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External Adjustment in the Major Industrialized Countries

Remarks by

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Commencement Address

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It is an honor to join you in celebrating the graduation of the Class of 1988 of Troy State University in Europe. As an alumnus of Troy State in Alabama, who carries fond memories and appreciation of my educational experience at this center of learning, I welcome you into the ranks of Troy State alumni. You too can look ahead with pride and confidence. Your experiences here at this institution have prepared you well for the challenges that face you.

There is something unique about your experience here at TSU. You are receiving a degree from an American institution on foreign soil, while many of you, I understand, have been stationed here in the U.S. Armed Forces. You, thus, have not only been exposed to various academic disciplines, but you have also benefitted from living in another economic, political, and cultural environment.

Your experiences living and studying abroad will serve you well. We live in a world that is highly integrated and economically and politically complex. A citizenry that is acquainted with the international dimension of these relationships will be productive participants in international ventures and will lend support to efforts to address issues of common concern in a spirit of understanding and cooperation.

I congratulate you all for participating in that effort, and I look forward to your contributions in the years ahead.

This leads me to the subject of my talk today: the adjustment of international trade imbalances. This problem involves adjustment and cooperation that challenges economic policymakers throughout the industrial world.

In recent years, the United States has recorded large current account deficits -- defined as the difference between what U.S. suppliers of goods and services sell to other nations and what U.S. consumers and producers buy from other nations plus our net earnings (or payments) on our international investment position. This deficit totalled $160 billion in 1987 -- roughly 3-1/2 percent of nominal U.S. GNP. In dollar terms this external deficit is unprecedented, and as a share of our nation's output it is high relative to our experiences since World War II. At the same time, many of our trading partners have recorded large current account surpluses.

Continuation of such large external imbalances among industrial countries is likely not sustainable. As a result, a corrective process is underway to reduce these imbalances to more manageable proportions. This process involves changes in relative prices, including exchange rate changes, and relative income among major trading nations.

The multilateral nature of the U.S. external imbalance deserves emphasis. Current account balances of all nations combined, in principle, add up to zero. One country cannot have a current account deficit without at least one other country having a current account surplus. There are other large industrial countries that have large external surpluses, large by historical standards and relative to their output. In 1987, Japan had an external surplus of roughly $87 billion, or 3-1/2 percent of its GNP. Likewise, Germany recorded an external surplus of roughly $45 billion, or 4 percent of its GNP. And a number of smaller, so-called Newly Industrialized Economies -- among them Taiwan and South Korea -- also have relatively large external surpluses.

These large external imbalances are the result of a process that began much earlier in this decade. A simple explanation for the emergence of the large U.S. current account deficit in the early 1980s is that it was the consequence of the appreciation of the U.S. dollar vis-a-vis other major currencies from 1980-1985.

The U.S. dollar appreciated from 1980 to its peak in 1985 by almost 60 percent against the currencies of the major foreign industrial countries. The rising dollar during this period led to a decline in exports from the United States as U.S. producers were priced out of foreign markets. At the same time, the sharp appreciation of the dollar made foreign goods very attractive to U.S. consumers and producers, thereby leading to an increase in U.S. demand for imports.

A contributing factor to this strong appreciation, particularly in the latter phase, was high U.S. real interest rates relative to foreign rates, and the perception of profitable investment opportunities, which sharply increased the demand for dollars relative to other currencies.

The relatively high real interest rates of the early 1980s reflected a combination of historically high budget deficits, dramatic changes in personal and business marginal tax rates, and tax incentives for increased investment in the U.S. Together these policies increased the supply of capital to the United States. At the same time, disinflationary monetary policies were being pursued worldwide in an attempt to reduce inflation and the inflationary psychology bred during the mid- and late-1970s. Growing investment opportunities in the United States were a contrast to the relative dearth of profit opportunities elsewhere in the world. In addition, the dollar was attractive as a "safe haven" because of the perception of political instability in some other parts of the world.

There is a linkage between a country's external balance and internal balance. The external balance in any country can be directly linked to savings and investment decisions (or expenditure and production decisions) made by its residents, including budgetary policies pursued by its government. The difference between domestic investment and domestic sources of financing, including government savings or dissavings, must be met by foreign sources of savings. If a country wishes to invest more than it saves (or spend more than it produces), this excess must be financed by a net inflow of foreign capital. Everything else equal, the higher is the government budget deficit -- or government dissaving -- the greater will be the need to borrow from abroad. The borrowing is manifested in various financial transactions and may be associated with interest rate and exchange rate movements.

