

CHAPTER 3

Growth, Competitiveness, and the Trade Deficit

THE DETERIORATION OF THE U.S. TRADE BALANCE has been a disturbing feature of the current recovery. From a surplus equivalent to almost 1 percent of real gross national product (GNP) in 1982, U.S. real net exports of goods and services declined sharply to a deficit equivalent to more than 4 percent of real GNP in 1986, far larger than the deficit recorded in any postwar year before 1984. The growing U.S. trade deficit is often cited as a principal cause of the slowdown of real GNP growth since mid-1984 and of the problems of many trade-sensitive industries. This chapter assesses the causes and effects of the growing U.S. trade deficit and discusses policies adopted by the United States and other countries that will gradually reduce international trade imbalances in a manner consistent with sustainable growth in the world economy.

The increase in the U.S. trade deficit is a macroeconomic phenomenon. Imports have grown strongly and exports have stagnated primarily because of the strong growth of the U.S. economy (especially in terms of demand growth) relative to other countries, the difficulties faced by many developing countries in managing their external debts, and the fall in U.S. price competitiveness associated with the large appreciation of the dollar between 1980 and early 1985. Underlying these developments are several macroeconomic imbalances, including the deterioration in the U.S. saving-investment balance that has resulted from the failure of the Federal Government to bring its expenditures in line with revenues.

Initially, the deterioration of the U.S. trade balance was associated with developments that had favorable effects for the U.S. economy (reduced inflation because of dollar appreciation and reduced upward pressure on interest rates because of a capital inflow). It certainly had favorable effects for the rest of the world, which was suffering from sluggish economic growth. More recently, however, large trade and payments imbalances have been recognized to pose substantial problems for the world economy, including the stimulation of protectionist sentiments.

Important policy actions have been taken in the United States and other countries to reduce international trade and payments imbalances. Better convergence of performance and policies and efforts at policy coordination have brought about exchange-rate adjustments that improve the price competitiveness of U.S. industries. However, there is a lag in the effect of exchange-rate adjustments on trade flows.

Further efforts are needed to reduce current payments imbalances. The United States must press forward in reducing the Federal fiscal deficit through restraint on the growth of Federal spending. At the same time, other industrial countries must undertake policies that will strengthen internally generated economic growth. Developing countries need to adopt growth-oriented strategies for resolving their economic difficulties. The overall strategy is to reduce international imbalances in a manner consistent with sustainable economic growth, in the United States, in other industrial countries, and in the developing countries, rather than by moving toward protectionism that would injure all countries.

THE MACROECONOMIC CHARACTER OF THE U.S. PAYMENTS POSITION

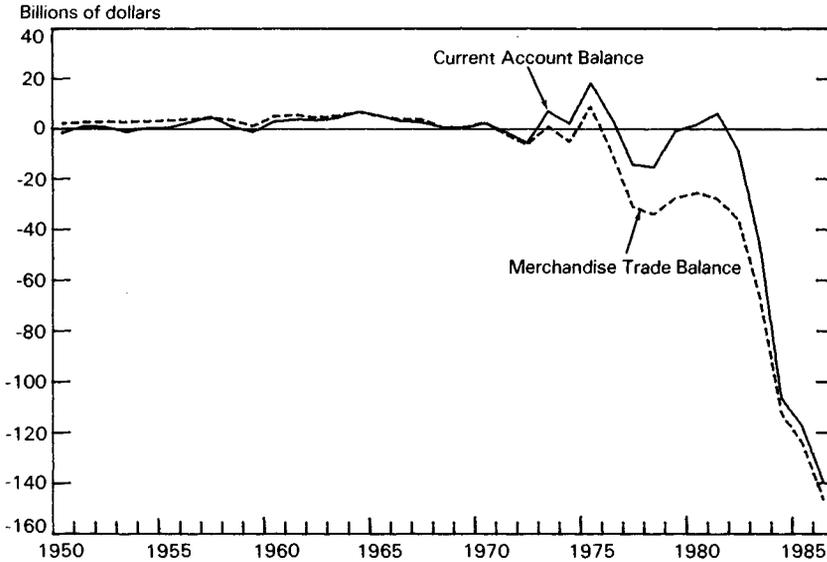
By any measure, the United States has experienced an unprecedented deterioration in its international payments position. The U.S. current account deficit—i.e., the excess of imports of goods and services over exports, plus net transfers made to foreign residents—widened from \$9 billion in 1982 to an estimated \$145 billion in 1986 (Chart 3-1). Almost all of this change is attributable to the increase in the merchandise trade deficit, which rose to an estimated record \$150 billion in 1986.

The deterioration of the U.S. trade balance has been across-the-board. Between 1982 and 1986, the U.S. merchandise trade balance (census basis) worsened in 9 of the 10 major product groups used to classify trade, including such disparate sectors as chemicals, food and live animals, and machinery and transport equipment. Among these major product groups, the U.S. merchandise trade balance improved only in the mineral fuels and lubricants sector. This exception, however, has clearly resulted from special factors, the most important being the decline in oil imports following the 1979-80 oil shock and the recent drop in petroleum prices.

Similarly, deteriorations in U.S. bilateral trade balances have been widespread. Between 1982 and 1986, the U.S. bilateral trade position worsened against all of the top 10 U.S. trading partners (based on total trade) and 19 of the top 20. The widening of the U.S. bilateral

Chart 3-1

U.S. Trade and Current Account Balances



Note.—Data for 1986 are first 3 quarters at an annual rate; seasonally adjusted.
Source: Department of Commerce.

trade deficit with Japan from \$19 billion in 1982 to more than \$55 billion in 1986 has attracted the most public attention, but this deterioration is not unique. The change in the U.S. bilateral trade balance with Western Europe has been about as large, falling from a surplus of \$5 billion to a deficit of more than \$30 billion. Substantial deteriorations in U.S. bilateral trade positions have also been recorded with Latin America and the newly industrializing countries of East Asia, in each case exceeding \$10 billion.

Special factors have undoubtedly influenced bilateral trading patterns and some markets are more open to U.S. exports than others. It is not correct, however, to place primary blame for the more than \$100 billion increase in the U.S. trade deficit over the past 4 years on unfair trading practices by U.S. trading partners. The deterioration of the U.S. trade balance is too pervasive to be credibly explained by analyses focused on a product-by-product, country-by-country, basis. Rather, the great bulk of the widespread deterioration must be viewed as a product of general macroeconomic developments in the United States and the rest of the world.

This point is demonstrated by recent developments in U.S. trade in manufactures. Between 1982 and 1985, the U.S. deficit in manufactures trade widened by \$101 billion. Imports of manufactures increased \$112 billion. This increase in manufactures imports has been a focus for protectionist pressures in the United States, especially regarding Japan. However, as shown by Table 3-1, most of the change in U.S. bilateral balances in manufactures trade during this period reflects general movements in imports and exports, not country-specific changes in bilateral trading relations. Although the U.S. balance of manufactures trade with Western Europe deteriorated by \$21 billion between 1982 and 1985, Western Europe provided virtually the same percentage of total U.S. imports of manufactures and absorbed the same percentage of total U.S. exports of manufactures in both periods. Japan supplied a somewhat higher share of U.S. imports of manufactures in 1985 than in 1982. This increase in market share, however, accounts only for about one-sixth of the \$32-billion increase in Japanese exports of manufactures to the United States during this period. At the same time, the share of total U.S. exports going to Japan increased. Clearly, general movements in U.S. imports and exports, not changes in bilateral trade relations, represent the proper focus for understanding the deterioration of the U.S. international payments position.

