Consumption Smoothing.

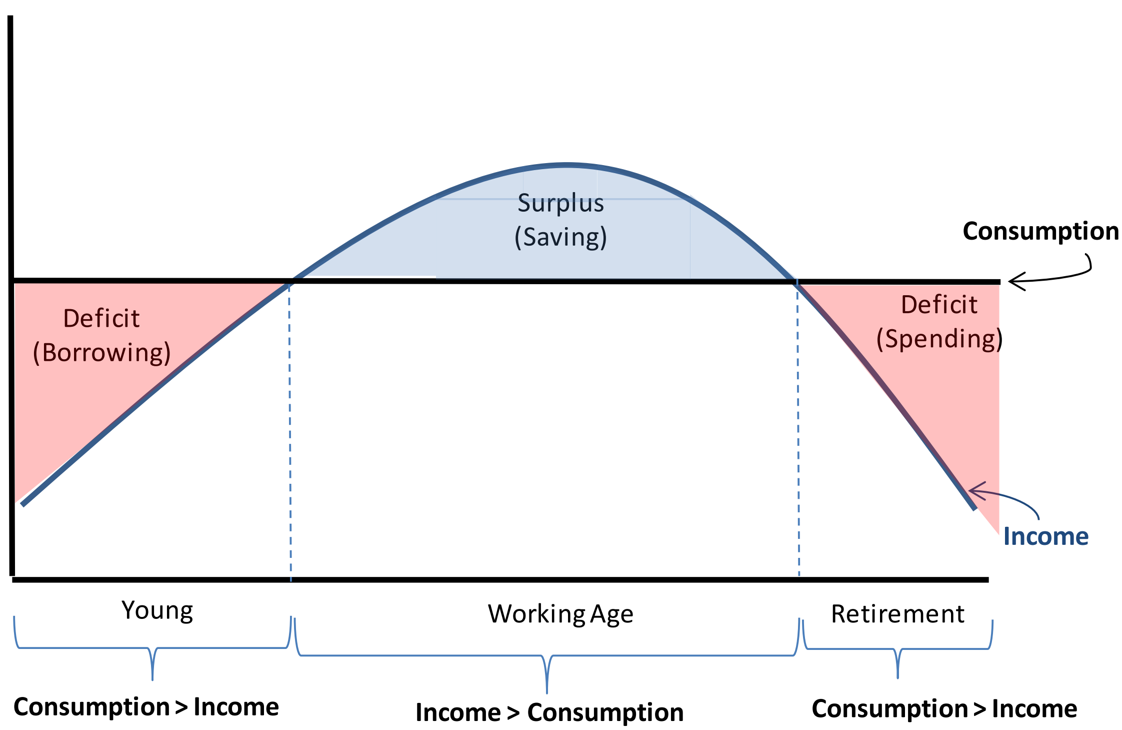
An Individual Example

The first graph shows how an example person smooths consumption over their own lifetime. When they are young they have little income but still consume by borrowing money (perhaps even from their parents) to finance college, the a car, then later (during their early working years) a house, etc. During this time their consumption is well above their income. As a result, to get the house and car, they must borrow. They are spending more money than they have.

During the main working portion of their lives they are paying off the houses and cars and saving for retirement. In order to repay old debts (mortgage on the house, for example) and save for retirement, they must be spending less on consumption than they earn in income (otherwise they wouldn't have any money to save).

During their retirement years, their income falls rapidly and they consume out of the retirement accounts they built up over their working years. Again, their consumption is higher than their income, but they are able to maintain a comfortable level of living because of their earlier accumulations.

This was simplified example to illustrate how someone can have "smooth" consumption (i.e., unchanged) over their lifetimes by borrowing and saving (i.e., running deficits and surpluses) appropriately during their lives.



An Open Economy's Consumptions Smoothing

Since each individual in an economy is attempting to smooth their own consumption, an entire economy made up of such individuals will also attempt to smooth aggregate consumption. It can only do this if it is an open economy.

Below is a simplified example of an economy with fluctuating "income" (i.e., GDP). The fluctuation represents the boom and bust cycles that nearly all economies experience although not necessarily in such a clear and simplified way as illustrated here.

Domestic Absorption (A) reflects all the domestic "consumption" of the economy, A = C + I + G. When there is a recession, the economy's output/income (i.e., GDP) declines. To keep domestic absorption smooth, individuals in the economy must be able to borrow in bad times (during recessions) and save in good times (during booms).

Since all individuals together can only borrow and save/lend in international markets, this kind of aggregate borrowing and lending can only happen in an open economy. When GDP > A and the economy is lending/saving the extra money, the economy is running a Current Account Surplus. When GDP < A and the economy is borrowing extra money, the economy is running a Current Account Deficit.