CHAPTER 2

The United States in the World Economy: Challenges of Recovery

THE INTERNATIONAL ECONOMY is in a much stronger position today than it was one year ago. In late 1982 the world was still in a severe recession, and prospects for recovery were uncertain; the third world debt crisis was a source of deep concern; and economic stagnation had given rise to strong protectionist pressures. In 1983 a vigorous recovery, originating in the United States, began to lead the world out of recession. Many of the high-debt countries made major strides toward successful adjustment. Despite increasing protectionist pressures, the open international trading system remained fundamentally intact.

But the outlook is not entirely sunny. The recovery is not a cure-all for the serious strains that remain in the world economy. From the U.S. point of view, the focus of these strains is the emergence of record trade deficits. Closely related to the problem of the trade deficits is the problem of the continued high value of the dollar in foreign exchange markets. There are also other economic troubles around the globe. Trade relations among the United States, Japan, and the European Community remain a source of friction. Much of Europe is lagging behind the recovery in North America. The high-debt countries are finding the road back to financial health to be slow and painful.

This chapter takes the U.S. trade balance as a starting point for an examination of the challenges that still face the world economy. It is organized in three sections. The first section examines the rise in the trade deficit and the related problem of the strong dollar. The second section covers developments among industrialized trading partners: Japan, Canada, and the European countries. The third section explores the third world debt problem.

THE U.S. TRADE DEFICIT AND THE DOLLAR

The most dramatic recent development in U.S. international economic relations is the rising trade deficit and associated capital inflow. The 1983 deficit in merchandise trade was about $65 billion,

approaching twice the previous record, which was set in 1982. A deficit in the neighborhood of $110 billion is forecast for 1984, three times the 1982 level. The deficits signify loss of income and employment in those U.S. industries that depend on exports or compete with imports. A common reaction is one of concern. It is easy to draw the impression that there is a serious adverse long-run trend in the competitive standing of the United States in the world economy. The greatest danger is that such ideas will come to be believed, and that as a result, the Nation will opt for major departures from its traditional economic system.

Understanding the source of the rising trade deficit is an essential precondition to making intelligent policy choices. If policy is charted in an atmosphere of panic, then crucial mistakes will be made. Mistakes in trade policy, once committed, cannot be easily undone. Foreign trading partners often react to protectionist measures in kind, while, domestically, powerful interest groups coalesce around the new status quo.

SOURCES OF THE TRADE DEFICIT

Although the 1983 and likely 1984 trade deficits are without precedent, they are not difficult to explain. To begin with, the United States has a normal or "structural" deficit in merchandise trade that is offset by a surplus in exports of services and therefore need not be a cause for special concern. But it is the recent increase in the trade deficit that has attracted attention. The increase can be broken down into three parts. First, the appreciation of the dollar has made it difficult for U.S. firms to compete in world markets. Second, there has been a substantial loss in net exports to debt-troubled countries. Third, the United States is experiencing more rapid growth in income, and therefore, in imports, than are Europe and Japan. These three factors concern economic perturbations that, though large, are believed to be temporary. The structural deficit is normal in that it would exist even in the absence of the temporary factors.

