GLOBAL ECONOMIC IMBALANCES

Edited by

C. FRED BERGSTEN

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Preface

In September 1984, the Institute held a conference in Washington which brought together for the first time, to our knowledge, most of the research institutions throughout the world which are conducting significant studies of international economic issues. As indicated in more detail in my introduction to the volume, the purposes were to discuss some of the central issues facing the world economy; to consider the research programs of the various centers; and to expand the opportunity for exchanges among them.

This volume presents the papers prepared for the conference, summaries of the discussion of each, the views expressed by a panel composed to draw policy conclusions from the papers and these discussions, and a synopsis of the research agendas submitted by a number of the participating institutions.

Fifty institutions from twenty-five countries and five international economic organizations attended the conference. As a result of its discussions, they decided to hold such sessions regularly in the future and to institutionalize the exchange of information on their respective agendas. The next meeting will take place at the Institute in September 1986.

The idea of instituting periodic conferences to bring together the family of research centers working on international economics was inspired to a considerable degree by the annual meetings held by the International Institute for Strategic Studies in London for the community of researchers on international security issues. Extensive consultations were held in late 1983 and early 1984 with the directors of a number of leading institutes in all parts of the world to consider the idea from which emerged widespread support for proceeding on an experimental basis. The Ford Foundation made the effort possible and was particularly instrumental in enabling representatives from a number of institutions in developing countries to attend the conference.

The conference was organized primarily by Stephen Marris, a Senior Fellow at the Institute, and myself. Miguel A. Kiguel, then a Research Associate at the Institute, assisted in analyzing and summarizing the research agendas submitted by thirty of the participating institutions. Carol Fox, Executive Assistant to the Director, handled all administrative arrangements.

The Institute for International Economics is a private nonprofit research 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 was created in November 1981 through a generous commitment of funds from the German Marshall Fund of the United States. Support is being received from other private foundations and corporations, and the Institute is now broadening and diversifying its financial base.

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 of the Institute, 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 is completely nonpartisan.

The Institute hopes that its studies and other activities will contribute to building a stronger foundation for international economic policy around the world. Comments as to how it can best do so are invited from readers of these publications.

C. FRED BERGSTEN
Director
December 1985

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1 Introduction

The Institute for International Economics hosted a conference for the directors or other senior representatives of fifty research institutions from twenty-five countries and five international economic organizations in Washington on September 21–23, 1984. A few individuals, also engaged in significant research on international economic issues, participated as well. The Institute attempted to bring together all centers involved in such research, for the first time, for three purposes:

- to discuss some of the central intellectual and policy issues confronting the world economy
- to consider whether the research agendas being pursued by the centers and individuals represented met the most salient intellectual and policy needs
- to enable the institutions engaged in international economic research to become better acquainted with each other, in the hope of fostering more effective interchange and cooperation among them—and thus a greater contribution to knowledge and policy formulation—in the future.

The substantive focus of the conference was deliberately broad, to encompass priority concerns of both industrial and developing countries. "Global Economic Imbalances" was defined to include three types of problems: shortcomings and inconsistencies in national macroeconomic policies, structural weaknesses and supply-side concerns, and trade policy issues (including those related to "industrial policies"). The author of each of the five main papers was asked to address this nexus of problems from his own geographical vantage point, and commentators from different regions were selected to provide a variety of perspectives. In keeping with the second focus of the meeting, on research agendas, each author was also asked to suggest topics emerging from his analysis that needed further study. The comments of the discussants are summarized after each paper. A separate chapter summarizes the general discussion on the policy implications of the individual presentations and sessions.

Martin S. Feldstein launched the conference with a presentation on the recent economic performance and policies of the United States, emphasizing their effects on the rest of the world. Richard G. Lipsey began the discussion, speaking from the viewpoint of Canada, and Luigi Spaventa introduced a European perspective. Armin Gutowski of Germany chaired the panel. After the conclusion of this session, over lunch, the conferees were offered another American perspective—this time centered on trade policy—by Ambassador William E. Brock, the United States Trade Representative.

