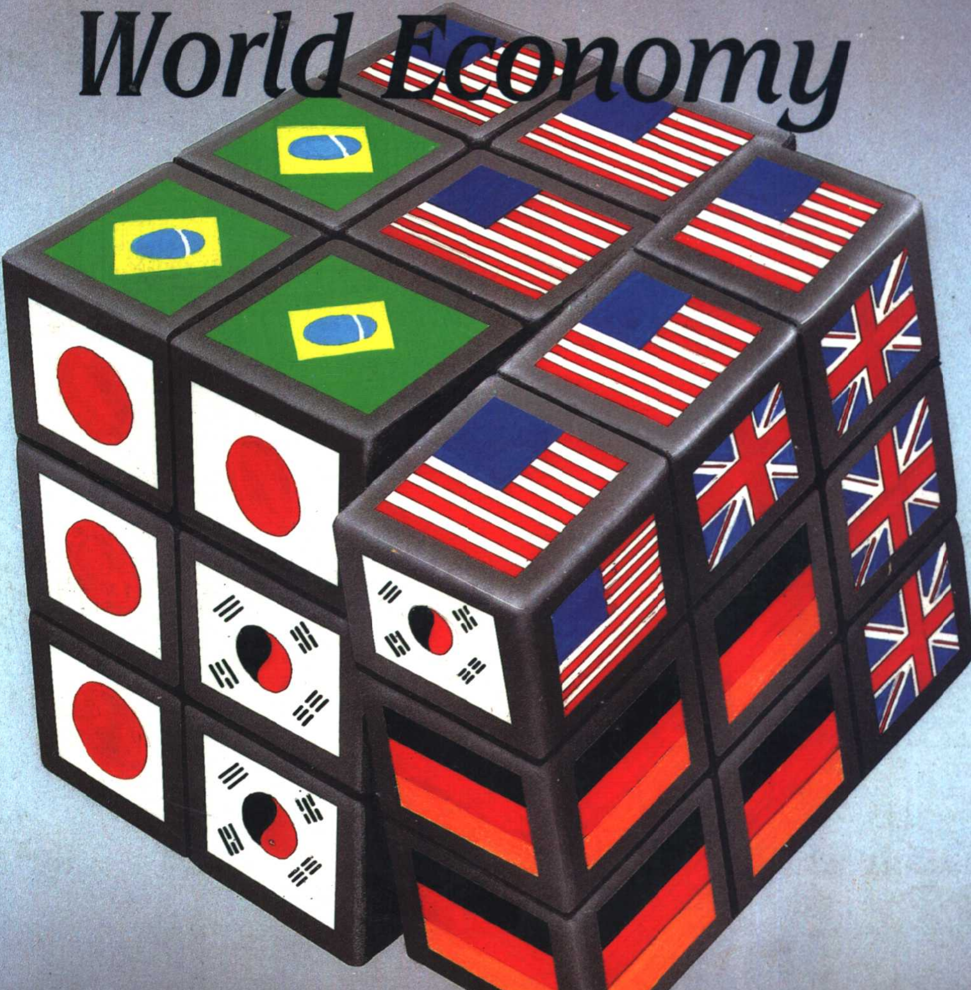
United States External Adjustment and the World Economy



William R. Cline

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External Adjustment and the World Economy

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Preface

This book presents a comprehensive analysis by William R. Cline of the outlook for the international imbalances of the United States and the world's other leading countries through 1992. It concludes that the progress of 1986–88 in reducing these imbalances is likely to end soon and in fact go into reverse, on the basis of present policies and exchange rates, and that substantial additional policy measures are therefore needed promptly both in the United States and in a number of other countries.

As with several earlier Institute studies, we are releasing our findings from this project in two different formats in an effort to meet the needs of different groups of readers. Chapter 1 of this book, which presents Dr. Cline's main analytical conclusions and policy recommendations, was released separately in March 1989 as *American Trade Adjustment: The Global Impact.*

The Institute has published several previous studies on the international imbalances of the major countries and their effects on the world economy. The first was *Deficits and the Dollar: The World Economy At Risk*, by Stephen Marris, originally released in December 1985 and updated in September 1987. Most recently, my own *America in the World Economy: A Strategy for the 1990s*, published in November 1988, draws heavily on the analyses presented here. Also related was a joint effort by 33 economists from 13 countries, released in December 1987, entitled *Resolving the Global Economic Crisis: After Wall Street*. In all these publications, the Institute has attempted to assess the "big picture" of where the world economy is headed and what policy changes may be needed to promote its successful evolution in the future.

The Institute for International Economics is a private nonprofit institution for the study and discussion of international economic policy. Its purpose is to analyze important issues in that area, and to develop and communicate practical new approaches for dealing with them. The Institute is completely nonpartisan.