TABLE 3-1.—U.S. trade in manufactures, 1982 and 1985

Country/Area	Change in bilateral balances, 1982 to 1985 (billions of dollars)	Percent share in			
		U.S. imports		U.S. exports	
		1982	1985	1982	1985
Canada.....	-4.6	20.1	18.8	19.8	26.2
Japan.....	-29.8	25.1	26.6	6.6	7.6
Western Europe.....	-21.1	26.0	26.1	26.7	26.7
Latin America.....	-10.4	6.1	6.2	12.2	12.9
East Asian NICs ¹	-16.4	14.6	15.0	7.0	7.2

¹ Newly industrializing countries: Hong Kong, Singapore, South Korea, and Taiwan.
Source: Department of Commerce, Bureau of the Census.

The general movements in U.S. imports and exports are summarized in Table 3-2. Growth of U.S. spending on imports, while strong, has not been especially rapid given the growth of the U.S. economy. Imports of goods and services (on a national income and product accounts basis) rose from 10.6 percent of nominal GNP in 1982 to 11.4 percent in 1986. Non-oil imports grew more rapidly, but this was partly offset by a decline in the oil import bill. This "normal" growth of import expenditures, however, masks a substantial increase in import volumes. Import prices have fallen sharply rel-

ative to other goods (most recently due to falling petroleum prices) and real imports rose 55 percent between 1982 and 1986. Real exports, however, grew less than 3 percent during this period even though real export prices have fallen significantly. This absence of export growth, combined with continued import spending and rapid growth of import volumes, accounts for the deterioration of the U.S. trade balance.

TABLE 3-2.—U.S. Exports and imports of goods and services, 1980-86

Year	As percent of GNP				Relative prices (1982=100) ¹	
	Current dollars		1982 dollars		Exports	Imports
	Exports	Imports	Exports	Imports		
1980.....	12.8	11.7	12.2	10.4	105.3	112.0
1981.....	12.5	11.4	12.1	10.6	103.7	108.1
1982.....	11.4	10.6	11.4	10.6	100.0	100.0
1983.....	11.4	10.5	10.6	11.2	97.5	93.7
1984.....	10.2	11.7	10.6	13.0	95.9	90.3
1985.....	9.2	11.2	10.1	13.1	91.6	85.6
1986 ²	8.9	11.4	10.1	14.2	87.7	80.3

¹ Implicit price deflator for exports or imports relative to GNP implicit price deflator.

² Preliminary.

Source: Department of Commerce, Bureau of Economic Analysis.

In summary, the deterioration of the U.S. trade balance over the past 4 years is a macroeconomic phenomenon. The trade balance has deteriorated against virtually all major trading partners and in virtually all major product categories. This deterioration has been associated with a stagnation in the growth of U.S. exports, strong growth of U.S. imports in volume terms, but only about normal growth of domestic spending on imports. The fundamental explanation of these developments is to be found in the relatively strong performance of the U.S. economy during the current expansion, in the factors that underlie the deterioration of the U.S. national savings-investment balance, and in the forces that generated the strong appreciation of the U.S. dollar and the associated loss of competitiveness of U.S. tradable goods industries during the early 1980s.

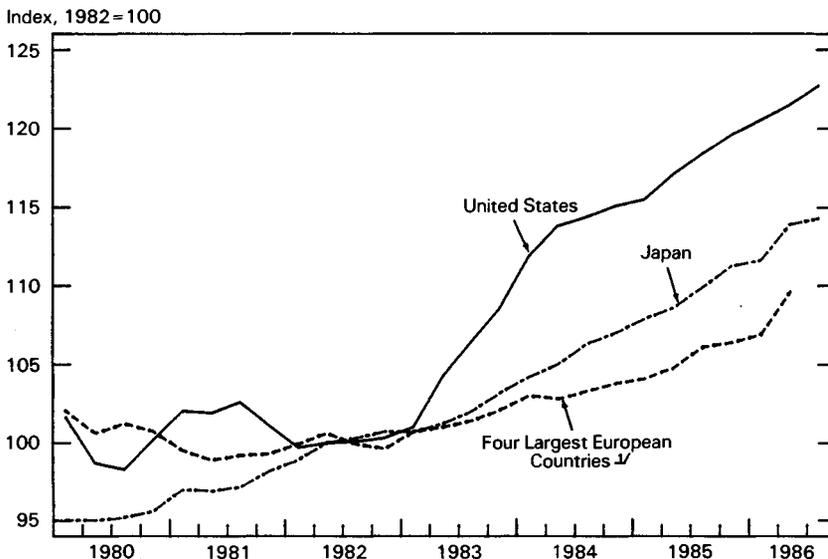
ECONOMIC GROWTH AND THE TRADE DEFICIT

A striking feature of the current expansion—and certainly one of the key factors in assessing world economic performance—is that the United States has enjoyed a strong expansion while the recovery of economic activity in most foreign countries has been weak. This difference in growth has been especially marked in total national spending, known as domestic demand. As indicated in Chart 3-2, total domestic demand grew much more rapidly in the United States than in other countries during the first six quarters of the expansion

(through mid-1984). Since then, differentials between U.S. and foreign demand growth have narrowed considerably, but a large cumulative gap in domestic demand growth remains. This gap reflects the fact that the current recovery of U.S. domestic demand is one of the strongest of the postwar period. It also reflects the fact, however, that the recovery of domestic demand abroad has been one of the weakest.

Chart 3-2

Real Domestic Demand in Selected Industrial Countries



1/ France, Italy, United Kingdom, and West Germany, weighted by GNP.

Note.—Domestic demand is the sum of personal consumption expenditures, gross private domestic investment, and government purchases of goods and services.

Sources: Department of Commerce and country sources.

These differences in output and demand growth have contributed to the deterioration of the U.S. international payments position in several ways. At an accounting level, the U.S. deficit on goods and services trade signifies that total expenditures on goods and services in the United States (domestic demand) exceed U.S. production of goods and services (GNP), and that the United States is importing the difference. Intuitively, the strong U.S. recovery—especially in terms of domestic demand—has boosted expenditures on imports as well as on domestically produced goods. Relatively weak growth abroad, however, has limited the expansion of U.S. export markets.

Weak foreign growth has been a critical problem for the world economy. Assessments of the U.S. recovery and the deterioration of the U.S. payments position must take account of this weakness and of the importance of the U.S. expansion to sustaining world growth. Similarly, domestic demand growth abroad needs to be assessed not only in terms of its effect on the U.S. trade balance, but also in its role in sustaining foreign growth as the U.S. economy adjusts. This section, therefore, reviews the recent economic performance of foreign industrial countries, developing countries, and the United States, and analyzes the deterioration of the U.S. trade balance in this regard.

FOREIGN INDUSTRIAL COUNTRIES

In the 1980s, the industrial countries faced critical economic challenges of reducing inflation rates generally from double-digit levels, adjusting to the second oil shock of 1979-80, recovering from the world recession, and halting or reversing the growth in government expenditures. All countries achieved substantial reductions in inflation, but experienced varying success in meeting other challenges.