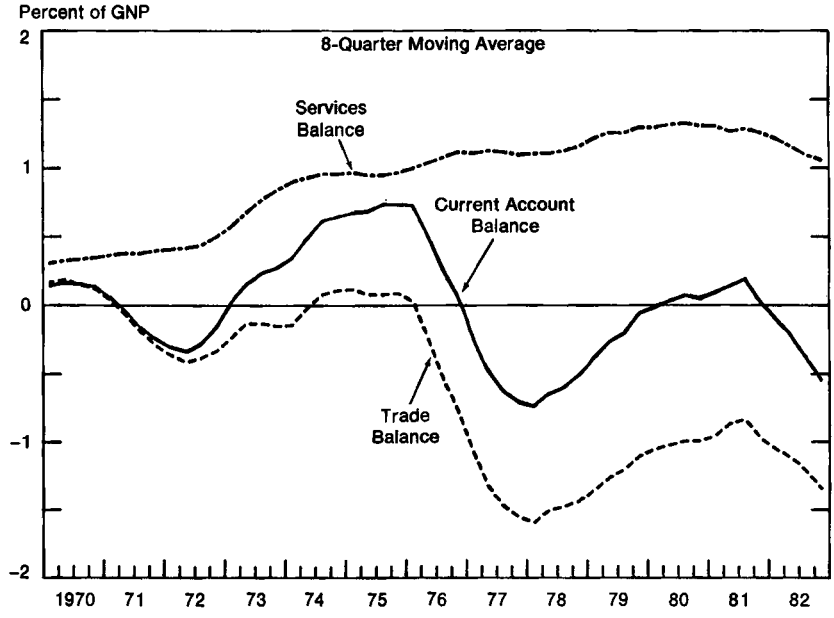
The Structural Trade Deficit

In the 1970s, the United States ran a merchandise trade deficit that was on average equal to 0.5 percent of gross national product (GNP), with a gradual increasing trend, as Chart 2-1 illustrates. This deficit in merchandise does not imply a failure of the Nation to pay its way in international trade. The United States normally runs a surplus in services to offset the deficit in merchandise trade. The largest component of the surplus is the earnings on overseas investments that American residents have made in the past; these earnings are counted as services because they are payments for the use of U.S. capital. But such exports as the services of lawyers, engineers, and computer

programmers, and banks, insurance companies, hospitals, and universities are also an important and growing component of the U.S. balance of payments. The balance in services trade has a gradual upward trend, as Chart 2-1 shows.

Chart 2-1

Balances on Current Account, Trade, and Services as Percent of GNP



Note.—Based on seasonally adjusted data.
Source: Department of Commerce.

Indeed, it is possible that, because of measurement errors, the true U.S. surplus in services is greater than that recorded. Statistics show that the sum of the services balance of all countries is a large negative number, on the order of −$80 billion. Because one country's exports are another country's imports, this number should in theory be zero. It must necessarily be that some countries are underreporting their services balance. For example, fleets of open registry (i.e., flying "flags of convenience") often do not report their earnings to any country. Another example is investment income that is channeled through tax havens and is thus unrecorded in the recipient country. Given the importance of the United States in services trade, it is possible that part of the unreported service exports are American.

Adding together the balances in merchandise trade, services, and transfers (such as immigrants' remittances to their countries of origin) gives the balance on current account. A country's current account balance indicates its changing investment position vis-a-vis its trading partners. A current account deficit means that foreigners are on net accumulating claims on assets located in the domestic country. Countries with profitable investment opportunities, such as South Korea, Taiwan, Singapore, and other rapidly industrializing countries, are normally in this situation, borrowing savings from abroad to finance their development. A current account surplus means that the domestic country is on net accumulating claims on assets located abroad. Capital-rich countries with high saving rates, such as Japan and West Germany, are normally in this situation, lending their savings to other countries where they can earn a higher rate of return. There is no clear argument as to whether the United States should normally be a net borrower or net lender at this stage in its history. The United States has been a capital-rich country throughout the 20th century, and before the 1970s the current account was normally in surplus. But the U.S. saving rate now appears to be the lowest among major countries. As it happens, the U.S. current account balance, as shown in Chart 2-1, was on average virtually zero during the 1970s.

The point is that a certain amount of the U.S. merchandise trade deficit is normal: it would be there, offsetting the surplus in services, even if the U.S. current account balance were zero. Judging from the long-run trends in the merchandise trade deficit and the services surplus, this structural trade deficit now appears to be in the range of $20 to $25 billion. Most of the recent trade deficit is thus still to be explained.

