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IMBALANCES AND ASYMMETRIES IN THE WORLD ECONOMY

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By

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Record trade and financial imbalances in the international accounts are among the most troublesome features of today's world economy. These imbalances pose a threat to continued economic growth and progress. Left unchecked, they may eventually endanger the international commercial and financial system -- the system that is essential to the conduct of our economic affairs.

I want first to delineate the size of the problem and its causes and then examine the alternative courses of action open to the international community.

I will argue that in devising effective adjustment measures, not only the problem facing the individual country, but also the prevailing global economic and financial environment should be taken into account. Adjustment measures that may be appropriate for one country may be inappropriate for another country. In addition, policy choices must be assessed from the standpoint of the global economy. That is the essence of the argument for policy coordination.

One important dimension that is often neglected in this context is time. Adjustment policies may be very different depending on the time horizon that is being considered. The careful design and implementation of these policies will help all of us to minimize the costs of adjustment and may even yield net benefits to most, if not all, of us.

The Nature of the Imbalances

Last year, the U.S. current account deficit amounted to $161 billion. Counterbalancing this deficit were surpluses of $86 billion in Japan and $44 billion in Germany. Adding in the $33 billion combined current account surplus of the newly industrialized countries of South Korea, Taiwan, Hong Kong, and Singapore we can pretty much account for the global imbalances. The problem confronting the world economic community is therefore clear.

The current pattern of external imbalances is a relatively recent phenomenon. In 1980, the United States still showed a small surplus of $2 billion on the current account, while Japan had a deficit of over $10 billion and Germany had a $15 billion deficit.

You will recall that this was immediately after the second increase in oil prices, which generated its own set of international payment imbalances. In 1980, the oil-exporting countries enjoyed a trade surplus of over $170 billion and a current account surplus of over $100 billion. At the same time, the industrialized countries as a group experienced a current account deficit of over $60 billion; only the United States, Norway, and the United Kingdom -- all of which are major oil producers themselves -- showed small surpluses. All the continental European countries suffered deficits, and so did Japan. But barely two years later, by 1982, the $103 billion surplus of the oil exporters had evaporated, and they themselves faced a $3 billion current account deficit.

This rapid adjustment may lend us hope that we may reduce our current imbalances much more rapidly than is commonly expected. If we take appropriate action, international markets may well react swiftly -- and positively.

At the same time, the disappearance of the oil surplus and the emergence of large imbalances among the industrialized countries may serve as a warning that unless we implement appropriate policies, the current round of international adjustment may well give rise to

yet another set of international imbalances. Most observers will agree that such an outcome would be counterproductive. Indeed, such an event might be extremely costly to the world economy.

We must, therefore, take care to design and implement policies that will dampen the oscillations in international trade and finance, and not set in motion another round of imbalances.

Reasons for the Emergence of the External Imbalance

No single reason seems to account for the current international imbalances. Probably, several factors have played a role.

For one, U.S. economic growth in 1983 and 1984 exceeded the growth in all other industrialized countries. Consequently, foreign producers focused their export efforts on the rapidly expanding American markets, and U.S. imports surged. Much of that growth was due to the stimulus provided by the rapidly growing U.S. budget deficit, which surged to $208 billion in 1983. The rapidly increasing governmental expenditures acted as a strong economic stimulus, and some of that spending spilled over into the international sector. At the same time, the heavy financing needs of the

government exerted pressure on the credit markets -- pressure that was, increasingly, relieved from abroad.

Second, many foreign countries grew slowly in the first half of the eighties, and consequently U.S. exports stagnated as well. What was true for U.S. exports in general was particularly true for exports to the developing countries. Prior to the international debt crisis of 1981, these countries had taken 40 percent of all U.S. exports; these exports declined by over 20 percent between 1981 and 1983.

Third, at the same time the United States pursued a strictly anti-inflationary monetary policy that restored confidence in the dollar as a store of value. The high U.S. interest rates prevailing in the early 1980s made dollar assets even more alluring, and foreign capital began to flow into the United States. The increase in the demand for dollars resulted in a sharp appreciation of the currency in the first half of the 1980s. This, in turn, helped weaken the competitive position of American business both at home and abroad.