Western Europe's recovery from world recession has been slack. Between 1982 and 1985, real GNP in Western Europe grew at an average annual rate of about 2.2 percent, one-half of the growth rate experienced in the United States, Canada, or Japan (Table 3-3). Annual growth of domestic demand was slightly weaker, averaging only about 1.8 percent. This slow growth has coexisted with rising unemployment during much of the recovery. In 1986, the average unemployment rate for the four largest European countries (France, Italy, the United Kingdom, and West Germany) was about 10 percent, roughly double its 1980 rate.

This slow growth is especially disappointing given the stimulus to world growth provided by the strong U.S. recovery and the appreciation of the dollar (which increased these countries' relative competitiveness). Most Western European countries, however, generally coped successfully with the depreciation of the dollar in 1986. The rapid passthrough of lower petroleum prices increased consumer incomes and both consumption and investment strengthened. This strengthening of domestic demand enabled many Western European countries to enjoy a slight acceleration of GNP growth despite a weakening of real net exports. The cumulative growth rate of Western European domestic demand over the course of the expansion, however, remains low, especially for West Germany (despite strong growth in 1986), where the level of domestic demand in 1985 was only slightly above its 1980 level.

TABLE 3-3.—Growth in real domestic demand and real GNP in major industrial countries, 1970–86

[Average annual percent change]

Country	1970 to 1980		1980 to 1985		1982 to 1985		1985 III to 1986 III	
	Real domestic demand ¹	Real GNP ²	Real domestic demand ¹	Real GNP ²	Real domestic demand ¹	Real GNP ²	Real domestic demand ¹	Real GNP ²
United States	2.5	2.8	3.4	2.4	5.6	4.2	3.6	2.3
Canada	4.9	4.6	2.1	2.5	4.2	4.2	3.3	3.5
Japan	4.2	4.7	2.8	3.9	3.1	4.3	3.8	2.3
France	3.7	3.6	1.2	1.2	.8	1.2	(³)	(³)
Germany	2.7	2.7	.2	1.3	1.9	2.4	3.6	2.3
Italy	2.9	3.1	.4	.9	1.5	1.7	4.5	3.0
United Kingdom	1.7	1.9	1.9	1.9	3.1	3.1	3.3	2.0

¹ Domestic demand is the sum of personal consumption expenditures, gross private domestic investment, and government purchases of goods and services.

² Data for Canada, France, Italy, and United Kingdom are real GDP.

³ Not available.

Sources: International Monetary Fund and country sources.

Unlike Western Europe, Japan grew at a 4.3 percent annual rate between 1982 and 1985. Much of this growth, however, was exported. Following the 1979 oil shock, domestic demand in Japan slowed markedly as the country adjusted to the higher oil import bill. During the first half of the 1980s, the average rate of domestic demand growth was only about one-half its 1970–79 average. Rising exports, however, enabled GNP to grow more than 1 percentage point higher than domestic demand. This excess of output over demand growth was reversed in 1986 as real Japanese exports fell in the wake of the sharp appreciation of the yen. Japanese internal demand increased somewhat, but not enough to offset the decline in exports, and Japan's rate of GNP growth slowed to under 3 percent.

Despite differences in their growth rates, Western Europe and Japan shared similar policies and challenges. They both faced the sudden increase in petroleum prices while shifting to anti-inflationary monetary policies. They both moved generally toward fairly austere fiscal policies by restraining government expenditures. While the resulting reduction in inflation and increased budgetary room for tax cuts should provide a good foundation for stronger growth in the long run, the initial effect of these developments was to depress economic activity.

In Western Europe, these developments interacted with structural rigidities that, in addition to reducing long-run growth, intensified and prolonged the effect of macroeconomic shocks. Substantial non-wage labor costs and excessively expensive job security arrangements

discouraged labor mobility and new hiring. High marginal tax rates, various regulatory burdens, and large subsidies to declining industries and to agriculture impeded adjustment and growth by retarding the flow of investment toward high-growth sectors.

In Japan, structural rigidities did not prevent the economy from growing strongly over much of the 1980s. They did, however, hold domestic demand below what it could have been, giving the economy a bias toward export-led growth. Restrictions that have prevented the efficient use of scarce land, combined with mortgage instruments that require substantial downpayments, have made housing less affordable. Limitations on consumer credit markets have dampened the demand for consumer durables, discouraging investment aimed at producing for local markets.

DEVELOPING COUNTRIES

Slack growth of output and demand during the 1980s has not been confined to foreign industrial countries. With the exception of developing countries in Asia, growth in the developing world has been particularly weak. Between 1980 and 1986, annual real GNP growth in Latin America averaged 1 percent, less than one-fifth the average growth rate enjoyed during the 1970s (Table 3-4). Real GNP grew equally slowly in Africa over this period; in the Middle East, real GNP declined. This slow growth has depressed U.S. exports. Developing countries are important trading partners for the United States. In 1981, developing countries purchased 41 percent of all U.S. merchandise exports. By 1985, however, their trade share had fallen to 34 percent.

TABLE 3-4.—*Real GNP growth in developing countries*
(Average annual percent change)

Region	1970 to 1980	1980 to 1986 ¹	1980 to 1983	1983 to 1986 ¹
Western Hemisphere	5.8	1.0	-1.1	3.2
Africa	3.7	1.0	.3	1.7
Middle East.....	6.4	-4	-6	-1
Asia.....	5.2	4.7	5.2	4.1

¹ Preliminary estimates.

Source: International Monetary Fund.

The slow growth of many developing countries is the product of many forces. The recession in the industrial countries in the early 1980s, followed by the slack recovery of domestic demand in Japan and Europe, reduced the demand for many exports by developing countries. Exporters of primary commodities suffered particularly, as the shift from the inflation of the 1970s to the disinflation of the

1980s, combined with sluggish world growth, depressed prices for these products. Since 1980, the dollar price of raw agricultural commodities has fallen 20 percent; mineral prices have declined 30 percent.

With the appreciation of the dollar, the real burden of the dollar-denominated debt of many developing countries increased considerably. Much of this debt was contracted at floating rates, making debt-service payments highly sensitive to the sharp rise in nominal and real interest rates in the early 1980s. These developments caused many lenders to doubt the capacity of several developing countries to meet their obligations, and to end abruptly the access of these countries to international capital markets.

The policies of many developing countries were an important cause of the interruption of voluntary lending flows. Overvalued exchange rates, price controls, and schemes to boost real wages by legislative fiat made the production of many goods unprofitable and reduced the international competitiveness of many developing countries. Maintenance of substantially negative real interest rates, as well as tax and regulatory policies that discouraged investment, induced capital flight instead of encouraging the inward flows of capital needed to promote more rapid development. Reliance on inefficient public enterprises to produce a wide variety of goods and services continued to be important drains on government budgets. These drains further increased external deficits in these countries while failing to engender the productive investment needed to increase their capacity to service the associated external debts.

