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Economic Expansion and the Balance of Trade: The Role of Aggregate Demand Elasticity

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Economic Expansion and the Balance of Trade: The Role of Aggregate Demand Elasticity

Abstract
This paper investigates the role of aggregate demand elasticity for the balance of trade when economic expansion occurs. Our conclusions are two. First, when an economic expansion results from an increase of aggregate demand, the balance of trade deficit is larger the less elastic is aggregate demand with respect to the general price level. Second, when an economic expansion happens from an increase of short-run aggregate supply, the price level elasticity of aggregate demand determines both the direction of change of the balance of trade and the size of the resulting deficit or surplus. We show here that a relatively elastic aggregate demand can result in a balance of trade deficit while a relatively inelastic aggregate demand can yield a balance of trade surplus.

Keywords
Balance of trade, aggregate demand, aggregate supply, price level elasticity

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Abstract

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JEL Codes: F10, F41, A20

I. Introduction

The United States has incurred a deficit in its balance of trade for each year since 1976. Moreover, for the time period from 1991 to 2005, this deficit was generally increasing, both absolutely and as a percentage of gross domestic product.¹ Explanations of this particular trend are numerous and varied and include increasing income in the United States, decreasing foreign demand, increasing trade deficits with China, large trade deficits with oil exporting nations, increasing oil prices, a decrease of the private saving rate in the United States, large and increasing US federal government budget deficits, increasing American productivity growth, increased purchases of US assets by foreigners, and improvements of global financial intermediation.²

The price level elasticity of aggregate demand is a concept which has been overlooked in both macroeconomic textbooks³ and the research literature⁴ but is a relevant influence for the balance of trade and changes in the size of the trade deficit or surplus. Specifically, for any exogenous change of aggregate demand or short-run aggregate supply, the resulting changes of real gross domestic product, the price level and, therefore, the balance of trade are affected by aggregate demand elasticity. The purpose of this paper is to demonstrate, with a graphical analysis, the implications of the price level elasticity of aggregate demand for the balance of trade when an economic expansion occurs.⁵

The paper proceeds as follows. Section II presents the analysis. We examine the role of aggregate demand price level elasticity for the balance of trade when an economic expansion happens as a result of either an increase of aggregate demand or an increase of short-run aggregate supply. Section III concludes the paper with a brief summary of the results.

II. The Analysis

The analysis in this paper is based on a number of standard assumptions. First, we assume that the aggregate demand for final goods and services depends negatively on the price level. This

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A. An Increase of Aggregate Demand

An economic expansion or increase of real gross domestic product may obtain of course because of either an increase of aggregate demand or an increase of short-run aggregate supply. In Figure 1 we examine the influence of aggregate demand elasticity on the balance of trade when an economic expansion occurs as the result of an increase of aggregate demand. This aggregate demand increase may arise from decreased saving or a federal government budget deficit, factors cited for the large and increasing trade imbalances of the United States. Panel A of Figure 1 shows the standard aggregate demand, short-run aggregate supply model expanded to include two aggregate demand curves of different price level elasticities. Because these two curves pass through the same point, the flatter represents the greater elasticity and is labeled $AD^{EL}$ while the steeper and more inelastic aggregate demand is $AD^{DN}$. An original short-run aggregate supply curve is constructed to intersect both aggregate demand curves at $E_0$ and establish the initial equilibrium price and real gross domestic product levels, $P_0$ and $Q_0$, respectively.

Panel B of Figure 1 shows the balance of trade or net exports $X_N$ as a negative function of real gross domestic product since total exports are normally assumed exogenous while total imports are endogenous and depend positively on real income. With the economy in equilibrium at $Q_0$, we assume for simplicity that the balance of trade is zero at $E_0$. Now assume that a positive aggregate demand shock occurs and shifts both aggregate demand curves horizontally by the distance $E_0X$.

When short-run aggregate supply is positively sloped, an increase of aggregate demand increases the price level and real gross domestic product, both of which cause the balance of trade to move into deficit. In other words, the direction of change of the balance of trade is known. However, as shown in Figure 1, the increases of the price level and real income and therefore the size of the balance of trade deficit depend crucially on the price level elasticity of aggregate demand. Specifically, when aggregate demand is elastic, the increase in real gross domestic product, from $Q_0$ to $Q_1$, causes by itself a trade deficit of $Q_1A$. In addition, the small increase of the price level, from $P_0$ to $P_1$, shifts the net export function downward by the relatively small amount, say, $AE_1'$, such that the total balance of trade deficit is $Q_1E_1'$. By contrast, when aggregate demand is inelastic, the changes of both real gross domestic product and the price level are larger with
FIGURE 1. Panels A and B
FIGURE 2. Panels A and B

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a resulting larger deficit in the balance of trade. In this case, the increase of real GDP from $Q_0$ to $Q_2$ increases the trade deficit to $Q_2B$, and the larger increase of the price level, from $P_0$ to $P_2$, shifts the net exports function downward by a greater amount than before, or the distance $BE_2'$, given the assumption of equal net export elasticity with respect to the general price level, and the total trade deficit is given as $Q_2E_2'$. The conclusion for an economic expansion caused by increased aggregate demand is unambiguous: the balance of trade deficit is larger the less elastic is aggregate demand with respect to the general price level.