The Institute was created by a generous commitment of funds from the German Marshall Fund of the United States in 1981 and now receives about 20 percent of its support from that source. In addition, major institutional grants are being received from the Ford Foundation, the William and Flora Hewlett Foundation, and the Alfred P. Sloan Foundation. A number of other foundations and private corporations are contributing to the increasing diversification of the Institute's resources. The American Express Foundation helped to finance the present study.

The Board of Directors bears overall responsibility for the Institute and gives general guidance and approval to its research program, including identification of topics that are likely to become important to international economic policymakers over the medium run (generally one to three years), and which thus should be addressed by the Institute. The Director, working closely with the staff and outside Advisory Committee, is responsible for the development of particular projects and makes the final decision to publish an individual study.

The Institute hopes that its studies and other activities will contribute to building a strong foundation for international economic policy around the world. We invite readers of these publications to let us know how they think we can best accomplish this objective.

C. FRED BERGSTEN
Director
March 1989

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Overview

Since the mid-1980s the United States has run huge external deficits, which reached as high as $154 billion on the current account (merchandise trade and services, including capital income) in 1987. Prudence requires that this annual imbalance be cut by at least $100 billion over the next few years. Although the current account deficit did decline to $135 billion in 1988,[1] under present policies it is likely to remain well above $100 billion in 1989 despite further modest reduction, and the deficit is then likely to widen again in 1990 and beyond (as analyzed in this study). Elimination of the US fiscal deficit and some further real decline of the dollar are likely to be required to achieve a sustainable external balance.

The solution of the US external deficit problem, however, could cause new economic difficulties for other countries, many of which relied heavily on exports to the United States to fuel their economic growth earlier in the 1980s. Patterns of major imbalances among other nations persist, as large surpluses remain in Japan and Germany, as well as Taiwan and Korea, while external positions of Third World debtor countries remain weak. In addition, there are rising deficits in the United Kingdom and some other intermediate industrial countries. These emerging weaknesses could intensify once the United States does begin to deal forcefully with its own deficits. In particular, the weaker foreign economies could bear a disproportionately large share of the counterpart of falling US external deficits, in the absence of special measures to concentrate the impact on the high-surplus countries.

This study examines what measures will be needed to achieve the required correction in the US external accounts, and goes on to analyze the nature of

1. The trade deficit on a balance of payments basis stood at $126.5 billion. US Department of Commerce, *Summary of US International Transactions: Fourth Quarter and Year 1988* (Washington: US Department of Commerce, BEA 89-09, 14 March 1989), hereafter referred to as *Commerce 1988 Current Account.*

international adjustment necessary to ensure that correction of the US external deficit can occur smoothly, without provoking new imbalances abroad and risking international recession.

Origins and Importance of the External Imbalance

As discussed in Chapter 2, the large US external deficit is the legacy of economic policies adopted in the early 1980s. The central feature of these policies was an unusual combination of fiscal stimulus with monetary restraint. Tax revenues failed to rise as rapidly as many supply-side advocates had hoped after the 1981 tax cut, and the total fiscal deficit (federal, state, and local) rose from 1 percent of GNP in 1981 to an average of 3.4 percent of GNP in 1982–86.[2] This stimulus pulled the economy out of the severe 1982 recession, and permitted the creation of 17 million jobs during the course of the decade. Meanwhile monetary restraint, aided by the good fortune of falling oil prices, made possible a reduction of US inflation from its peak of nearly 14 percent in 1980 to about 4 percent by 1988.

Unfortunately, these gains came only at the expense of the so-called "twin deficits": the internal fiscal deficit and the external deficit on trade and services. The rising fiscal deficit caused a widening gap between the domestic use and availability of resources. Private saving did not rise to offset the decline in public sector saving—on the contrary, gross private saving fell from approximately 18 percent of GNP in 1979–81 to 16 percent in 1985–87, largely because of falling personal savings rates. Instead, foreign resources had to be called upon to fill the resource gap. Nor was the resulting inflow of foreign capital (and the goods and services it financed) dedicated to a boom in US investment, which might have justified borrowing abroad. The ratio of gross private investment to GNP actually declined from 17 percent in 1979–81 to less than 16 percent in 1985–87. The nation had simply gone on a spree of private and government consumption, financed by foreigners.

The resource gap caused high real interest rates, as the government vied with the private sector to borrow in the credit market. High interest rates attracted capital from abroad, and this capital inflow bid up the real price of the dollar by some 40 percent or more. The overvalued dollar acted like a tax of this amount on exports, and a subsidy of the same size to imports. As a result (and because of a higher rate of growth in the United States than abroad, as well as curtailed US exports to the debtor nations following

2. References for these and other data not otherwise cited in this overview are given in the subsequent chapters.

the debt crisis), in the first half of the 1980s the value of US exports stagnated while imports rose by nearly 50 percent despite lower oil prices.