Whatever the cause, the cessation of voluntary lending flows forced developing countries with debt-management problems to cut import spending rapidly in order to reduce their borrowing needs. Between 1981 and 1983, the value of U.S. merchandise exports to Mexico fell \$9 billion, a drop of almost 50 percent. Exports to the rest of Latin America fell nearly 37 percent, or about \$8 billion. In contrast, U.S. exports to industrial countries fell 10 percent. Since 1983, exports to Latin America have recovered somewhat but still remain below 1980 levels.

GROWTH AND THE TRADE DEFICIT

The strong recovery in the United States—and the resulting deterioration of the U.S. international payments position—was a powerful stimulant to growth in both industrial and developing countries. This growth, which took place against the background of world recession, provided a vibrant market for foreign exporters at a time when many developing countries, suddenly facing credit constraints, needed to expand exports to finance imports sufficient to maintain politically

acceptable levels of output and income. In contrast, sluggish growth in most other industrial countries limited increases in their imports. Between 1982 and 1984, the United States absorbed about 95 percent of the increase in merchandise exports by Latin American countries to industrial countries, much more than would be implied by the normal 50 percent U.S. share of Latin American exports to industrial countries.

At first, the deterioration of the U.S. payments position helped as well as hurt the U.S. economy. During the first six quarters of the expansion, real GNP grew at a healthy 6.8 percent annual rate; domestic demand grew even faster, averaging 8.8 percent. In effect, growing net imports allowed desired increases in spending to be satisfied without pushing production growth to levels that would have caused bottlenecks. Although the strong appreciation of the dollar reduced U.S. international competitiveness, the resulting decline in import prices boosted real incomes in the United States and helped to ameliorate inflationary pressures.

Since mid-1984, domestic demand has grown at a 3.1 percent annual rate. However, despite this slowing of demand growth to more sustainable levels, increases in imports continued to outpace exports, and the annual rate of real GNP growth from the second quarter of 1984 to the fourth quarter of 1986 averaged only 2.4 percent. Insofar as the expanding capacity of the U.S. economy was more than sufficient to meet increases in total U.S. demand, the expansion of the U.S. trade deficit during this period was an important factor limiting growth. This negative consequence has stimulated protectionist sentiment in the United States, especially because the burden of the resulting adjustment has not been spread evenly through the economy. Industries that account for about 70 percent of U.S. GNP produce either services that do not enter into international trade or products that are largely nontradable. The deterioration in the U.S. balance in goods and services trade between 1980 and 1986, amounting to 5.7 percent of real GNP, was therefore concentrated in sectors of the economy that account for only about 30 percent of GNP. Moreover, the distribution of the adjustment within these sectors was not even.

THE SAVING-INVESTMENT BALANCE

The deterioration of the U.S. international payments position has also been closely associated with movements in national saving and investment. As discussed in the previous section, the U.S. deficit in goods and services trade signifies that total spending in the United

States on goods and services exceeds U.S. production of goods and services. This necessarily implies that the United States is absorbing foreign saving to finance the difference between expenditures and income or, equivalently, that U.S. investment exceeds U.S. saving. For example, in 1986, gross national saving in the United States was \$537 billion; gross private investment was \$686 billion. The difference was financed by a net capital inflow of nearly \$150 billion from abroad.

THE PRIVATE SAVING-INVESTMENT BALANCE

The national saving-investment balance is the excess of the private saving investment balance—the difference between gross private saving and gross private domestic investment—over the general (Federal, State, and local) government deficit. Between 1982 and 1986, the private saving-investment balance fell from 3.5 percent of GNP to -0.1 percent. This decline reflected the strength of consumption and investment growth, as is normal for a recovery. Given the length of the current expansion, the current level of the private saving-investment balance is not unusually low. The private saving-investment balance was lower in 1969 and 1979 than it was in 1986.

Between 1982 and 1985, the gross private saving rate—defined as gross private saving divided by GNP—fell less than one-half percentage point (Table 3-5). The ratio of private saving to GNP fell significantly, but this decline was more than offset by increases in net business saving. Such offsetting movements in household and business saving are not surprising, since households are the ultimate owners of all wealth, including the capital owned by businesses.

TABLE 3-5.—*Private saving and investment*

Year	As percent of GNP					Relative price of investment (1982=100) ³
	Private saving			Gross private domestic investment		
	Gross ¹	Personal	Business (net) ²	1982 dollars	Current dollars	
1979.....	17.8	4.7	2.5	18.0	18.1	100.6
1980.....	17.5	5.0	1.4	16.0	16.0	100.1
1981.....	18.0	5.2	1.4	16.8	16.9	100.6
1982.....	17.6	4.9	.6	14.1	14.1	100.0
1983.....	17.4	3.8	1.9	15.4	14.7	96.0
1984.....	17.9	4.5	2.4	18.7	17.6	94.1
1985.....	17.2	3.6	2.7	18.1	16.5	91.8
1986 ⁴	16.2	2.8	2.8	17.9	16.3	90.9

¹ Gross private saving is personal saving plus net business saving and capital consumption.

² Net business saving is undistributed corporate profits plus inventory valuation and capital consumption adjustments.

³ Implicit price deflator for gross private domestic investment relative to GNP implicit price deflator.

⁴ Preliminary.

Source: Department of Commerce (Bureau of Economic Analysis) and Council of Economic Advisers.

The gross private saving rate fell sharply in 1986. However, even with the drop in private saving, most of the decline in the private

saving-investment balance during the current expansion is accounted for by strong investment growth. Real gross private domestic investment rose 46 percent between 1982 and 1984, boosting the share of real investment in real GNP from a near record low of 14.1 percent to a near record high of 18.7 percent. Although investment growth has been sluggish since 1984, the share of real investment in real GNP has remained near cyclical highs.

This strength in real investment spending, however, was partially offset by a substantial decline in the relative price of investment goods. As reported in Table 3-5, the relative price of investment goods fell 9.1 percent between 1982 and 1986. In 1986, nominal expenditures on gross private domestic investment accounted for 16.3 percent of GNP, well below 1978-79 levels and only 0.3 percentage point above the average share of nominal investment expenditures experienced over the past 25 years. Thus, the lower relative price of investment goods allowed large increases in real investment to occur with only moderate demands on nominal saving. This development produced a normal cyclical decline in the private saving-investment balance, despite the decline in the gross private saving rate and the strength of real investment.