The second session of the conference focused on the other industrial countries, with papers by Edmond Malinvaud of France and Masaru Yoshitomi of Japan. The initial commentators were Herbert Giersch of Germany, presenting an alternative view of the European outlook, and Lawrence B. Krause with an American view of Japanese developments. Paul W. McCracken of the United States chaired the discussion.

The third segment of the conference turned to the vantage point of the developing countries. Papers were presented by Mario Henrique Simonsen of Brazil, an advanced developing country, and Deepak Lal of India, one of the poorer nations. Commentary was initially offered by Bela Balassa of the United States and Amir H. Jamal of Tanzania, and Jagdish N. Bhagwati of the United States and India chaired the panel.

The final substantive discussion of the conference was launched by a panel selected to discuss the policy implications of the foregoing exchanges, again from a series of different national perspectives. In that vein an American view was offered by Richard N. Cooper, a Japanese appraisal by Saburo Okita, a European approach by Stephen Marris, and a presentation focused on the developing countries by I. G. Patel. An effort was made to draw inferences for each region although, in the event, most comments addressed the US policy mix and its external implications, and the structural and cyclical problems currently confronting Europe.

Questions of research, in both substantive and procedural terms, were taken up on the last day. The objective was to enable the institutions represented to learn more about the nature of their colleagues' work programs, in an effort to promote more extensive interchange in a way that would permit researchers in this field to build more effectively on projects underway in other centers. In preparation for this part of the meeting, the Institute had asked participating institutions to submit descriptions of their own research programs for inclusion in a summary which, along with the substantive papers, was distributed in advance and is included as appendix C in this volume.

The discussion of research agendas was launched with presentations by Anne O. Krueger of the United States (and the World Bank) and, from a political economy perspective, Thierry de Montbrial of France. Initial comments were offered by William H. Branson of the United States and Ahn Seung-Chul of Korea, with the session chaired by C. Fred Bergsten.

The conference closed with a luncheon for the directors of participating institutions given by the Director of the Institute. Its purpose was to discuss the array of possibilities for intensifying and systematizing collaboration among the institutions engaged in significant research on international economic issues, most of which were represented at the meeting. Numerous ideas were suggested, and a good deal of enthusiasm was expressed for pursuing more active interchange within the group.

Virtually all participants indicated a desire to engage in regularly scheduled conferences of the type launched here, so that the institutes working on international economic issues could maintain active discussions on both substantive topics and their respective research agendas. Some directors preferred annual sessions while others thought biennial conferences would be adequate. Some suggested a greater focus on research agendas and priorities; others voiced a desire to maintain the mix of substance and research agendas embodied in this first exercise; still others would opt for almost exclusive attention to substance, perhaps with more narrowly defined topics to encourage greater depth of discussion. There were also proposals to hold periodic "subconferences" to discuss research on particular aspects of international economics, such as trade or international monetary affairs, and to create a permanent association of institutions engaged in international economic research.

To date, three decisions have been made in light of these exchanges: to continue on a regular basis the series of conferences of research institutes begun in September 1984, to meet biennially, and for the Institute to host the next conference in Washington in September 1986. (The conference would again be linked to the Annual Meetings of the International Monetary Fund and World Bank, as in 1984, which met with widespread approval.) Past and future participants in the process will consult on the topics to be discussed and the mix of items for the agenda.

A second area of nearly total consensus was on the need for systematic, ongoing exchanges of information among the research institutes concerning their respective programs and priorities. The compilation of agendas prepared for this conference was viewed as a useful model of what needed to be done in order to improve the dissemination of knowledge about work in progress. Several participants hoped that such information could be more detailed and could be provided early in the research process. At the suggestion of a number of participants, the Institute has decided to undertake such an effort and is now working on its modalities.

All participants were asked to reflect further on the outcome of the conference and to convey additional thoughts both on the session itself and on possibilities for future cooperation. A large number took the opportunity to do so, and the process of continuing consultation seems to be well underway.