As a consequence of these and other factors, U.S. imports almost doubled between 1980 and 1986. Over that period, they increased from $171 billion to $335

billion. That works out to be an average annual rate of 16 percent for all our imports. What's more, our imports from Japan and the Asian NICs grew more than 26 percent per year. As a result, economic activity abroad recovered and the United States effectively led the world into an economic upswing that is still continuing.

On the other hand, U.S. exports grew not at all: they amounted to $224 billion in 1980 and also in 1986. And because prices increased somewhat during that period, these numbers mean that the volume of exports actually declined. Exports to Western Europe and the debt-ridden Latin American countries contracted even in nominal dollar terms.

The emergence of the U.S. balance of payments problem is therefore due largely to a surge in imports and the stagnation of exports.

We should pause, however, before reaching the conclusion that foreigners closed their markets to our products or that American producers could no longer compete in world markets. Neither of these conclusions is true: the stability of U.S. exporters' share in world markets during this period demonstrates that.

Instead, U.S. exports stagnated because world markets stagnated. The value of total world trade outside the United States actually declined in the early 1980s. Imports by all countries, excluding the United States, slipped from $1,689 billion in 1980 to $1,679 billion in 1986 -- and that's before taking account of inflation. In short, the stagnation in U.S. exports was caused by the stagnation in world trade, and not by a shrinkage in the U.S. market share.

Two factors were responsible for most of the decline in world trade as measured in dollars. One is the drop in the average price of petroleum: Saudi Arabian crude cost $32.00 in 1980 and only $13.50 in 1986. Second, between 1980 and 1985, the value of the dollar increased sharply in world currency markets -- before it declined a bit in 1986. The value of trade carried on among other countries and denominated in other currencies therefore decreased when measured in dollars. The volume of world exports actually continued to expand by about 2-1/2 percent per annum from 1980 to 1986.

In recent research the staff of the Federal Reserve has identified the elements of the $166 billion deterioration in the real trade balance of the United States between 1980 and 1986: $42 billion was due to

the growth differential between us and our trading partners, and $121 billion was due to the change in relative prices of our exports and non-oil imports, which was mostly due to the appreciation of the dollar. This leaves only $3 billion to be accounted for by other factors.*

This analysis confirms that the growth differential and shifts in relative prices, which largely reflected the appreciation of the dollar, have been responsible for the deterioration in the U.S. trade balance.

The External Debt Dynamic

The need to correct the external imbalance is accentuated by the dynamics of the external debt that the United States is accumulating. If nothing is done to rectify the imbalances, the external payments situation of the United States may become more and more troublesome.

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* William Helkie and Peter Hooper, "An Empirical Analysis of the External Deficit, 1980-86," in: Ralph Bryant, Gerald Holtham, and Peter Hooper, eds., External Deficits and the Dollar, Brookings Institution, 1988, p. 41.

If the deterioration in the current account deficit were to continue unabated and thus were to add about $150 billion per year to the external indebtedness of the United States, the net external debt of the United States would total about $1 trillion four years from now.

Historically, the U.S. economy has grown about 3 percent per year. If the scenario I have outlined plays out, much of these gains will have to be transferred abroad in the form of debt service payments, leaving U.S. residents with a stagnant per capita income.

If we fail to rewrite this scenario, eventually all the gains achieved by economic growth may disappear abroad. This is a dismal prospect indeed, and we should take action now, before it is too late.

Asymmetries of Alternative Adjustment Policies

This brings us to the crucial question of what adjustment policies should be followed.

It is useful to distinguish between two kinds of policies that may be used to rectify an external imbalance: expenditure-switching and expenditure-

changing policies. Expenditure-switching policies change the relative prices of domestic and foreign goods. They may take the form of changes in exchange rates or changes in the general price level.

Expenditure-changing policies raise or lower the aggregate level of economic activity. They may work on the demand side -- for example, through an increase or decrease in governmental purchases, or they may work on the supply side -- say, through policies that strengthen or weaken the incentives for work and investment.

Each kind of policy is associated with certain benefits and costs, and may therefore be more or less desirable. It is important to recognize that these benefits and costs may differ according to the general economic characteristics of the country and macro-economic setting within which the policies are implemented. What may be the least-cost adjustment policy in one set of circumstances may well prove very costly in another set of circumstances.