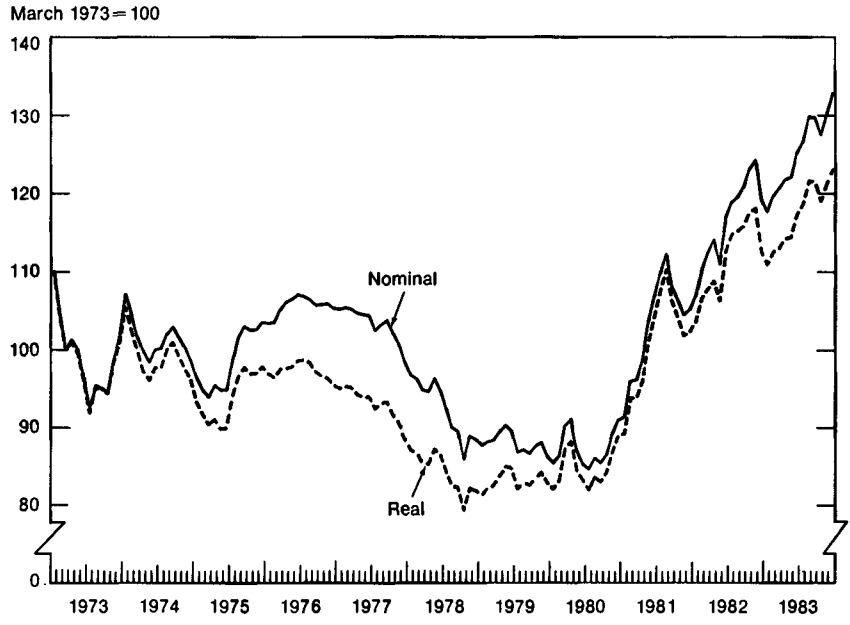
Effect of the Strong Dollar

The high value of the dollar in foreign exchange markets is the most important cause of the recent increases in the trade deficit. As Chart 2-2 shows, the dollar has appreciated sharply over the past 3 years. As of December 1983, the dollar had risen 52 percent against an average of 10 trading partners' currencies weighted by their shares in world trade, relative to the average for 1980. (Weighting countries by trade with the United States alone, which gives relatively less weight to Europe and relatively more to Canada and Japan, yields a smaller number.) Exchange rate trends sometimes match international differences in inflation rates, but that has not been the case in this episode. Very little of the appreciation of the dollar was offset by a more rapid increase in the foreign price level than in the U.S. price level. In other words the dollar appreciated not only in *nominal* terms, but in *real* terms as well. The real appreciation of the

dollar between 1980 and December 1983 came to 45 percent. This means that U.S. firms are now offering their products on world markets at prices that on average have risen significantly relative to those of their competitors, when compared in a common currency.

Chart 2-2

Nominal and Real Effective Exchange Rate of the U.S. Dollar



Source: Board of Governors of the Federal Reserve System.

The year 1980 does not constitute a proper standard of comparison because the dollar had depreciated in real terms in the late 1970s: in 1980 U.S. firms were offering their products on world markets at prices that on average had fallen relative to those of their competitors, when compared in a common currency. If one takes the average over the period 1973–79 as the standard of comparison, then the real appreciation of the dollar as of December 1983 comes to 33 percent.

This real appreciation represents a large loss in competitiveness of U.S. producers. In response, foreign residents are more likely to buy their own country's products than to buy the more expensive U.S. exports, and U.S. residents and companies are more likely to buy cheaper imports than to spend their money on products made at home.

The effect on the trade balance is complicated by questions of timing. Although the dollar's rise began in 1980, it was not until 1981 that the negative effect on the trade balance began to show up. It was not until late 1982 that the balance on goods and services turned to deficit. This pattern is in line with historical experience. The immediate effect of a dollar appreciation is actually to *improve* the trade balance, because it takes fewer dollars to buy a given quantity of imports. As time passes, more and more customers, both domestic and foreign, switch to the less expensive foreign producers. The real volume of imports rises and of exports falls, and the trade balance worsens. The dollar had completed a real appreciation of 27 percent by late 1982, relative to the 1973–79 standard of comparison. If the usual pattern of recent years holds up, the full effect on the trade deficit will be reached in late 1984. Estimates indicate that every 1 percent real appreciation adds about $2 billion to the deficit at the peak. Thus the 27 percent real appreciation of the dollar translates into about $54 billion of the projected deficit in 1984. The continued appreciation of the dollar through 1983 portends further deterioration of the trade balance in 1985.