The large US external deficit poses three major risks. The first is that failure of the deficit to show progress toward further reduction could at some point provoke a collapse in foreign confidence in the dollar and in the US economy, causing a sharp decline in the dollar well beyond the moderate further reduction from current levels needed to correct the external deficit. Under these circumstances, US monetary authorities would be likely to permit (or even encourage) a large rise in interest rates to stem the excessive fall of the dollar and its threat to revive inflation. A surge in interest rates by perhaps some 5 percentage points would be likely to lead to domestic recession. There would thus be a "hard landing" for both the dollar and the US economy.[3] There have already been storm warnings that the hard-landing scenario could occur, as two episodes of rising US interest rates in 1987 (when foreign private finance began to dry up and central banks had to finance most of the US external deficit) provoked first a bond market collapse and then the stock market crash of October.

The second risk of a large external deficit is that, if it continues over the longer term, the United States will be forced to maintain high real interest rates indefinitely to attract ongoing financing from abroad. High interest rates would discourage investment and thus limit longer-term economic growth. The burden imposed on the next generation would be twofold: not only would Americans have to service a large net external debt (already projected at close to $1 trillion by 1992), but in addition the American economy would have a smaller production base from which to make these payments.[4]

The third risk is an outbreak of protectionism. Congress was already moving toward higher protection in 1985 before the Plaza Agreement among governments to bring the dollar down from its excessively strong levels. If the US trade and current account deficits fail to decline after 1989 and begin to widen again, as projected in this study, there is considerable risk that

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3. For the first and definitive statement of this risk, see Stephen Marris, *Deficits and the Dollar: The World Economy at Risk*. POLICY ANALYSES IN INTERNATIONAL ECONOMICS 14 (Washington: Institute for International Economics, December 1985). Note that the crucial dynamic of the hard landing is one of "bandwagon" expectations that cause a falling dollar to plunge far below its longer-term equilibrium level. The rise of the dollar in 1988 (after its three-year decline) somewhat reduces this risk by serving notice to speculators that simple extrapolation of past trends can be costly. However, from another standpoint the risk of the hard landing rises while net external debt is rising faster than exports or GNP.

4. If the external deficit were being used to finance unusually high domestic investment, this concern would not be relevant. However, as noted, the foreign financing has been used for consumption rather than investment.

politicians will conclude that macroeconomic policies such as exchange rate changes have had their chance and failed, and that the time has come to impose direct import restrictions. New protectionist measures and the foreign retaliation they would be likely to incite could only push the world economy toward recession.[5]

Medium-Term Prospects for the US External Deficits

Because of the risks of persistent high external deficits, it is crucial to diagnose whether the US trade and current account balances are well on their way toward correction, or whether instead more energetic policy measures are required to achieve adjustment. This study applies two econometric models to project the medium-term path of the US external accounts.

Recent Trends

In 1987 the exchange markets began to despair that the US trade deficit would ever decline. Although the dollar had begun its descent by the second quarter of 1985, the nominal trade deficit for 1987 was larger than ever before at $160 billion versus $122 billion in 1985 and $145 billion in 1986 (see table 3.2 in Chapter 3).[6] Actually the continued widening of the trade deficit should have come as no great surprise, in view of past lags of up to two years in the exchange rate–trade relationship.[7] It takes time for firms

5. For an overview of these risks and comprehensive policy proposals for correcting the US external deficit, see C. Fred Bergsten, *America in the World Economy: A Strategy for the 1990s* (Washington: Institute for International Economics, 1988).

6. In real terms the merchandise trade deficit did decline in 1987, from $168.6 billion to $158.9 billion at 1982 prices. However, the rise in dollar import prices meant that the nominal value widened. Note that the trade balance data used here refer to the balance of payments concept, which treats imports on an f.a.s. (free alongside ship) basis and excludes sales by military agencies. Press reports more commonly refer to the trade balance with imports on a c.i.f. (cost including insurance and freight) basis. That deficit stood at $170.3 billion in 1987 and $137.3 billion in 1988. US Department of Commerce, *US Merchandise Trade: December 1988*, FT 900 (Washington: US Department of Commerce).

7. Whether this time there was a "hysteresis" that fundamentally reduced or unusually delayed the trade response to the exchange rate remains a matter of debate. One popular argument has been that foreign firms accepted reduced profit margins rather than raise their dollar prices. However, tests comparing actual dollar export prices to what would have been expected on the basis of foreign wholesale prices divided by dollar exchange rates show an extremely close tracking for the cases of Germany,