Moreover, the decision calculus may shift with the time dimension. We will return to this important issue later.

Aggregate Demand Management

Traditional Keynesian analysis emphasizes expenditure adjustment through changes in aggregate demand. A country that wishes to eliminate an external deficit by dampening expenditures will either lower government spending or force a reduction of private expenditures through an increase in taxation or a tightening of monetary policy. As income falls, people will spend less on imports. This is the classic adjustment through austerity.

What is the cost of such a policy? It is simply the income forgone as a result of the austerity measures. Two factors will influence that cost: the first is the size of the initial imbalance; and the second is the degree of openness of the economy as measured by the country's propensity to import. (To keep matters simple, we will assume that the marginal propensity to import is equal to the average propensity to import. Marginal propensities are the appropriate measure in the case of small external adjustments.)

As a general proposition, the more open an economy is, the lower will be the costs of dampening income to eliminate a given imbalance. Take the Netherlands, which spends half its income on imports. To reduce

imports by, say, $1 billion, the Netherlands must reduce national income by $2 billion.

In contrast, the United States, which spends only about 10 percent of national income on imports, must reduce national income by $10 billion to reduce imports by $1 billion -- other things equal, of course.

Income dampening, that is to say, is a relatively expensive policy for a country with a small foreign trade sector and a relatively inexpensive policy for a country with a large trade sector. This point is often neglected in policy discussions, in which each country is urged to adopt an equal share of the external adjustment. It might be less expensive for the world economy as a whole if income-dampening policies were pursued mainly by open economies.

Supply-Side Policies

The potential for supply-side policies should be seen not as an absolute, but rather in relation to the potential for improvements in economic performance through the abolition of institutional rigidities and the enhancement of economic incentives. In countries with severe institutional rigidities or a confiscatory tax structure (or both), the potential for positive

action is greater than it is in countries that already have a market-oriented economy or low tax rates.

What makes the design and implementation of supply-side policies more complex is that we have no one simple formula that can be applied mechanically to all situations. Instead, each case must be analyzed on its own merits and policies to cope with it must then be designed and implemented.

Only protectionists will argue in favor of policies that artificially restrict imports. Such policies will typically reduce the level of welfare enjoyed by the populace at large. Only few would advocate protectionism as a means of rectifying an external deficit Instead, protectionists generally want to favor one area of activity at the expense of others.

Supply-siders are likely to focus on market-opening measures that the country's trading partners can undertake and that will encourage an expansion of exports that redresses the balance of payments. But such an endeavor is fraught with difficulty. Unless the negotiations are carefully controlled, they can easily degenerate into finger pointing -- each side claiming that the other should liberalize its policies.

It follows that supply-side policies are best suited to eliminate balance of payments surpluses by increasing imports through market-opening measures. Pari-passu, the exports of the deficit countries will be eliminated as well.

Expenditure-Switching Policies

Expenditure-switching policies are those that influence the relative prices of domestic and foreign goods. They make take the form of changes in the general price level or in the exchange rate.

As was true for expenditure-changing policies, the desirability of expenditure-switching policies is subject to asymmetries. Few people would advocate that a surplus country undergo a general price inflation in order to eliminate its balance of payments surplus. Instead, an appreciation of the currency may be more appropriate. That choice is easy.

But deficit countries face tougher choices. In a country that suffers from inflation, an external deficit lends weight to the argument for stringent anti-inflationary measures. In a country with price stability, on the other hand, it may be difficult to argue for a deflationary policy in order to rectify the

external balance.

Changes in exchange rates can bring about the same relative price effects without the need to change the general price level. For a very open economy, however, changes in exchange rates and changes in the general price level may amount to one and the same thing. If half the GNP is traded internationally, it makes little difference whether all prices in the domestic sector are adjusted or all prices in the foreign sector are adjusted as a consequence of an exchange rate change. Of course, there are secondary adjustments as well, as the substitution effects between foreign and domestic goods induced by the original price changes lead to further price changes that may impact the entire economy.