Effect of Debt Problems in Latin America

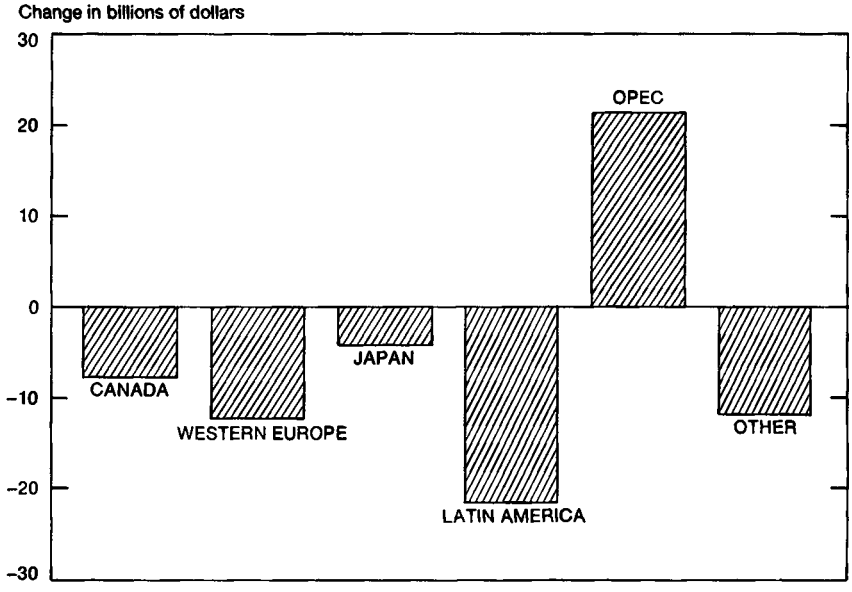
In the last couple of years, a number of highly indebted third world countries have experienced great difficulty meeting their debt obligations. They have had to take strong measures to reduce their imports and to boost their exports, in order to generate the foreign exchange to pay the interest on the debt. Many of these countries are in Latin America and conduct an especially high proportion of trade with the United States. Mexico alone accounted for 7.6 percent of U.S. exports in 1981. Seven of the most indebted Latin American countries together accounted for 13.9 percent of U.S. exports. The reductions in net imports that these countries have been obliged to undertake because of a shortage of foreign exchange are so great that the U.S. share looms large in the U.S. trade balance. Exports of U.S. industries such as farm and construction machinery have been particularly hard-hit.

As Table 2–1 shows, the U.S. bilateral trade balance with Mexico alone, which changed from surplus to deficit in 1982, registered a decline of $12 billion between 1981 and 1983. The U.S. loss in net exports to Latin America was about $21 billion. By comparison, the projected U.S. loss in net exports to Japan from 1981 to 1983 was only $4 billion, and to all of Western Europe about $12 billion, as illustrated in Chart 2–3. (The only source of improvement, U.S. trade with the Organization of Petroleum Exporting Countries (OPEC), is registering smaller deficits than in the past as a consequence of a decline in the demand for OPEC oil and in the dollar

price of oil.) As many of the Latin American debtors still have further economic adjustments to make, the loss in U.S. net exports to that region is not expected to diminish much in 1984.

Chart 2-3

Change in U.S. Bilateral Trade Balances From 1981 to 1983



Note.—Based on preliminary data for 1983.

Source: Department of Commerce.

Effect of Relative Cyclical Position of the United States

A country's level of imports varies with its level of income during the course of the business cycle. Thus world trade in general contracted in the 1980–82 period of recession.

As of late 1982, cyclical factors were a plus for the U.S. trade balance. In the first place, even when business cycles are synchronized across countries, the U.S. trade balance historically tends to improve in recessions and worsen in expansions. U.S. imports from other countries are usually more responsive to U.S. income than other countries' imports are to their incomes. In the second place, as of 1982, the recession had been more severe in the United States than for most trading partners. Real GNP had been on average almost constant in the United States from 1980 to 1982, but had grown at

TABLE 2-1.—*U.S. trade balance by country, 1980–83*

[Balance of payments basis, millions of dollars]

Country	1980	1981	1982	1983 [1]
Total	−25,544	−28,067	−36,389	−63,521
Canada	−1,277	−2,242	−9,198	−9,810
Western Europe	20,348	12,235	6,793	98
United Kingdom	2,970	−263	−2,352	−2,099
Germany	−243	−887	−2,688	−4,344
Other	17,621	13,385	11,833	6,541
Japan	−10,411	−15,802	−16,991	−19,886
Other developed countries	584	3,388	2,623	1,585
Latin American republics	5,860	7,481	−3,389	−13,911
Brazil	629	−676	−863	−2,491
Mexico	2,647	4,440	−3,808	−7,762
Venezuela	−740	−122	429	−2,328
Other	3,324	3,839	853	−1,330
OPEC (non-Latin America)	−37,476	−28,546	−10,978	−7,111
Other developing countries [2]	−4,584	−7,490	−7,908	−15,909

