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Adjustment and Growth: The U.S. Experience

Remarks by

Manuel H. Johnson

Vice Chairman, Board of Governors of the Federal Reserve System

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I am pleased to have this opportunity to share with you some thoughts on how the adjustment process is working in the United States. Certain aspects of the adjustment facing the United States differ from that facing many developing countries, but there are a number of common features as well.

In 1987, the United States recorded a current account deficit of about $160 billion -- roughly 3-1/2 percent of nominal GNP. Most forecasts envision an improvement in the nominal current account balance in 1988, with further strengthening in the years beyond. However, based on current policies, comparable U.S. and foreign growth rates, and limited further currency realignments, it will take a while before the U.S. current account deficit is reduced substantially.

Nevertheless, in both volume and nominal terms the U.S. external adjustment process is already underway. Real net exports of goods and services expressed in constant (1982) dollars began to strengthen toward the end of 1986. Recent Commerce Department estimates based on January and February data indicate an improvement of some $5-10 billion (seasonally adjusted annual rate) in the nominal trade balance between the final quarter of last year and the first quarter of this year.

The U.S. current account performance during the 1980s has changed substantially the country's net external asset position. Although the exact level of net external assets (the U.S. net international investment position) in any particular year is not precisely known for a variety of reasons,[1] the cumulated U.S. current account deficit of nearly

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1. The reasons for doubting the accuracy of the data include the valuation of past direct investments and the interpretation of the statistical discrepancy in the balance of payments accounts.

$600 billion for the 1983-1987 period sharply eroded the U.S. net external asset position, and probably transformed the United States from a substantial net creditor nation into a net debtor. The estimate of the net external debt position at the end of 1987 -- approximately $400 billion, the official number will be published in June -- is about 10 percent of nominal GNP. The near-term outlook for the U.S. current account implies that the U.S. net debtor position will continue to grow for at least the next few years, but at a decreasing rate.

Causes of the current account deficit

Between 1980 and 1987, the annual U.S. current account went from essentially balance to a deficit of some $160 billion. Several attempts have been made by economists to quantify the various causes of the U.S. current account deficit. The results of these efforts are, of course, rough and far from unanimous. Nevertheless, the general conclusion is that less than half of the decline in the current account was associated with the strength of U.S. economic activity compared with that in foreign economies, and over half was associated with the loss of competitiveness of U.S. goods, owing largely to the strength of the dollar in the first half of the decade.

Of course, the pace of economic activity at home and abroad as well as the appreciation of the dollar actually were proximate causes only, which, in turn, reflected more fundamental factors. Simulations with various econometric models indicate that expansionary fiscal policy in the United States, together with restrictive fiscal policy in the major foreign industrial countries and a non-accommodating U.S. monetary policy, can explain a substantial amount of the developments in economic activity

and exchange rates. However, about one third of the rise in the dollar remains unexplained by these models. An important element during this period was the relative attractiveness of U.S. assets. The consequent demand for U.S. assets bolstered the flow of capital into the United States and contributed to the upward pressure on the dollar.

When Governor Lyle Gramley addressed this meeting three years ago in Guadalajara, the dollar was about at its peak. In his talk, Governor Gramley discussed the various factors that had contributed to the sharp increase in the dollar over the first half of the decade. He also anticipated that a significant decline in the dollar would be needed to help restore external balance in the U.S. economy. We have now seen the dollar return to its 1980 level, on average, in the brief span of three years, but the external balance has been slow to adjust.

With regard to the persistence of the U.S. current account deficit, several points should be kept in mind. First, some adjustment in real trade volumes is evident beginning in 1986, as I mentioned earlier. Second, if the dollar had not fallen, the current account balance probably would have been even weaker. Moreover, the persistence perhaps should not be too surprising: much of the dollar's initial decline can be viewed as an unwinding of its surge at the end of 1984 and early 1985, and probably was not reflected in prices or trade volumes anyway.

There also are technical reasons for expecting a delayed external adjustment: trade volumes react with a fairly substantial lag to changes in prices; dollar prices of imports typically respond with a lag to changes in exchange rates; and the dollar's fairly continuous depreciation since early 1985 has meant that a series of so-called J-curve effects

would have tended to obscure the improvement in the underlying current account position for a period of time.