In contrast, a change in the exchange rate will disrupt a comparatively closed economy relatively less. That is, exchange rate changes, however undesirable they might be, have less of a disturbing effect in comparatively closed economies.

To see the validity of these propositions, one has only to look at the kinds of exchange rate systems various countries choose. Frequently, a small open economy will peg its exchange rate to the currency of its most

important trading partner. Very small countries even go so far as simply to adopt the currency of another country -- quite often a large neighbor country. Liechtenstein uses the Swiss franc; San Marino uses the lire; Monaco uses the French franc; and Luxembourg is in a currency union with Belgium. All these are cases in point.

The maintenance of an independent currency is often seen as an important manifestation of national sovereignty. However, as economic and financial integration proceeds, the de-facto exercise of national sovereignty in economic and financial relations becomes more constrained. One may well argue that once full economic union is achieved and capital and labor are free to move across national borders, the incremental loss of national sovereignty due to the adoption of a common currency is minimal indeed. That is the case for the countries I just mentioned, which, small though they may be, guard their own identity as jealously as any others.

It follows that as countries become more integrated and as foreign trade and finance expand and become more significant, exchange rate adjustments become less and less desirable. This point is illustrated by the move toward greater exchange rate stability in Europe

through the formation of the European Monetary System, as the economic and financial integration of the continent is proceeding.

The Time Dimension

Earlier, I mentioned the importance of time in choosing among policies for redressing an external deficit. The magnitude of an import or export response to a policy change depends heavily upon the amount of time that is allowed for adjustment. The longer the time horizon, the greater the response to price or exchange rate changes.

This observation has important implications for policy, because it implies that the attempt to undertake the entire adjustment within a short period may necessitate larger exchange rate changes than would be called for if a longer period were allowed. These larger changes may run the risk of overshooting and thus may engender further instabilities.

Excessive fluctuations in exchange rates, in turn, may be accompanied with additional costs not only in the form of increases in risk and uncertainty, but also in the form of misallocation of resources.

It makes no sense to argue that decision makers endowed with rational expectations would see through the short-term fluctuations in exchange rates and thereby would be able to avoid the misinvestments. If that were true, rational speculators would have eliminated the overshooting of the exchange rate in the first place by engaging in appropriate and profit-maximizing foreign currency transactions.

That, too, is a powerful argument for policy coordination.

The Global Constraint

The desirability of a policy also depends upon the global economic situation. This consideration is probably most relevant in those markets where trading is conducted on a global basis, such as commodity markets.

In times of strain on global resources, such as the late 1970s, commodity prices rise everywhere. This universal rise may be interpreted as a signal that adjustment policies that would stimulate aggregate demand would be undesirable.

Under these circumstances, the elimination of external imbalances should be undertaken in such a way that deficit countries reduce their demand on foreign resources. At the same time, surplus countries should refrain from policies that would increase their imports.

Conversely, at times of falling commodity prices in world markets, countries in balance of payments surplus should strive to increase their imports, so as to bolster aggregate world demand. If deficit countries sought to restore their external balance by cutting imports, the global deflationary tendencies might be further exacerbated.

A Framework for a Global Solution

What can we learn from the arguments advanced so far for the solution of the imbalances facing the world economy? The thrust of these arguments is that any solution should be sensitive to the global environment and to the conditions prevailing in the individual countries, rather than placing reliance on automatic mechanisms or a symmetric sharing of the adjustment measures.

The Louvre Accord built a broad framework for policy coordination of the kind envisioned here. It has often been represented as a simple exchange rate agreement; but that is much too narrow an interpretation of the broad set of policy changes agreed upon.

Furthermore, the Louvre Accord is not an agreement that can be signed, implemented, and forgotten. Instead, it should be seen as the first step in a dynamic process of policy coordination that will never be fully completed. As long as we live in a dynamic and changing world economy, new adjustments will be called for and no static set of one-time policy measures will offer a permanent solution.

What then, are the constraints within which the current account imbalances must be reduced?

First of all, global expenditure-increasing policies may well run the risk of igniting a new round of world inflation. Expenditure-increasing policies in one set of countries should be counterbalanced by expenditure-reducing policies in other countries. To the extent that capacity is expanded through investment, global expenditures may also increase.

