**Keynesian policies in open economy - SHORT NOTES**

*The determination of aggregate demand and income in an open economy*

The Keynesian model (see Chapter 4 of the book/Springer) can be represented by the following equations:

*Y = C + I + G + E – M*

*C =Ca + cY*

 = 

*I = *

*G = *

*T = tY*

*E = *

*M = mY.*

The penultimate equation shows exports as exogenous data determined outside the model by foreign demand for our goods (this may depend on the real exchange rate or the growth of the world economy). The last equation shows imports as a function of actual demand, in the sense that when demand increases, demand increases not only for domestic goods but also for goods produced abroad. The increase in imports will concern for example energy products and raw materials, which are necessary to increase production, but also consumer goods.

The equation that determines aggregate demand and national income is:



*The foreign trade multiplier*

Consider the following, now known, equations:

*M = mY* (A)

*E = E\** (B)

They suggest that imports are a function of national income, while exports are an exogenous figure that depends, e.g., on world demand (i.e. other countries' income). The former are therefore controllable by the economic policy authorities, while the latter are not, or are more limited.[[1]](#footnote-1) In the long term the trade balance must be balanced, therefore*: M = E\*.* From which we *get: mY = E\*,* and finally

,

which is known as *foreign trade multiplier*.

It suggests that the level of income compatible with the balance of trade depends on the level of exports and the marginal propensity to import. It shows how an open economy is subject to foreign constraints. Domestic expansion determined, for example, by an increase in public expenditure leads to a growth in imports, given the level of exports *E*. If the trade balance was balanced, it will now get worse. This is why there is often talk - or was talk in Keynesian times - of the need for expansionary policies coordinated between countries. Only if the various countries linked by strong trade links - for example the countries of the European Union - expand aggregate demand and production at the same time, will both imports, which constitute exports for the partners, and exports, which constitute imports from other countries, increase in each country. If, on the other hand, a single country alone expands its economy, its trade balance will soon go into deficit and it will not be able to maintain its growth policies in the long term. Francois Mitterrand's French socialist government in the early 1980s, for example, came across this experience. After only a few months of expansionary policy, the French trade balance went into deficit because Germany was not interested in expanding its economy and Mitterrand had to return to more restrictive economic policies (see Chapter 5 of the book/Springer).

Equations A and B are represented in figure 1. It shows how, if a country expands its income from Y1 to Y2, imports increase from M1 to M2. Then imports from other countries should increase from E1 to E2, in order to rebalance the trade balance. However, this depends on the adoption of expansionary policies by trading partners.

If these countries do not want to expand their economies, a country that wants to pursue Keynesian policies could adopt alternative measures such as import control. With this measure, imports are stopped at the M1 equilibrium level, compatible with the given level of exports E1. In this way, it should be noted that the other countries are not affected as they continue to export M1. The country can thus expand to Y2 without incurring a trade deficit (it moves from point A to point C instead of point B).[[2]](#footnote-2) However, this type of policy is now badly seen, discouraged or even banned by bodies such as the EU or the WTO.

Alternatively, a country can finance current account imbalances by borrowing abroad. This cannot last too long, however. In addition, debts and interest must be paid, so at some point the country will have to make current account surpluses to pay off its external debt.

##### Finally, a country may resort to a devaluation of its currency to stimulate an adequate volume of exports (and make imports more expensive). This road also has its flaws because (i) other countries could adopt the same strategy - and therefore the game becomes zero sum - and because, even if this does not happen, (ii) the higher cost of imports creates inflation and distributive conflict. In fact, who has to pay the higher cost of imported goods?

1. Indeed, economic policy can influence exports through changes in the exchange rate, in the short term, and through industrial and innovation policies, in the long term. [↑](#footnote-ref-1)
2. The control of imports will be selective in the sense that some imported goods will be needed to increase production, such as oil, raw materials, industrial machinery, etc.. It will then tend to reduce the import of certain goods, such as luxury cars, etc., to make room for more indispensable goods. [↑](#footnote-ref-2)