THE GOVERNMENT DEFICIT

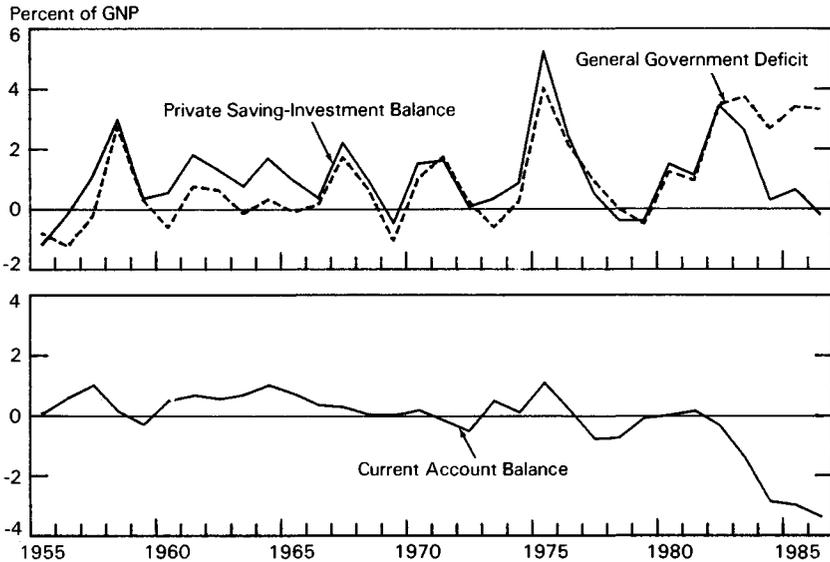
The large increase in the general government budget deficit, however, stands in marked contrast to its normal cyclical behavior. The general (Federal, State, and local) government budget deficit averaged 3.4 percent of GNP in 1986. This deficit/GNP ratio, although large, is not the largest experienced during the past 15 years. The general government budget deficit exceeded 3.4 percent of GNP in both 1975 and 1982. The 1975 and 1982 deficits, however, occurred during sharp recessions; the current large deficit comes in the fourth year of an expansion.

As indicated in Chart 3-3, until recently the general government budget deficit has tended to track the private saving-investment balance during cyclical expansions and declines. National saving has approximated national investment and the current account balance has been small. In recessions, government budget deficits typically widen as a result of declining tax revenues and increased expenditures associated with income support. The private saving-investment balance, however, usually increases by more than the cyclically induced decline in the general government budget deficit (because of weak investment and consumption spending), and the current account balance tends to improve. In the sharp 1975 recession, for example, the largest general government budget deficit in the postwar era (meas-

ured as a percent of GNP) coincided with one of the largest U.S. current account surpluses.

Chart 3-3

Private Saving-Investment Balance, Government Deficit, and Current Account Balance



Note.—For current account balance, data for 1986 are first 3 quarters at an annual rate; seasonally adjusted.
Source: Department of Commerce.

Similarly, strong investment growth during an expansion usually outstrips increases in private saving, and the private saving-investment balance declines. The associated growth in tax revenues, however, traditionally lowers the general government budget deficit, and the deterioration in the U.S. current account deficit usually remains modest. This pattern has not been followed in the current expansion. The increased surpluses of State and local governments have been more than offset by the large growth of the Federal Government budget deficit. This unprecedented deterioration of the U.S. fiscal position during an expansion, combined with a normal cyclical decline in the private saving-investment balance, has been reflected in an unprecedented deterioration in the U.S. current account balance.

It is important to emphasize that the government budget deficit and the U.S. international payments position are the product of many forces and that the link between them is complex. As noted above, increases in the government budget deficit that result from a cyclical

decline are typically associated with improvements in the U.S. international payments position. Clearly it is incorrect to say that movements in budget deficits always cause equal movements in the U.S. current account balance. It is equally clear, however, that the persistence of the Federal deficit late into the current expansion is one of the most important factors contributing to the growth of the trade deficit.

It is also important to emphasize that the desirability of any fiscal measure taken to reduce the current large budget and trade deficits depends critically on whether the measure is desirable in its own right. Federal outlays have remained at a high percentage of GNP. Sustained efforts to control Federal spending are needed not only to preserve the benefits of tax reform but also to reduce the U.S. international payments imbalance. The key point is that a substantial reduction in the U.S. current account deficit will require restraint of U.S. domestic demand growth relative to GNP growth. If this restraint does not come from controlling government spending, it must come from the other components of domestic demand—consumption and investment. Tax increases are not the answer. Higher tax rates would not only lower GNP growth in the short run, but would also continue to dull economic incentives and to reduce growth far into the future. This would make even more painful the necessary adjustment of consumption and investment to bring domestic demand in line with GNP in the long run.

INTERNATIONAL CAPITAL FLOWS

The link between the current account balance and the national saving-investment balance also helps to emphasize the importance of international capital markets and net capital flows in the development of the U.S. current account deficit. The counterpart to the U.S. current account deficit is a capital account surplus; developments influencing one account significantly influence the other. On the one hand, deep, liquid international capital markets have represented a ready source of financing for the large shortfall of U.S. saving relative to U.S. investment. On the other hand, changes in the desirability of holding U.S. assets, particularly dollar-denominated assets, have had substantial effects on exchange rates, thereby affecting the current account.

International capital markets channel resources from the ultimate savers in the world economy to those countries that offer the most attractive opportunities to invest. For example, through most of the 19th century, the inflow of capital from abroad helped the United States to exploit its vast productive potential much more quickly than if U.S. capital formation had been limited to U.S.-based saving. In

this case, the associated current account deficit was part of a process that invigorated a then-young economy.

Similarly, the capital inflows now associated with the U.S. current account deficit have once again become an important source of investment financing. Several factors have made the United States one of the most attractive places in which to invest funds. The strong growth of the U.S. economy during the first six quarters of this expansion stood in marked contrast to the sluggish performance abroad, especially in Europe. This growth, combined with the reduction in capital taxation embodied in the Economic Recovery Tax Act of 1981 (ERTA), surely increased the relative attractiveness of investment in the United States.

It is important to recognize, however, that the development of the U.S. current account deficit has also been associated with a sharp drop in the national saving rate (relative to the cyclical peak in either 1979 or 1981). Between 1981 and 1986, the national saving rate fell more than 4 percentage points (Table 3-6). This drop has made the United States increasingly dependent on net capital inflows to finance U.S. investment. In 1986, net capital inflows—and the associated buildup of foreign claims on the United States—equaled one-half of U.S. net capital formation. To the extent that the drop in the national saving rate is not desirable, this dependence on net capital inflows to finance U.S. investment is also not desirable. Part of the decline in the national saving rate has resulted from the failure to bring government expenditures in line with revenues. Part of the increased dependence on capital inflows to finance U.S. investment, therefore, ought to be viewed as a by-product of a fiscal stance that should be corrected by gradually reducing the share of Federal expenditures in GNP.

TABLE 3-6.—National saving, investment, and net capital inflow

[Percent of GNP]

Year	Gross private saving	Government saving ¹	Gross national saving	Net capital inflow ²	Gross private domestic investment ³
1979.....	17.8	0.5	18.3	-0.1	18.1
1980.....	17.5	-1.3	16.3	-3	16.0
1981.....	18.0	-1.0	17.1	-2	16.9
1982.....	17.6	-3.5	14.1	-0	14.1
1983.....	17.4	-3.8	13.6	1.1	14.7
1984.....	17.9	-2.7	15.2	2.4	17.6
1985.....	17.2	-3.4	13.8	2.7	16.5
1986 ⁴	16.2	-3.4	12.8	3.5	16.3

¹ Federal, State, and local governments.

² Includes statistical discrepancy.

³ Nominal prices.

⁴ Preliminary.

Source: Department of Commerce, Bureau of Economic Analysis.

This conclusion, however, in no way minimizes the role capital markets have played in driving the current account. Exchange rates are determined in asset markets. As is discussed in the next section, the strong increase in the demand for dollar-denominated assets during the first half of the 1980s, and the consequent appreciation of the dollar between 1980 and early 1985, was a key factor underlying the deterioration of the U.S. current account balance.