Some special factors also help explain the limited trade balance response thus far to the sharp depreciation of the dollar, such as the ups and downs of the oil market and an apparent tendency of foreign companies to adjust their profit margins in the face of dollar depreciation more than in the past in order to maintain competitiveness and to protect their market shares. Another factor has been the disparity between the dollar's movements against the currencies of industrial countries and those of developing countries. On an inflation-adjusted basis, there has been only limited dollar depreciation against the latter. While the lack of a significant degree of real depreciation against the currencies of the heavily indebted developing countries is understandable and probably warranted, the relatively modest movement of the dollar against the currencies of the newly industrialized Asian economies is more debatable.

The external adjustment process

As I indicated previously, the U.S. net external debt position was about 10 percent of GNP at the end of last year. Even making the pessimistic assumption that U.S. current account deficits in 1988-1990 will remain at the 1987 rate ($160 billion), the ratio of U.S. net external debt to GNP is likely to be less than 20 percent at the end of 1990. Comparable ratios for "highly indebted" Latin American countries such as Argentina, Brazil, and Mexico are larger -- about one quarter to one third of GNP or GDP. Cross-country comparisons of debt ratios are not necessarily meaningful, since the "optimal" debt-GNP ratio depends on many things, including how the borrowed or invested capital is used, that can

vary across countries and over time. Nevertheless, the large discrepancy between the U.S. ratio, even using pessimistic assumptions about the next few years, and current Latin American ratios indicate that a U.S. "debt crisis" is not imminent.

However, it does seem clear that at some point the rate of increase of net U.S. external debt must at least slow. Otherwise, the debt-service requirements on the external debt could become excessively burdensome. A slowing of the rate of external debt accumulation requires that the U.S. current account strengthen over time. Indeed, since early 1985, when the dollar's exchange value hit its peak and began its decline, this was the signal that foreign exchange markets were transmitting. Thus, the recent pattern of improvement in the U.S. nominal trade deficit likely explains the general stability of the dollar so far during 1988.

In order to continue the improvement in the U.S. external balance, world demand will have to maintain its momentum toward U.S. exports relative to U.S. imports. An actual reduction in worldwide real expenditures is not particularly appealing to either the United States or its trading partners since it would involve a slowdown in U.S. output growth as the means for a reduction in U.S. import demand. Most of you can attest to the undesirability of real expenditure reduction and to the political difficulties associated with persisting with such a policy. Moreover, given the size of the U.S. economy, the expenditure-reduction option in the case of the United States also would imply a slowdown in foreign economic activity unless expansionary macroeconomic policy measures were taken abroad.

Expenditure switching, in which U.S. residents and foreigners direct more of their total spending or domestic demand -- that is,

consumption plus domestic capital formation plus government spending -- on U.S. products, is more attractive. The expenditure-switching option would boost domestic demand relative to output in foreign countries and reduce domestic demand relative to output in the United States. Foreign saving rates would decline and the U.S. saving rate would increase.

In fact, a large part of the adjustment process in the United States and elsewhere is the achievement of a better balance between saving and investment behavior. The United States must provide a better environment for domestic saving. An increase in U.S. domestic saving relative to domestic investment would avoid U.S. dependence on foreign capital and allow U.S. interest rates and the dollar's exchange rate to adjust without inflation risks. Developing countries need net inflows of capital -- the United States should be in a stronger position to generate its own capital. An important component of the increase in the U.S. saving rate should be a decline in government dissaving, that is, a closing of the Federal budget deficit -- the United States' "other" deficit.

In principle, expenditure switching need not affect the level of output in either the United States or its trading partners, but any redirection of demand on the scale needed to address the U.S. external imbalance almost certainly would entail a significant reallocation of productive resources within the economies involved. Such reallocations typically are painful in the short run. Macroeconomic policy can ease the transition during which foreign industrial economies become less dependent on U.S. demand, but adjustment in the rest of the world cannot be avoided. By definition, if the United States is to close its external deficit, its

trading partners -- taken as a group -- have to close their external surplus.

One way of implementing an expenditure-switching policy is through trade policy -- tariffs, subsidies, and quantitative restrictions. That is, the United States could adopt protectionist measures. As you are well aware, the pressure to move in this direction has been great. However, I am strongly opposed to such a policy -- both in principle and in practice. Trade policy distorts economic incentives and the allocation of resources, puts upward pressure on the domestic inflation rate, and would be subject to foreign retaliation. We have been fortunate that despite the intense pressure for trade measures, the United States, in fact, has held the line against protectionism.

