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External Adjustment in the United States: The Challenge Ahead

Remarks by

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I feel honored to be asked to participate in your Baird/Manegold Lecture Series. Looking over the list of past lecturers, I note that you have benefited from the remarks of two of my colleagues at the Federal Reserve Board -- former Chairman Paul Volcker in 1980 and, more recently, Governor Martha Seger in 1986. A major theme in Chairman Volcker's lecture was the importance of taming inflation, which at the time was running at double-digit rates. The major macroeconomic concern of the day was achieving internal adjustment in the U.S. economy. Six years later, as Governor Seger pointed out in her remarks to you, the U.S. domestic economy was performing quite well judging by the conventional macroeconomic indicators of inflation and GNP growth. However, Governor Seger identified a major area in which the United States faced a significant problem -- the large external imbalances, exemplified by our high foreign trade deficits.

Today, I want to focus our attention on the challenge represented by these external imbalances. Bringing about the needed external adjustment is not easy; in many ways it is an even more difficult task than achieving internal adjustment because external adjustment involves, necessarily, other sovereign nations. Moreover, external adjustments of a fundamental nature have important consequences for the domestic economy, and carry the risk of upsetting the impressive gains made to date with regard to inflation and internal adjustment.

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 was about $150 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 the highest recorded during this century. At the same time, many of our trading partners have registered large current account surpluses.

Continuation of such large external imbalances among industrial countries is not likely to be sustainable. As a result, a corrective process is underway to reduce these imbalances to more manageable proportions. This process has involved changes in relative prices, including exchange rates, and relative incomes 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. Other major industrial countries have large external surpluses, large by historical standards and relative to their output. In 1987, Japan had an external surplus of nearly $90 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 substantial external surpluses.

These 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 more vigorous economic recovery in the United States, relative to that abroad, boosted U.S. demand for imports and reinforced the impact of the stronger dollar on the U.S. trade balance.

The U.S. dollar appreciated sharply from mid-1980 to its peak in early 1985 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 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 United States. 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.

A country's external balance and internal balance are linked. 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 a current account deficit must 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 imbalance 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 then. Although improvement in the nominal trade figures to date has been slower, the trade data for the first nine 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 was 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 almost continuous depreciation until this year 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 the U.S. external deficit, on the one hand, and the Japanese and German surpluses on the other, should occur without imposing undue strains on other countries involved in the multilateral trading process. For example, it would be undesirable to have Japan's surplus increase with 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 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 negative. Alternative sources of aggregate demand, therefore, will be necessary to sustain a reasonable growth rate. Japan, like other countries in surplus, 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. These trends appear to have continued this year. 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 of the countries in deficit 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 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.

The external adjustment problem facing the United States is essentially the opposite of that confronting Japan and Germany -- we must increase the relative contribution to growth from external sources, that is, from net exports. I have already mentioned the important role played by the appreciation of the dollar in leading to the sharp deterioration of the U.S. trade balance, and the important role played by the dollar's depreciation since early 1985 in the subsequent turnaround in our external accounts. Since the U.S. external deficit remains large, some are tempted to say simply that more dollar depreciation is needed. Indeed, nearly all econometric models of U.S. trade -- if taken literally -- convey this message in that they predict that if the dollar stays at roughly current levels the improving trend in the trade deficit will continue for a few more years, but then the deficit will resume widening.

However, there are many reasons for not taking these models literally. First, calculations of relative costs of production in the United States and its major trading partners suggest that at <u>current</u> exchange rates, U.S. producers are already very competitive with their foreign counterparts. Second, the econometric models do not adequately capture the lags involved in supply-side adjustments to changes in exchange rates (and relative profitability). This latter concern is particularly relevant when the exchange rate changes are as large as they have been in the 1980s.

Thus, we really do not know how much additional U.S. external adjustment is "in the pipeline" already or whether the dollar has reached a sustainable level. What we do know is that a declining dollar can have adverse consequences for the rate of inflation and, therefore, can complicate the other major objective of U.S. macroeconomic policy that I mentioned earlier -- the preservation and consolidation of the gains made during the 1980s in the area of inflation and internal adjustment. It is largely for this reason that policymakers have welcomed the period of more-or-less stability of the dollar experienced for much of this year.

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. We all stand to gain if this results from stronger U.S. saving rather than diminished investment. 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 both absolutely and 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 the Group of Seven and in other international forums. Through these forums, economic policymakers are in close contact, discussing their objectives and evaluating the policy alternatives that might 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.