EXCHANGE RATES AND COMPETITIVENESS

Exchange-rate changes are a direct channel through which international divergences in economic policy are transmitted to domestic economic performance. Exchange-rate movements that persistently exceed international inflation differentials—real exchange-rate movements—change the prices of a country's imports relative to domestically produced goods and alter the ability of its producers to compete in world markets. This section reviews the behavior of the real foreign exchange value of the dollar and the relative price of U.S. imports over the past decade, investigates the sources of these real exchange-rate movements, and assesses the effect of these exchange-rate movements on the international cost competitiveness of U.S. manufacturers.

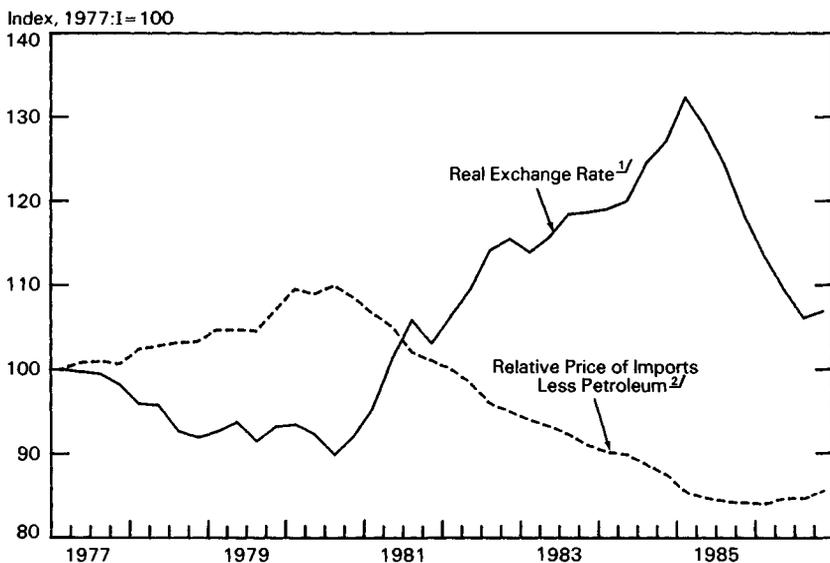
SOURCES OF REAL EXCHANGE RATE MOVEMENTS

The past decade has been characterized by wide swings in the foreign exchange value of the dollar and in the relative price of imports. Chart 3-4 presents an index of the foreign exchange value of the dollar against a trade-weighted basket of currencies from 18 other industrial and 22 developing countries. The index is adjusted for differences in wholesale price inflation in each country and thus measures changes in the real foreign exchange value of the dollar. Also presented is an index of the relative price of non-oil imports, computed as the ratio of the import price deflator excluding petroleum to the total GNP price deflator. As can be seen from the chart, broad movements in the dollar's real exchange rate and the relative price of imports over the past decade can be divided into three phases.

During the late 1970s, the real value of the trade-weighted dollar depreciated and the relative price of imports increased by roughly 10 percent. According to many observers, the weakness of the dollar in the late 1970s was directly related to the perception that the United States was embarked on significantly more inflationary policies than were Japan and many West European countries. This perception led to depreciation of the dollar not only in nominal terms, but also in real terms. The nominal foreign exchange value of the dollar fell

Chart 3-4

Real Exchange Rate and Relative Price of Imports



^{1/}Trade-weighted value of the dollar adjusted by relative wholesale prices.

^{2/}Ratio of implicit price deflator for imports less petroleum to GNP implicit price deflator.

Sources: Morgan Guaranty Trust Company of New York and Department of Commerce.

more than was justified by the actual excess of inflation in the United States over inflation in other countries, because the exchange rate responds to expected future inflation as well as to current and past inflation.

The relatively weak dollar during the late 1970s benefited many trade-sensitive industries in the United States. The real depreciation of the dollar shielded these industries from their foreign competitors because, as is shown in Chart 3-4, import prices increased faster than did the prices of domestically produced goods and services. This allowed some manufacturing industries to remain profitable while increasing real wage rates substantially more rapidly than in the rest of the United States economy, despite slow productivity growth. The insulation from foreign competition that the weak dollar provided to many trade-sensitive industries in the United States in the 1970s left many of these industries poorly prepared to deal with such competition in the 1980s.

The first half of the 1980s was marked by an unprecedented surge in the real foreign exchange value of the dollar. From the third quarter of 1980 through the first quarter of 1985, the real value of the trade-weighted dollar appreciated by some 47 percent and the relative price of imports declined by 22 percent. Although some observers have claimed that the dollar's appreciation can be attributed to a single cause, several factors contributed to the sustained rise in the dollar between 1980 and early 1985.

The shift in monetary policy from one of perceived ease and accommodation to an actual and ultimately perceived anti-inflationary stance in the early 1980s was likely critical to the reversal during 1981 and 1982 of the real depreciation of the dollar that had occurred in the late 1970s. Between the third quarter of 1980 and the fourth quarter of 1981, the dollar appreciated in real terms back to its early 1977 level. The dollar appreciated an additional 12 percent in real terms in 1982. This appreciation was likely due, at least in part, to increasingly persuasive evidence that the Federal Reserve was committed to an anti-inflationary monetary policy.

From the trough of the recession in the fourth quarter of 1982 through the first quarter of 1985, the dollar appreciated an additional 15 percent in real terms. The initial dramatic decline and subsequent stability of inflation, in conjunction with the strong growth in real GNP in comparison with both past expansions and growth in most other industrial countries, probably played an important role in the further appreciation of the dollar during 1983-84.

The excess of real domestic demand over real domestic output that has characterized the current expansion translates into an excess of real domestic investment over real domestic saving that, in turn, equals the real net inflow of foreign capital. At least a portion of this capital inflow and the appreciation of the dollar during 1983-84 likely resulted from the increase in the after-tax profitability of physical investment in the United States during this period. The increase in the after-tax profitability of investment resulted from the interaction of the ERTA tax reductions with the decline in inflation, which increased the value of original cost depreciation.

Real business fixed investment grew much more rapidly relative to real GNP in the first 2 years of the expansion than in previous cyclical upswings. Indeed, the share of real business fixed investment in real GNP achieved a postwar record in 1984. This strength occurred despite high real interest rates and concern that the Federal budget deficit would crowd out private investment. Furthermore, the real valuation of the corporate capital stock by the equity markets also surged during this period. As discussed in previous *Economic Reports*, these facts are consistent with the view that changes in the tax law

raised the value in equity markets of new physical capital and the attractiveness of foreign investment in the United States.

Since the first quarter of 1985, the real value of the trade-weighted dollar has fallen by 20 percent, back to its late 1981 level. Although the causes of this steep depreciation of the dollar are difficult to isolate with precision, the decline in real GNP growth in the United States since mid-1984 likely contributed to the dollar's fall. In addition, the announced intentions of the Group of Five to seek a lower dollar in the Plaza Agreement and subsequent actions to back up these intentions, especially the continuation of the easing of U.S. monetary policy that began in late 1984, probably contributed to further dollar depreciation after September 1985. More generally, the convergence of economic performance and economic policies of the leading industrial countries in 1985 and 1986 was probably necessary to support a significant adjustment of exchange rates.