This volume comprises the papers presented to this first meeting of institutions engaged in research on international economic issues, summaries of the comments on them by formal discussants and other conference participants, and the compilation of research agendas prepared for the meeting. It is hoped this book will be the first of a series emanating from an ongoing set of conferences of this particular family of research centers.

2 *The View from North America*

Martin S. Feldstein

The topic that I have been assigned—the imbalances in the US economy and their impact abroad—is a formidable task given the expertise that is assembled here. The basic nature of the problem is well known to you, but I would like to give you my interpretation of those two imbalances:

- the domestic imbalances—the deficits in the federal budget
- the international imbalances—our trade deficit and its mirror image, the capital account imbalance.

I also want to discuss the link between the domestic and international imbalances—the dollar.

I shall begin by reviewing the situation in the United States with respect to the government deficit and its domestic impact. My basic point is that although the 1982–83 deficits were not on balance a problem for the American economy, probably doing more good than harm, the deficits that we face now and into the future will do substantial damage.

After exploring the domestic impact of this imbalance, I shall discuss the rise in the dollar over the last four years, the role of the budget deficit in that rise, and the impact of the higher dollar. The most obvious consequence of the stronger dollar, as seen from this side of the ocean, is the damage to US industry. Less obvious is that the increase in the dollar has served as a useful safety valve that has prevented an even higher real interest rate in the United States in response to the large budget deficit. In other words, the rise in the dollar is a healthy market response to a serious underlying problem. Finally, I shall discuss very briefly my own speculations about the effect of the US deficit on Europe and on the debtor countries in the developing world.

Let me begin with the budget deficit in the United States. The deficit for fiscal year 1984 is going to be about $170 billion. Realistic projections indicate that, by the end of the decade, if there is no further legislative action, the deficit will increase to about $250 billion. Had the legislative action known as the downpayment package not occurred in the summer of 1984, the deficit by the end of the decade would have been over $300 billion.

Seen in terms of a constant unemployment rate of 6.5 percent, the structural deficit rose from about $100 billion in 1983 to $140 billion in 1984. That is, $140 billion of $170 billion of the 1984 deficit was structural. Without legislative action this portion will continue to rise until, by the end of the decade, essentially the entire $250 billion budget deficit will be structural.

The impact of such deficits will be substantial. The clearest effect is the increase in the US national debt—about $1,000 billion over the next five years—and its consequences. To put that number in perspective, the gross national product at the end of the decade is projected at $5.5 trillion. The increase in the national debt would be nearly 20 percent of GNP. The resulting interest costs, assuming no change in current interest levels (about 12 percent), would be $120 billion a year. Such costs would be cause for a tax increase of $120 billion a year, 20 percent of the current projected levels of personal and corporate income tax revenue. The distortions arising from those higher tax rates are part of the permanent costs of running budget deficits of the magnitude currently projected.

The second long-term cumulative effect of high deficits is on capital accumulation. Excluding the savings of state and local governments, net nonfederal saving is less than 8 percent of GNP. The projected deficits mean that the government is absorbing somewhat more than half of all the net savings generated domestically in the United States, leaving net investments of less than 4 percent of GNP except for the capital inflow. Even with that capital inflow, the net effect is clearly slower growth and lower future productivity.

What about the short-run effects of persistent high budget deficits? I have stated that the 1982–83 deficits actually helped the recovery by adding to consumer demand directly and therefore to overall GNP. Nevertheless, I would not exaggerate the importance of those deficits in stimulating the recovery. Future research will have to sort out how much of the strong recovery in the last two years was due to fiscal stimulus and how much to changes in monetary conditions.

Deficits now and in the future seem to have moved from being a positive factor to being a harmful one for the economy because they are creating serious imbalances in the structure of demand—imbalances that become more important as full employment nears. The most obvious of those imbalances has been the trade deficit—an unprecedented merchandise trade gap running at about 3 percent of GNP.