Second, exchange rate changes that are not accompanied by other appropriate adjustment policies may well be counterproductive.

Third, because quick adjustment may well be costly and lead to resource misallocation, it is important to allow sufficient time for the adjustments to be implemented and to become effective.

Fourth, maintaining the confidence of financial markets is also essential so that the imbalances may be financed while the adjustment is under way.

Fifth, adjustments should be implemented in a way that avoids triggering a new set of global imbalances.

Taking these principles into account, we can outline a broadly consistent set of policies for the key countries.

The United States, which is getting closer to capacity in labor markets and in factory utilization, has already experienced significant realignments of its exchange rate -- especially vis-a-vis Japan and Western Europe. Exports are booming, and to make room for the export expansion, aggregate domestic demand must be held in check.

Domestic consumption has already flattened, but actual cutbacks would pose new domestic economic problems. Investment is needed to expand capacity and to forestall capacity constraints in the future.

What of the government sector? The government deficit calls for correction in its own right, but in conjunction with the need to free resources for export expansion, the case for reduction of the budget deficit becomes compelling.

The remaining question is whether this deficit reduction should be accomplished through an increase in taxation or a decrease in government spending. Higher taxes would siphon resources from the private sector, a strategy that was just rejected. This leaves restraint on governmental spending as a desirable policy both for domestic and international reasons.

In Europe, considerable capacity exists in labor markets, and export demand will slow as U.S. import demand slows. It makes little sense to increase governmental deficits, which are already quite large in many of these countries. Governmental stimulus or further income transfers to the private sector should therefore be ruled out.

With these actions rejected, supply-side policies emerge as the preferred means to stimulate domestic demand and imports. Loosening the rigidities in labor markets should not only help to create new jobs, but also increase spending power to boost aggregate domestic demand and imports. Deregulation of commercial and financial markets would also contribute to increasing the potential for economic growth and enhance efficiency. Liberalizing governmental procurement practices, freeing agricultural markets, and dismantling cartel arrangements that discriminate against the developing countries should help cure the external imbalances as well.

Those European countries that now have current account surpluses should take the lead in implementing these measures. By doing that they will ease the external constraint on their partner countries and allow all of Europe to utilize its domestic resources more completely.

In the absence of positive action by the surplus countries, exchange market pressures within the European Monetary System may well build again and necessitate exchange rate changes that would be detrimental to the creation of an integrated European economic and financial system.

In Asia, Japan is growing quite satisfactorily, having taken appropriate measures when the export boom started to fade. However, given the current exchange rates and the marked improvements in productivity that Japanese industry has achieved, there is little prospect that the external surplus will vanish soon. Supply-side measures to liberalize import markets, especially for agricultural products, and better access for foreign suppliers to Japan's distribution system would stimulate imports and thereby improve the external balance and relieve pressure on the foreign exchange markets.

Korea and Taiwan continue to experience very large trade surpluses. Removal of a broad range of import barriers and taxes as well as more realistic exchange rates are called for.

In Latin America, growth remains depressed by inappropriate economic policies and the burden of accumulated external debt. Most Latin American countries still have rather small foreign trade sectors, and an outward-looking expansion strategy that emphasizes investment and a reduction of governmental regulation should foster economic growth and prosperity. At the same time, it should enable these countries to service their external debt.

Conclusion

The key to long-range progress in reducing the external imbalances lies in asymmetrical adjustment policies that take into account not only the global environment, but also the individual circumstances of the various countries.

Efficient and effective adjustment programs will differ widely among countries, depending upon their integration with the world economy, their degree of openness, their patterns of resource utilization and the scope they offer for supply-side policies.

The challenge facing the world economic and financial community is plain: we must reduce the global imbalances with all deliberate speed before these disequilibria threaten the prosperity of the world and perhaps even endanger the fabric of the international economic and financial system upon which we all depend.

Economists and policymakers are in broad agreement about the central features of an appropriate solution. The framework for policy coordination was set up in the Louvre Accord, and the machinery of the OECD, the IMF, and the various consultative groups is in good order to assist in the design and implementation of appropriate

policies.

The execution of those policies will be up to all of us.