Another method for switching expenditures toward U.S. products is, of course, by means of a real depreciation of the dollar, that is, a nominal depreciation of the dollar in excess of the inflation rate differential. Subsequent economic developments, including the effectiveness of the depreciation, depend on how the depreciation is brought about.

One approach to the U.S. external situation is to facilitate whatever exchange rate is needed to equilibrate the trade balance. However, this approach carries a very substantial risk: the decline in the dollar could be sudden and steep, even by the standards of the 1980s, and excessive as well, with adverse implications for the U.S. inflation rate. Moreover, the notion that exchange rate depreciation is a painless answer to our problems is very dangerous. It tends to divert the attention of producers from the need to restrain costs and increase

productivity, and to divert the attention of policymakers from difficult questions of economic policy priorities.

Another approach to U.S. external adjustment is to use macroeconomic policy to "manage" the external adjustment process. In principle, adjustments to macroeconomic policy could produce a stronger trade balance without disturbing the level of economic activity or creating an unstable price environment. Although, as we all know, such exercises are more easily conceptualized than executed, the idea would be to put the economy on a path that would be less potentially disruptive than the path determined by the financial markets alone.

At this point, I would like to point out and emphasize the important ways in which cooperative policy actions in the economies with current account surpluses -- chiefly Germany, Japan, and some of the newly industrialized economies in Asia -- could promote the international adjustment process. Expansionary macroeconomic measures, perhaps in the form of tax reductions and reforms, in those economies would boost their demand for U.S. exports and would help maintain demand for and supply of their own products as the volume of U.S. imports weakens. There is scope in some of these economies for a non-inflationary expansion of domestic demand, particularly in light of the expected continued easing in U.S. demand for their products. The expansion of aggregate demand abroad is an especially attractive approach to external adjustment since it promotes higher employment and output at the same time. Also, the more slack taken up by higher relative growth in the surplus economies, the less pressure there is on the exchange rate as the adjustment mechanism.

U.S. adjustment: progress to date

As mentioned earlier, in volume terms the U.S. external deficit has been declining since the end of 1986. On the other hand, the nominal current account deficit has only just begun to improve, after widening by $20 billion last year. However, the 1987 decline in the nominal current account balance is misleading in several respects. First, in the absence of the surges experienced in oil imports, the nominal U.S. trade balance would have shown signs of a turnaround in 1987, rather than further deterioration. Moreover, even when oil imports are included, the nominal merchandise trade deficit essentially leveled off during 1987.

The leveling-off of the trade deficit has not been widely perceived perhaps because of the large fluctuations registered in the monthly trade figures. Unfortunately, the monthly U.S. trade data -- which attract a considerable amount of attention in the news media -- currently are not seasonally adjusted and value imports on a basis that tends to overstate imports relative to exports.[2] Beginning in June, with the trade data for April, the monthly data will be seasonally adjusted, which may reduce some but certainly not all of the disruptive monthly volatility. Quarterly data measured on a seasonally adjusted balance-of-payments basis show little change over the course of 1987. In fact, excluding oil, the trade balance on this basis would have hit bottom in the fourth quarter of 1986 and strengthened during 1987.

Last year's improvement in real net exports of goods and services reflected a nearly 20 percent increase in the volume of goods exports, and