**B. An Increase of Aggregate Supply**

We now consider the significance of aggregate demand elasticity for the balance of trade when an economic expansion results from an increase of aggregate supply. This increase of aggregate supply might be caused, for example, by increased productivity growth, another factor cited for the large trade imbalances of the United States from 1991 to 2005. Panel A of Figure 2 again shows the standard aggregate demand, aggregate supply model expanded with two aggregate demand curves of different elasticities, labeled as before. An initial aggregate supply curve is drawn to intersect these two aggregate demand curves at $E_0$ such that the starting equilibrium price and real gross domestic product levels are $P_0$ and $Q_0$, respectively. As before, we assume for convenience that net exports is zero, as shown by $E_q$ in Panel B. Now suppose that aggregate supply increases from $SRAS_0$ to $SRAS_1$. For any given increase of aggregate supply with a negatively sloped aggregate demand curve, the price level will decrease, real GDP will increase, and the net effect on the balance of trade is ambiguous. In this case the price level elasticity of demand, by governing the relative strengths of the price level and real GDP changes, determines both the direction of change of the balance of trade and the size of the resultant trade deficit or surplus. In general, when aggregate demand is more elastic, the increase in real GDP is larger and the decrease in the price level is smaller such that a balance of trade deficit would be greater or a balance of trade surplus would be smaller than for a less elastic aggregate demand curve. Alternately, an elastic aggregate demand could result in a balance of trade deficit while an inelastic aggregate demand could yield a balance of trade surplus. We illustrate this third possibility in Figure 2. When aggregate demand is inelastic, the relatively small increase of real income creates the trade deficit $Q_2B$, while the smaller increase of the price level shifts the net exports schedule upwards by less, to only perhaps $X'(P_2)$, again assuming that net exports exhibit the same elasticity with respect to the price level for the two aggregate demand curves. In this case, the balance of trade ends in deficit equal to $Q_2E_2'$.

**III. Summary and Conclusion**

This paper has examined the role of the price level elasticity of aggregate demand for the balance of trade when economic expansion occurs as the result of either an exogenous increase of aggregate demand or an exogenous increase of short-run aggregate supply. We reach two conclusions. First, when economic expansion occurs as the result of an increase of aggregate demand, the balance of trade deficit is larger the smaller the elasticity of aggregate demand with respect to the price level. Second, when economic expansion results from an increase of short-run aggregate supply, the price level elasticity of aggregate demand determines both the direction of change of the balance of trade and the size of the deficit or surplus. Beginning with a balance of payments of zero, we have shown that a relatively elastic aggregate demand curve will result in a balance of trade deficit while an inelastic aggregate demand function will cause a balance of trade surplus.

**Notes**

1. These conclusions are based on nominal values of exports, imports, and gross domestic product.
3. We reviewed a total of sixteen macroeconomic textbooks, at both the principles and
intermediate levels, and in none of these did we find either explicit mention of the concept of the price level elasticity of aggregate demand or discussions of its importance. Three of those texts did, however, make reference to the slope of the aggregate demand curve and thereby hint to its elasticity. Colander (2013:572) for example implies that aggregate demand is quite inelastic with respect to the price level because “While all economists agree about the logic of the interest rate effect, the international effect, and the money wealth effect, most also agree that for small changes in the price level, the net effect is relatively small. So, even after the effect has been expanded by the multiplier, the AD curve has a very steep slope.” Froyen (2013:51) states in a footnote that the aggregate demand curve in the Classical school is a rectangular hyperbola which, of course, has a unit elasticity with respect to the price level. Lastly, Gordon (2012:249,250) explains that when either the IS curve is vertical or the LM curve is horizontal the aggregate demand curve will become vertical with the inference that it is completely inelastic with respect to the price level.

4. The literature on the price level elasticity of aggregate demand is relatively small. Gambs (1974) showed that the Classical school implied that aggregate demand is unit elastic with respect to the price level. Keynes (1936) and his early disciples implied that aggregate demand was perfectly inelastic with a liquidity trap. Havrilesky (1975) and Purvis (1975) derived expressions for the price level elasticity of aggregate demand within the standard price-flexible IS-LM macroeconomic model. Kyer and Maggs (1992) derived an expression for aggregate demand elasticity which distinguished clearly between the Keynes and Pigou effects. Kyer and Maggs (1996) have also shown the relevance of aggregate demand elasticity for supply-side economics, for various monetary policy rules when aggregate supply shocks occur (Kyer and Maggs 1995), and for the federal government budget deficit (Kyer and Maggs 2013). Kyer and Maggs (2009) also demonstrated that the inclusion of inflation-indexed government bonds in real wealth will decrease the price level elasticity of aggregate demand.

5. For brevity, this paper considers only the case of economic expansion. The conclusions, however, are of course symmetric for decreases of real gross domestic product.

References