[1] Preliminary estimates.
[2] Residual excluding Eastern Europe and international organizations.
Source: Department of Commerce, Bureau of Economic Analysis.

an average annual rate of 1.4 percent in other industrialized countries. As of December 1982, U.S. industrial production was 12 percent below its previous peak, but industrial production in the other six major industrialized countries had fallen only 4 percent over the same period. Thus, the recent recession tended to reduce U.S. imports from the rest of the world more than it reduced the rest of the world's imports from the United States.

The cyclical position of the United States relative to its trading partners began to turn around rapidly in early 1983. In the third quarter of 1983 the United States reattained its previous peak in the level of economic activity as measured by industrial production; most of the major industrial countries had not yet done so. For the year, real GNP grew at an annualized rate 3.8 percent faster in the United States than among a weighted average of trading partners. Thus sometime in the middle of the year the two output paths crossed; the relative cyclical position was a positive factor in the trade balance in the first half of the year and a negative factor in the second half. The overall effect in 1983 was probably close to neutral.

With U.S. growth from 1983 to 1984 expected to continue well above that of its major trading partners, U.S. imports from other countries will rise faster than other countries' imports from the United States. The relative cyclical position becomes an increasingly negative factor for future trade balances. Estimates suggest that the relative cyclical position will account for $15 to $20 billion of the projected worsening in the trade deficit between 1983 and 1984.

Each of the three sources of the increase in the trade deficit—the exchange rate, the third world debt problem, and the relative cyclical position of the industrialized countries—warrants further analysis. In each case, the impact on U.S. trade may be the channel through which the problem is most forcefully brought to the attention of the American citizen; but each topic bears examination for its own sake. The exchange rate and related topics are considered in the remainder of this section; the cyclical position of other industrialized countries and the third world debt problem are considered in the second and third sections of the chapter.

SOURCES OF THE STRONG DOLLAR

In the 1950s and 1960s central banks were committed to maintaining their countries' exchange rates at fixed levels. This effort became increasingly difficult over time, due particularly to divergent inflation rates among countries. By 1971 the dollar had become unsustainably overvalued in the sense that the supply of dollars greatly exceeded the private demand for dollars. Central banks made up the difference, buying unwanted dollars in exchange for foreign currencies. The effort was abandoned in 1973 and the major currencies moved onto a system of floating, i.e., market-determined, exchange rates. When exchange rates float, there is no such thing as undervaluation or overvaluation, in the sense of excess market supply or demand for currencies. The value of the currency is whatever the market dictates that it should be.

The Floating Exchange Rate System

It is nearly impossible to imagine the world economy going through the past 10 years in the straightjacket of fixed exchange rates. Given the events of this period, notably the large changes in oil prices and the divergent macroeconomic policies among the industrialized countries, floating exchange rates have performed well.

Nevertheless, some critics argue that the system is not working as it should. They base their case on the large fluctuations that exchange rates have exhibited over the past 10 years—short-term variability as well as longer term swings such as the large rise of the dollar from 1980 to 1983. The critics also point to the fact that many exchange-rate fluctuations cannot readily be explained. Few believe that an early return to fixed exchange rates is possible, but there is sentiment in some quarters for government action to try to dampen the fluctuations.

Transactions costs in financial markets and government-imposed barriers to the flow of capital across national boundaries are today very low among most of the larger industrialized countries. The high international mobility of capital means that the foreign exchange

market is now dominated by capital transactions, not by trade transactions. The foreign exchange market is an asset market, like the stock or bond market; the exchange rate is the price of one currency in terms of another. It is not surprising that it is difficult to explain all the month-to-month ups and downs of the exchange rate, just as it is difficult to explain all the ups and downs in stock prices or bond prices. But most observers agree that an increase in the demand for dollar assets underlay the 1980–83 appreciation. An increase in the demand for a currency results in an increase in its price, for the same reason that an increase in the demand for any commodity results in an increase in its price.