In addition, capital accumulation has been lower than it would have been otherwise. The recent significant upturn in spending on plant and equipment followed a period of very low investment spending. We actually had negative net investment at the end of 1982 and the beginning of 1983. So, even with the sharp upturn, net investment is still at the low end of recent average performance.

Moreover, we are beginning to see a slowdown in some capital spending. Housing starts, which had until recently been kept up by a backlog, have begun to drop substantially and are down to about 1.5 million units annually.

From this consideration of the purely domestic impact of the budget deficit, let me turn to the international imbalances. Since 1980 the dollar has gone up by a remarkable 60 percent in real terms calculated on a multilateral trade-weighted basis. The deficit is an important reason, but not the only reason.

A more inclusive explanation is that US investments are now more attractive, compared with foreign investments, than they were a few years ago; they have a relatively higher expected return and are perceived to be much less risky. The reasons for that higher return and lower risk are threefold: changes in monetary policy, changes in tax policy, and changes in the budget deficit.

US monetary policy tightened in 1979, temporarily pushing up real interest rates from a purely monetary point of view. But of more sustained importance has been the shift in the perceived risk of inflation in the United States that resulted from the shift in Federal Reserve policy. The Fed's tenacity—the credibility that it has developed—has given the correct impression that a sound monetary policy will continue to be pursued. That has made investment in US securities lower risk than in the pre-1979 period.

The second factor enhancing the attractiveness of US securities has been the change in US tax policy. In 1981 a major change in tax rules increased after-tax rates of return. Depreciation has been cut and effective tax rates reduced. In addition, the fall in inflation has, in itself, reduced effective tax rates because of the way inflation reduces the present value of depreciation. This combination of lower inflation rates and formal changes in tax rules has significantly increased after-tax rates of return and therefore the interest rates that firms are able and willing to pay for debt and equity capital. That in turn reinforces the pretax differences in profitability that may well have widened between the United States and Europe in the past half decade or so.

In addition to these changes in monetary and tax policy, I would emphasize the substantial increase in the government deficit. Because those deficits are absorbing about half of all net savings, they inevitably push up interest rates. This shrinks private demand for funds, and supplements that demand for funds with an inflow of capital from abroad.

It is no paradox that a large actual and projected budget deficit in this country should be the source of the strengthening of the dollar. The fundamental difference in monetary policies explains the seeming paradox between the US experience and the foreign experience, where a large budget deficit has often led to a deterioration in the exchange rate. In other countries large budget deficits have very frequently been accompanied by a monetization of the resulting increase in debt, either as an implicit policy decision or because the domestic capital markets were not well enough developed to absorb additional government debt. The United States, however, has had a continued sound monetary policy and an expectation that it will remain sound. That expectation, combined with large budget deficits, has allowed real interest rates to attract funds from the rest of the world.

Let me briefly address the impact of the strong dollar on the US economy. Three distinct effects should be noted. First, the dollar has helped to slow the rate of inflation. The consumer price index (CPI) is probably 5 percentage points lower than it would have been if the dollar had not increased as it did over the past four years. The current inflation rate is probably from 1 percentage point to 1½ percentage points below where it would have been if the dollar had not risen over the last 18 to 24 months.

Second, and the one most obvious to the public, is the effect of the strong dollar on the US trade deficit. From the late 1970s to 1980, the United States had a merchandise trade deficit of about $25 billion a year. By 1983 that had jumped to $60 billion and in 1984 it ran well over $100 billion. It is obviously doing quite substantial damage to particular firms and industries that are or used to be in the export business or that compete with imports from abroad.

Moreover, the strong dollar is having longer term effects as American firms look abroad for sources of inputs that were previously obtained in the United States. They look abroad to locate whole new manufacturing facilities to take advantage of the changes in the exchange rate. In addition, the very substantial damage that the strong dollar is doing to particular industries is encouraging protectionism in the United States. The current administration's basic instincts are for free trade, but it is operating in an environment that is unusually hostile to free trade.

