the increasing anti-globalization sentiment?
- 12) Why isn't the U.S. a net exporter of capital like Germany or Japan? Why is it a net importer? Is international capital allocated according to where it's most needed?