Three reasons are often given for the recent increase in demand for dollar assets. They are (1) reduced expectations of U.S. inflation, (2) increased U.S. real interest rates, and (3) "safe-haven" and other possible portfolio shifts. We consider each in turn.

Effect of Reduced Expectations of Inflation

In the long run, the exchange rate tends to follow the differential trend in the domestic and foreign price levels. If one country's price level gets too far out of line with prices in other countries, there will eventually be a fall in demand for its goods, which will lead to a real depreciation of its currency.

Investors in international money markets are fully aware of the relationship between the price level and the exchange rate. If market participants think that a currency will be losing value in the future through inflation, then they will seek to avoid losses by immediately shifting their holdings out of that currency and into other assets. This attempt to sell the currency will cause its price to decline, even before the anticipated inflation occurs. For example, in the late 1970s the value of the dollar declined, in large part because of heightened expectations of U.S. inflation.

There is no way to know exactly what the market expects the inflation rate to be in the future, as opposed to what the inflation rate actually is. Table 2–2 shows three alternative measures of expected inflation: the actual inflation rate over the preceding year; a weighted average of actual inflation over the preceding 3 years (with more weight on the most recent years); and forecasts of future inflation made by Data Resources, Inc. Regardless which measure is used, there was a large drop in the expected U.S. inflation rate between 1980 and 1983. The market reduced its expectations of U.S. inflation in response to the firm anti-inflation policies of the Administration and of the Federal Reserve, to the 1980 and 1981–82 recessions, and to the actual decline in the observed inflation rate. As the table shows, expected inflation also fell in other countries between 1980

and 1983, but not as much. The differential between U.S. and foreign expected inflation declined.

The fall in the expected inflation differential is the first of the three reasons for the appreciation of the dollar. Investors who had previously shifted out of dollar assets because of fears of inflation, now shifted back. The increase in the demand for dollar assets caused an increase in the price of dollar assets, i.e., the exchange rate.

TABLE 2-2.—*Decreases in expected inflation rates and increases in real interest rates, 1980 to 1983*

Item	1980 average			November 1983			Change		
	United States	Trading partners [1]	Difference	United States	Trading partners [1]	Difference	United States	Trading partners [1]	Difference
	Percent per annum						Percentage points		
Long-term government bond rate	11.39	11.34	0.05	11.92	10.29	1.63	0.53	−1.05	1.58
1-year inflation [2]	13.54	11.38	2.16	3.19	5.17	−1.98	−10.35	−6.21	−4.14
Real interest rate 1	−2.16	−.05	−2.11	8.73	5.11	3.61	10.88	5.16	5.72
3-year distributed lag inflation [3]	11.67	9.35	2.32	4.90	6.46	−1.56	−6.76	−2.88	−3.88
Real interest rate 2	−.28	1.99	−2.27	7.02	3.82	3.19	7.30	1.84	5.46
DRI 3-year forecasted inflation [4]	10.05	8.56	1.49	5.29	5.90	−.60	−4.76	−2.67	−2.09
Real interest rate 3	1.34	2.77	−1.44	6.63	4.39	2.23	5.29	1.62	3.67

[1] Canada, France, Germany, Italy, Japan, and United Kingdom. Weighted by 1980 GNP.
[2] Change in the consumer price index (CPI) over the preceding 12 months.
[3] Weights beginning with the immediately preceding 12-month change in the CPI are .5, .3, and .2.
[4] Forecasts of CPI inflation over the subsequent 36 months. 1980 is the average of the four quarters' forecasts.
Sources: International Monetary Fund and Data Resources, Inc. (DRI).

Effect of Increased Real Interest Rates

The effect of the decline in expected inflation is only part of the story. If exchange rate movements were determined solely by inflation rates, the decline in expected inflation could explain the nominal appreciation of the dollar, but not the real appreciation of the dollar. The latter is the important concept for the question of the competitiveness of U.S. producers in world markets.