The third effect receives the least attention and it is the one I want to emphasize: the strong dollar's impact on the capital inflow. The United States was a capital exporter for almost the entire postwar period; it was still running a surplus in the capital account in 1980 and 1981 despite its merchandise trade deficit of about $25 billion. But in 1982 that switched: the current account deficit was $9 billion; in 1983, $43 billion: and recently over $100 billion. The United States has become a dramatic importer of capital: $100 billion is nearly 3 percent of GNP. It is more than half of the budget deficit and about two-thirds of the structural budget deficit. It represents a 50 percent increase in the net funds available for investment in the United States. This can have a very dramatic effect on US capital markets, keeping interest rates lower and equity prices higher than they otherwise would be. Of course, this is just a temporary effect; it is not sustainable.

Capital imports have been a useful safety valve for the American economy, allowing it to make the best of the bad problem of budget deficits. The dollar's rise is a healthy, normal market response to that bad problem. It spreads the pain around; it avoids the problems that would come from concentrating the crowding out solely on the capital goods and capital formation part of the US economy. It would therefore have been inappropriate to try to prevent this increase in the dollar by intervention or by capital controls even if those might have worked.

Let me conclude by looking at the impact of these US imbalances on the economies of Europe and on the less developed debtor countries. With respect to Europe, there are clearly both pluses and minuses of the recent US imbalances. To start with the positive effects, the strong US recovery and the strong dollar have increased European exports to the rest of the world, not only to the United States but to the third markets in which the United States competes, and have reduced European and third-country imports from the United States. A second favorable effect: the improved trade balances spurred recovery in Europe and permitted several European countries to pursue more expansionary domestic policies than they might otherwise have been able to do.

But there have been negative effects as well. With the declining exchange rate, these European countries experienced increasing inflationary pressures. To prevent or to limit the actual increase in inflation, they frequently pursued contractionary monetary and fiscal policies.

Which effect on the European recovery was stronger is still an unanswered question. My own conjecture is that without the increase in the US deficit and without the strong dollar, the recovery in Europe would have been weaker than it has been. But I would like to see careful research on that.

A second adverse effect in Europe in response to the US imbalance has been a change in the composition of GNP in European countries. The capital outflow from Europe to the United States has meant more investment in the United States and less in Europe than there otherwise would have been. I would argue that the US deficit leads to a better global allocation of resources than would have occurred had the United States simply bottled up the two separate capital markets and not allowed imbalances in trade and the capital flow—imbalances should not be read in this context as a bad word. Of course individual countries could have tried to offset this tendency for investment to fall at home. Although they might not have been able to influence the real interest rate faced by their domestic capital market, they could have changed their domestic fiscal incentives to encourage investment at home and some countries did.

Finally, turning to the impact of the US imbalances on the LDC debtor countries, again there are pluses and minuses. The higher real interest rates that resulted from the deficit were clearly adverse for these countries. The real interest rate increased about 3 percent over this period. In Brazil's case that represents a rise of $3 billion a year in the increased real cost of servicing its international debt—more than 10 percent of its gross exports. So it puts an extra strain on the debtor countries in their attempts to service their debt and forces them to restrict their imports. That restriction in turn has had adverse consequences for their domestic rate of economic growth.

A second effect of US policies, the higher dollar, has had a more ambiguous impact on the debtor countries. The direct effect of the higher dollar is to increase the real value of the debt and that is unequivocably an additional burden to the debtor countries. When I say it increased the real value of the debt, what I have in mind is that only a fraction of the exports of those countries are sold to the United States; the others are sold to nondollar countries and, therefore, for a given physical volume of exports, the rise in the dollar raises the ratio of the value of the debt to the value of the exports.

The higher dollar also has a favorable effect, hence the ambiguity. It increases exports and decreases imports. Latin America does about 40 percent of its trade with the United States, and virtually all of the trade improvement of Latin America in the last few years has been due to the United States and Japan. The stronger dollar has, in that sense, helped these countries improve their trade and current account balances.

The net impact is uncertain and again this seems to be an area that needs additional research. The answer may well differ from country to country. I look forward to hearing your comments.