So far, little evidence exists of the effect of the substantial depreciation of the dollar on U.S. trade flows. Several factors help to explain this limited impact. Existing empirical evidence indicates that import prices respond with a lag of up to 2 years to even large changes in exchange rates. This phenomenon results from the choice of foreign producers to boost profit margins as their currencies depreciate against the dollar and to allow these margins to narrow so as to maintain market share as their currencies appreciate against the dollar. According to one study, foreign producers widened their profit margins considerably during the 1980-84 appreciation of the dollar. This provided them ample room to narrow profit margins by limiting price increases and thus maintain market share as the dollar depreciated. Indeed, as is shown in Chart 3-4, non-oil import prices actually declined in 1985 and began to rise only in 1986.

Another factor that has limited the immediate effect of the depreciation of the dollar on U.S. trade flows is that the dollar has not in fact depreciated substantially against the currencies of several important trading partners. Total imports from Canada, Korea, and Taiwan exceed imports from Western Europe or Japan, yet the dollar has depreciated less than 7 percent against the currencies of Canada and Taiwan and has actually continued to appreciate against the Korean won.

PRODUCTIVITY AND COMPETITIVENESS

Declining international competitiveness of the U.S. economy, especially manufacturing industries, is often cited as an important cause of the deterioration of the U.S. trade balance. Programs to revive supposedly sagging productivity growth are often recommended as a means of improving competitiveness and reducing the trade deficit.

In fact, as is discussed in Chapter 1, productivity growth in manufacturing during the current cycle has exceeded the postwar average and substantially exceeded the sluggish rate of productivity growth during the 1970s. Since the business cycle peak in the third quarter of 1981, output per hour in manufacturing has grown at an average annual rate of 3.8 percent, 46 percent faster than the postwar average of 2.6 percent per year and more than twice the annual average rate of 1.5 percent recorded between 1973 and 1981. Furthermore, real wage growth in the manufacturing sector has exhibited notable restraint during the current cycle. Since the business cycle peak, real hourly compensation in manufacturing has grown at an average annual rate of 1.0 percent, 50 percent slower than the postwar average annual rate of 2.0 percent.

As the result of restrained wage increases and strong productivity growth, unit labor costs in manufacturing have increased at an average annual rate of only 0.7 percent since the 1981 peak and have actually declined at an average annual rate of 0.8 percent since the recession trough in the fourth quarter of 1982. By contrast, unit labor costs in manufacturing have grown at an average annual rate of 3.4 percent over the entire postwar period and grew at an average annual rate of 8.2 percent between 1973 and 1981.

Table 3-7 compares movements in unit labor costs in the United States with a trade-weighted average of unit labor costs in 11 of the largest foreign industrial countries. As is shown in the second column of the table, when measured on a national currency basis, growth in unit labor costs during the first half of the 1980s was 5 percentage points higher abroad than in the United States. In the absence of other developments, the relatively better U.S. performance—which was a product of surging productivity growth and restrained wage increases—would have improved U.S. international cost competitiveness. However, the cost competitiveness of U.S. manufacturers also depends upon the dollar exchange rate. Foreign importers can charge a lower dollar price to cover the same level of national currency costs when the dollar appreciates against their own currencies.

As indicated by the third column of Table 3-7, the appreciation of the dollar during the first half of this decade overwhelmed the other determinants of international cost competitiveness. In national currency terms, unit labor costs in the 11 largest foreign industrial countries rose more than 16 percent during the first half of the 1980s; in dollar terms, foreign unit labor costs fell nearly 20 percent. Instead of experiencing a 5 percent improvement in U.S. international cost competitiveness between 1980 and 1985, the strong appreciation of

TABLE 3-7.—U.S. and foreign unit labor costs, 1980-85

[1980=100]

Year	United States	Eleven foreign industrial countries ¹	
		National currency basis	Dollar basis
1980.....	100.0	100.0	100.0
1981.....	107.3	108.2	96.9
1982.....	114.0	114.4	91.6
1983.....	111.1	115.4	88.5
1984.....	110.5	115.1	81.9
1985.....	111.2	116.3	80.3

¹ Trade-weighted average of Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Norway, Sweden, and United Kingdom.

Source: Department of Labor (Bureau of Labor Statistics) and Council of Economic Advisers.

the dollar boosted the ratio of U.S. unit labor costs to foreign unit labor costs by 39 percent.

This gap between the unit labor costs in U.S. manufacturing industries relative to manufacturing industries in most other industrial countries has been narrowed significantly by the depreciation of the dollar that began in early 1985. According to the International Monetary Fund, the ratio of unit labor costs in the United States to a trade-weighted average of unit labor costs expressed in dollars in other industrial countries fell almost 30 percent to its 1981 level between the first quarter of 1985 and the second quarter of 1986.

In sum, the deterioration of international cost competitiveness in U.S. manufacturing during the first half of this decade was the result of the real appreciation of the dollar, not sagging productivity growth or excessive wage increases. This fact does not imply, however, that the United States can or should rely solely on exchange-rate movements to improve further its international cost competitiveness. Exchange-rate depreciation can increase competitiveness in the intermediate run by making foreign-produced products more expensive, but at the cost of slower real income growth. By contrast, improving international cost competitiveness through greater productivity and economic efficiency increases real income growth. The United States should seek to strengthen international competitiveness by implementing policies that increase productivity. The President is sending to the Congress a package of initiatives to enhance further U.S. productivity and competitiveness, including increased funding for basic and applied scientific research, reforms of Federal regulations to reduce business costs while continuing to serve important regulatory goals, and efforts to improve access for U.S. products and services in foreign markets.

POLICY COORDINATION AND EXCHANGE RATE STABILITY

There is general agreement among economists that better convergence of economic performance and better coordination of economic policies among the leading industrial countries is both desirable and essential for achieving greater stability of exchange rates. At the Tokyo Economic Summit, the leaders of the seven largest industrial countries agreed to a flexible approach to improving the international monetary system by providing more effective procedures for the coordination of economic policies. The approach adopted in Tokyo represents an important step down the path to greater convergence of economic performance and better coordination of economic policies—a path that was charted at earlier Economic Summits and Ministerial Meetings, including especially the Versailles Economic Summit and the Group of Five meeting of September 1985. Three features of the approach outlined at the Tokyo Summit deserve particular emphasis.

First, efforts at policy coordination will not focus narrowly on achieving specific values or ranges for exchange rates. Policymakers are to consider a broad class of indicators of economic performance and economic policy: GNP growth rates, inflation rates, interest rates, unemployment rates, fiscal deficit ratios, current account and trade balances, monetary growth rates, reserves, and exchange rates. This approach should help to avoid the inherent weakness of pegged exchange-rate systems: rigid commitments to particular exchange-rate values or ranges become too expensive in terms of other important policy objectives and ultimately collapse under the pressure of policy conflicts. The Tokyo Summit leaders explicitly stated that the objectives of policy coordination are much broader than limiting exchange-rate movements. Objectives include “promoting non-inflationary economic growth, strengthening market-oriented incentives for employment and productive investment, opening the international trading and investment system and fostering greater stability of exchange rates.”