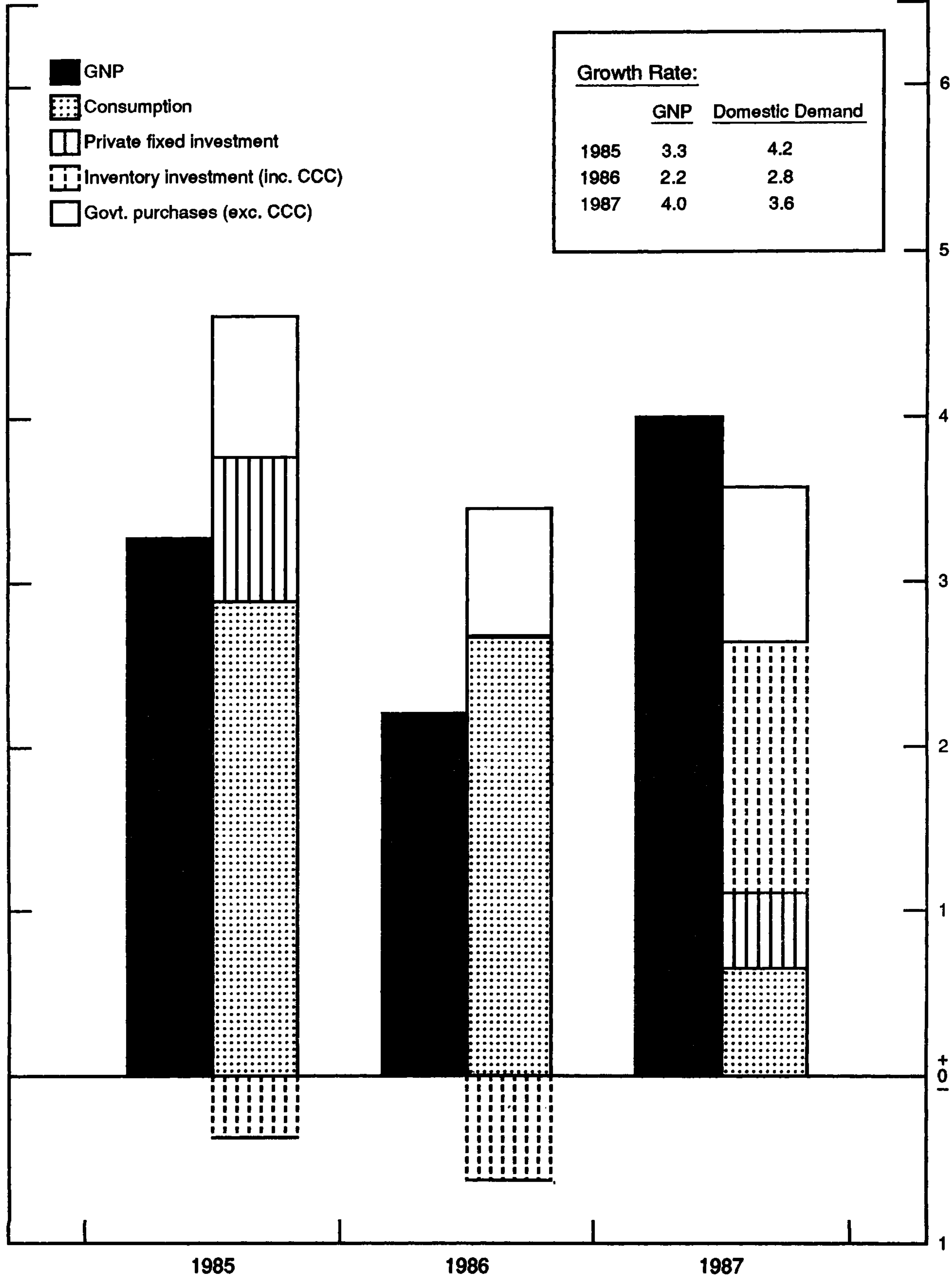
2. Imports are valued on a c.i.f. (cost, insurance, and freight) basis; exports are valued on an f.o.b. (free on board) basis, which excludes insurance and freight charges.

has been a source of considerable strength to U.S. industry. The macroeconomics of the adjustment process now going on in the United States are captured by the figures shown in Chart 1. The solid bars depict the growth of total GNP, in real terms. To the right of the solid bars are bars divided into the components of domestic demand. The sum of the components equals the rate of growth of domestic demand. The difference between GNP growth and domestic demand growth is the contribution of net exports to economic growth. (See the box in Chart 1.) In 1985 and 1986, the contribution of net exports to U.S. growth was negative. In 1987, the contribution was positive, and this year it is generally expected to be even more strongly positive. The swing in the relative size of the bars is what external adjustment and expenditure switching are all about. Note also the compatibility of growth of output and external adjustment evident in the chart: GNP growth accelerated in 1987, the year in which the contribution of net exports switched signs.