Any country with an external deficit must, therefore, borrow from external sources in order to finance that deficit. It is the same as when a household spends more than it earns; the household must borrow to make up the deficit. Countries that are lending are generating domestic savings in excess of domestic investment and a surplus of exports over imports. Japan and Germany are currently large net lenders to the rest of the world, and the United States, given its large current account deficit, is a large borrower.

The process of reducing the external balance in the United States is already underway in both nominal and real terms. Net exports of goods and services in real terms (that is adjusted for price changes) began to improve toward the end of 1986 and have continued to improve since. Moreover, although improvement in the nominal trade figures to date has been less, the trade data for the first three months of this year indicate that the U.S. trade balance improved considerably from its level last year. We anticipate a continuation of this trend of lower U.S. trade deficits in the year ahead.

One reason forecasters are predicting a continued reduction in the U.S. external deficit is the fairly continuous and dramatic depreciation of the dollar since early 1985 to a level close to where it started in 1980. Although the trade accounts have shown less adjustment than some would have anticipated from such a sharp depreciation, there are technical reasons for expecting a delayed 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 continuous depreciation 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. These J-curve effects occur because import volumes adjust more slowly than import prices. Thus, when the dollar depreciates, the cost of imports rises initially, and the trade balance weakens.

Adjustment of external imbalances should occur without imposing undue strains on other countries involved in the multilateral trading process. Thus, it would be undesirable to have Japan's surplus increase with, for example, the developing countries, or some of the smaller European countries at the same time as it succeeds in lowering its surplus with the United States. What is necessary is a reduction of Japan's total global surplus.

A consequence for Japan of a smaller total external surplus is that the external sector's contribution to Japan's total GNP growth is weakened. Alternative sources of aggregate demand, therefore, will be necessary to sustain a reasonable growth rate. Japan, like other surplus countries, is reducing the contribution to its overall growth from international or external sources and increasing the contribution to growth from domestic or internal sources. For this to continue, a balance of domestic and internationally oriented policies must be pursued, in Japan and elsewhere.

In 1987, Germany's bilateral surplus with the United States declined slightly but its surplus with its European trading partners increased. This sort of adjustment has economic and political consequences within the European Community and within the European Monetary System. It places strains on the currencies in the deficit countries within the European Monetary System. And through these pressures in exchange markets it places strains on trading relationships and can affect levels of production and employment in the deficit countries of the European Community. To reduce its total external surplus, Germany, like Japan, must increase the contribution to growth from internal or domestic sources relative to the contribution from international or external sources.

In summary, a large part of the global adjustment process 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 reduce the U.S. dependence on foreign capital and allow U.S. interest rates to be lower than they might otherwise have to be. Likewise, other countries, including among others, Japan and Germany, must become less dependent on their export sectors for growth. They must encourage the further development of their domestic markets and thereby increase domestic investment relative to domestic savings.

But this may not be accomplished easily and smoothly if left to international financial markets alone. There is a sensitive policy balance that must be struck between domestic and international policy objectives in leading economies in the industrial world. And this fine balance requires continuous and informed dialogue between policymakers.

National leaders have an important role to play in this process. Economic performance in the major industrial countries should be monitored closely. There should be candid and frequent consultations. And as in the past there will undoubtedly be concerted and coordinated measures to reduce external imbalances and related, and potentially costly, pressures in financial markets.

Such a process has been pursued in such international forums as the Group of Five or the Group of Seven. Through these forums, economic policymakers are in close collegial contact discussing their objectives and the ramifications of pursuing policies to achieve those objectives. It is a challenging process that at times requires coordinated efforts, with one eye on domestic objectives and the other on international objectives. These efforts, in turn, have consequences for domestic growth, inflation, and financial market developments.

And this brings me to where I started. We are a highly integrated world community. There is a continuing need for international understanding and cooperation. This understanding and cooperation can and will help in achieving mutually beneficial objectives.

The educational program at Troy State University, here in Europe, has offered you the opportunity to study in another economic and political environment. This will enrich your understanding and appreciation of international economic developments in a broader perspective.