Second, individual nations are responsible for formulating their economic objectives and forecasting the critical indicators of economic policy and performance. Collective assessment of the mutual compatibility of objectives and forecasts is required as the essence of policy coordination, and the managing director of the International Monetary Fund is assigned his traditional role in assisting multilateral surveillance. However, no agency is asked to undertake the essentially impossible task of forcing sovereign nations to pursue policies contrary to their perceived national interests. Instead, the onus is on individual nations to live up to their own commitments and forecasts.

Third, when significant deviations from the intended and agreed upon course arise, individual nations are pledged "to make their best efforts to reach understanding on appropriate remedial measures. . . ." This pledge is not an effort to fine-tune the world economy to correct for all of the minor and inevitable deviations from its forecasted path. The emphasis is on "significant deviations from intended course." Further, the Summit leaders agreed that remedial efforts should "focus first on underlying policy fundamentals. . . ." This agreement does not preclude official intervention in foreign exchange markets, when such intervention would be useful. However, it does place the emphasis for policy coordination where it belongs—on the economic policies that ultimately influence important developments in the world economy.

Experience with the operation of this new system of policy coordination will contribute to its further development. Even at this stage, however, it is clear that better policy coordination offers the promise of more stable exchange rates, reduced external imbalances, and a more favorable economic environment for developing countries.

CURRENT REQUIREMENTS FOR POLICY COORDINATION

In the period ahead, the principal challenge of policy coordination is to reduce present international payments imbalances in a manner that will support sustained, noninflationary growth in the world economy. Unilateral actions by the United States are not sufficient to accomplish this goal. Although a sharp U.S. recession would probably improve the U.S. trade balance, it would not only injure economic well-being in the United States, but would also sharply curtail prospects for growth in the rest of the world. Massive dollar depreciation, by shifting world demand toward U.S.-produced goods, would help reduce the U.S. external deficit but at a cost of increased inflationary pressures in the United States and depressed output growth in the main U.S. trading partners. Put simply, reduction of the U.S. current account deficit requires that real GNP in the United States grow more strongly than domestic demand. This implies that real GNP growth abroad will fall short of foreign domestic demand growth. Unless foreign domestic demand strengthens, improvement in the U.S. current account balance will necessarily be associated with reduced foreign growth. Given the size of the potential adjustment in the U.S. current account, the risk is that foreign growth would be sharply reduced.

An essential element of any program to reduce current external imbalances, therefore, is that other industrial countries must achieve stronger, domestic-led growth. Stronger domestic demand growth is needed primarily to maintain satisfactory output and employment

growth in these countries while the United States adjusts. It is also needed to engender the much needed expansion of U.S. export markets without having to rely on further massive depreciation of the dollar. Finally, strengthened foreign domestic demand is needed to maintain the growth of demand for the exports of many developing countries. Many of these countries, especially those with debt service problems, face considerable pressures to improve their external positions. The United States, however, will be reducing, not increasing, its external deficit; thus, further improvements of the developing countries' payments positions must come from the other industrialized countries.

Because the reduction of the U.S. current account deficit will take time, strengthened foreign growth must be sustained over the medium term. Achieving such long-lasting improvements requires the elimination of those structural (i.e., microeconomic-based) distortions that have impeded growth. In particular, to ease adjustment in the traded goods sectors, efforts must be redoubled to eliminate not only those practices that have restrained domestic demand but also those rigidities that have reduced the mobility of labor and capital between sectors. In Western Europe, where the recent economic recovery has coexisted with sustained rises in unemployment—in some countries to depression levels—there is a clear need to reform those policies that have reduced labor flexibility and have rendered employment unprofitable. In Japan, where the emphasis has been on export-led growth, the need is to eliminate those policies that have hindered domestic demand. In many countries there is a need to consider tax reforms that would substantially lower marginal tax rates, without necessarily reducing government revenues in the long run. These measures are desirable not simply because they would indirectly help reduce present external imbalances; they are desirable because they would improve long-term economic performance and well-being.

Efforts by foreign industrial countries to effect a growth-oriented reduction in external imbalances must be matched by corresponding efforts by the United States. Reductions in the U.S. current account deficit require that domestic demand in the United States grow less rapidly than GNP and that national saving increase by more than national investment. The United States can make a critical contribution to achieving these results by reducing the Federal deficit through expenditure restraint. Restraint on Federal spending would help slow domestic demand growth, but the effects of this slowing would not significantly reduce GNP growth, provided that stronger growth of demand abroad and the lagged effects of dollar depreciation boost U.S. exports.

The preferred approach to unwinding current external imbalances calls for continued growth of world demand, but with a smaller contribution coming from the United States and a larger contribution from surplus countries. Domestic demand growth abroad would expand faster than potential GNP, while domestic demand in the United States would grow more slowly than potential output. Movements in exchange rates would offset the effect of these changes in the sources of world demand for any one country's products. In the United States, the reduced size of the government would allow for a greater percentage of the Nation's output to be devoted toward private investment and consumption.

Two other elements are also essential for the effective implementation of this program. First, developing countries, especially those with external debt problems, need to adopt more growth-oriented policies. The critical issue here is really for developing countries themselves to make the reforms necessary to support long-term growth. However, the industrial countries and the international financial system have an important role to play in assisting countries that are moving toward more growth-oriented reforms. This role is the essence of the program articulated by the Secretary of the Treasury in October 1985 to deal with the problems of debtor countries. The long-term goal of this approach is to restore the access of these countries to international capital markets by increasing their capacity to service their debts. By taking the measures needed to restore their access to international credit markets, these countries will not only be pursuing policies that will promote long-term growth with existing resources, but will also restore the capital inflows needed to underwrite additional investment and growth. These developments would primarily benefit the developing countries themselves. They would also expand markets for the products of the industrial countries. Meanwhile, industrial countries can contribute to growth-oriented adjustment in developing countries by sustaining a growing market for their exports. (For a detailed analysis of this subject, see *Economic Report of the President: 1986*, Chapter 2.)

Finally, all countries must avoid new protectionist measures and work to reduce and eventually dismantle existing barriers to international trade in both goods and services. Much attention has recently focused on growing protectionist sentiment in the United States. Progress in reducing the U.S. trade deficit, combined with efforts abroad to reduce protectionism in foreign markets, are clearly important in resisting protectionist actions in the United States.

Similarly, efforts in the United States to resist protectionism are needed to prevent the awakening of protectionist forces abroad. International trade, after all, is dominated by trade in goods. Just as

most of the deterioration of the U.S. trade balance was in manufactures, improvements in the U.S. trade balance will come about largely from a swing in manufactures trade. This development will present serious adjustment problems for U.S. trading partners, especially as the performance of manufactures output in many countries, notably Western European countries, has been weak. It would be singularly unfortunate, therefore, if the United States were to suggest—just as its trade position was beginning to improve—that protectionist measures were an acceptable response to these adjustment pressures. In the end, all countries share an important common interest in the liberal system of international trade and must work to protect and expand that system.

International policy coordination will always be made difficult by intercountry differences in economic situation and policy priorities. At a minimum, however, it is important to identify those situations in which joint actions will reinforce efforts to achieve individual as well as common goals. Clearly, it is in every nation's interest that international payments imbalances unwind in an environment of continued world growth. Actions by other nations to strengthen their domestic demand and to reduce structural rigidities that have impeded adjustment, combined with resolute action by the United States to restrain Federal spending, offer a means of accomplishing this goal.