As we have seen, the U.S. economy has already begun to adjust. However, with a current account deficit of over 3 percent of GNP and a rapidly mounting stock of external debts, the United States still has a considerable amount of adjusting to do. The adjustment process is not necessarily easy or costless, but it is necessary in order to restore the U.S. external accounts to a more sustainable position. Given the size of the U.S. economy, its importance in the world economy, and short-run constraints on productive capacity, the adjustment necessarily will have to be gradual. But it is important that the adjustment be steady, consistent, and well managed. Any backsliding not only would delay the process, it also would generate uncertainties in exchange markets and

Chart 1

Domestic Contributions to Q4/Q4 Growth



other financial markets, and would probably make the subsequent inevitable adjustment more difficult and less orderly.

Many of these observations on the U.S. experience could just as well have been written about some of the other countries of the American Continent represented at this meeting. Allow me, therefore, to add some remarks on the adjustment process in those countries.

Latin American situation

Latin America has experienced rapid external adjustment of impressive magnitude since 1982. Unfortunately, most of the adjustment in external balances in Latin America to date has been attributable to import compression rather than export expansion. The current account deficit of the 10 Latin American countries included in Treasury Secretary Baker's list of 15 heavily indebted developing countries decreased by more than $30 billion from 1982 to 1983, while the trade surplus surged from $13 billion to $36 billion. Imports declined in these countries by about $20 billion (30 percent), while exports expanded only by about $2 billion (2 percent). Given the need for rapid adjustment in light of the sharp contraction in available external finance, perhaps there was little alternative to relying on expenditure reduction, even though this meant a painful recession in most heavily indebted Latin American countries. The region did manage to expand real exports in 1983, but the expansion of nominal exports was kept low by unfavorable export prices.

Economic growth at relatively low rates has resumed on average in Latin America since 1983, and imports partially recovered in 1986 and 1987. However, exports have shown little growth in nominal terms, although some growth in real exports has taken place. It would seem that

from the standpoint of adjustment and growth it would be useful for the countries in Latin America to emphasize export expansion. Given the higher level of commodity prices, it should be easier now to generate significant increases in nominal as well as real exports. Since no quick rebound in external financing appears to be on the horizon, it is likely that the most assured way in the short run for the heavily indebted developing countries to finance the imports needed for economic growth is by pursuing policies conducive to sustained export expansion. Policies should also be aimed at building private sector confidence and increasing domestic saving so that domestic investment, which has been weak for some time, can be strengthened. Indeed, measures aimed at establishing a sound environment for investment and saving and private sector activity are the best way of eventually restoring the needed net flow of foreign capital into the developing countries.

Export expansion is not an impossible task for the heavily indebted countries. Chile and Colombia are two examples of successful export expansion since 1983. In 1987, Mexican non-oil exports expanded very rapidly in response to market-oriented incentives. The experience of Brazil, our host country, over the past few years has shown how responsive export demand is to changes in exchange rates. In 1986, excessive domestic demand and an overvalued exchange rate led to export contraction and import expansion. In 1987, a more competitive exchange rate allowed Brazilian exports to rebound sharply, and for the trade balance to improve, despite continued import expansion.

Given the need of the United States to adjust its own current account deficit, it would be prudent for the Latin American countries to seek expanded export markets around the world, even though the United

States and Latin America of course will remain important trading partners. Increased imports by the United States from the heavily indebted Latin American countries since 1982 account for more than the total expansion of exports from these countries during the same period. Clearly, the Latin American countries must make inroads into other markets if they are to be successful in expanding exports in any significant degree, thereby enhancing their growth prospects.

Adjustment with growth

The countries of the American Continent have a common need: external adjustment with sustainable growth. Achieving such an ambitious goal requires a stable macroeconomic policy environment, and market-oriented as well as outward-looking economies. By and large, important strides have been taken in several of our countries to these ends, but much remains to be done. A reorientation of an economy toward a better balance between domestic saving and investment and a greater reliance on export demand — as a means of strengthening the external position without reducing domestic output — obviously requires open export markets. Our countries' mutual needs to adjust limits how much net demand each of us can contribute to the others. Thus, the economies of Europe and Asia in current account surplus have special responsibilities if the general problem of external imbalances is to be solved by expenditure switching in an environment of economic growth. These responsibilities entail not only the macroeconomic policy responsibility to ensure an adequate rate of non-inflationary growth in their own economies, but also the microeconomic policy responsibility to open or keep open their domestic markets to foreign products.