A second cause of the appreciation of the dollar between 1980 and 1983—and the major cause of its real appreciation—is the increase in the U.S. real interest rate. The real interest rate is defined as the nominal interest rate corrected for expected inflation. If nominal interest rates had come down as quickly as the expected inflation rate, then there would have been no increase in the real interest rate. But by the three measures in Table 2-2, the U.S. real interest rate rose between 1980 and 1983. This is typical of historical experience with monetary disinflation: it takes time for reduced expectations of infla-

tion to be reflected in reduced nominal interest rates. Real interest rates rose somewhat in other countries too, but not by as much. The real interest differential shifted in favor of dollar assets.

Because U.S. assets now pay a higher expected real rate of return than foreign assets, they have become more attractive to hold. The increase in demand for dollar assets arising from a higher real interest differential can explain an increase in the exchange value of the dollar, *above and beyond the increase that would be due to a lower expected inflation differential* in the absence of a change in the real interest differential. It explains why the dollar appreciated not only in nominal terms but in real terms as well.

Large real appreciations of a currency tend to be temporary. In the long run, the real value of the dollar is widely expected to fall back to a level that allows U.S. firms to compete in world markets on an equal basis. To believe otherwise would be to believe that U.S. producers can continue to be priced out of world markets, and the United States can continue to run 12-digit trade deficits, indefinitely. It is impossible to say when the dollar will come back down. The decline could start in 1984 or it could come later. To judge by past experience, even if there were no unforeseen developments, it could be as long as 10 years before the dollar returns to its long-run value.

It is possible to get a rough idea of how much above its long-run real value the dollar is currently, in the market's view, by looking at the long-term real interest differential in favor of the dollar. The long-term interest rate is the one reported in Table 2–2. The 10-year real interest differential is the compensation that investors get for holding assets in a currency that is expected to depreciate, in real terms, over the next 10 years. Taking the present 10-year real interest differential to be 3.2 points, the implication is that the market expects the dollar to depreciate, in real terms, at an average rate of 3.2 percent a year over the next 10 years, or 32 percent altogether (ignoring compounding). This arithmetic example would suggest that the market regards the dollar as currently being about 32 percent above its long-run real value.

In 1980 the real interest differential was *negative;* the market regarded the dollar as being about 23 percent below its long-run real value. Taking the increase in the real interest differential between 1980 and 1983 to be 5.4 points, the implication is that this factor by itself is sufficient to explain an increase in the dollar's value over this period of about 54 percent (without any change in its long-run real value). One can get different answers by choosing different horizons or different measures of the rise in the real interest rate. It is possible that none of the three alternative measures of expected inflation in Table 2–2 adequately reflects true expectations over the 10-year

horizon that is relevant. Nevertheless, it is evident that the real interest differential is capable of explaining the sort of real appreciation that the dollar has experienced.

Effect of "Safe-Haven" and Other Possible Portfolio Shifts

The third reason that is commonly given for the current strength of the dollar is the "safe-haven" effect: capital flees social and economic instability in other countries for the safety of the United States. There is some danger here of using the term "safe-haven" as a vague label for unexplained shifts in investors' portfolios. But one concrete interpretation is that investors have shifted their portfolios into dollar assets in response to the increased riskiness of investments in other parts of the world, Latin America in particular.

A decision by Latin Americans to move capital into the United States generates partly offsetting capital outflows from the United States to Europe and other countries. But in the eyes of some observers, investments in Europe have also become riskier, as a result of economic and political developments. Thus, a worldwide portfolio shift into U.S. assets in response to a change in relative risk may explain some part of the dollar appreciation. Other factors that are sometimes mentioned are the more favorable tax treatment for capital investment in the United States and the strength of the U.S. recovery in 1983.

The Source of High Real Interest Rates

If high real interest rates are the most important explanation for the high real value of the dollar, what is the explanation for the high real interest rates? This question is a subject of some controversy.

The real interest rate equilibrates the supply of saving, both private and public, to the demand for saving, in the form of investment. The real interest rate will rise either if the supply of saving shifts down or if investment shifts up. The contribution of the corporate income tax to the cost of capital facing firms has been reduced under this Administration. It is hoped that the increased incentive to firms will stimulate investment in the future. Unfortunately, as the second column of Table 2-3 shows, investment as a percentage of GNP was still lower in 1983 than in 1980, or than the average since 1970. Thus an upward shift of investment cannot be the sole explanation for the increase in real interest rates. A decrease in the supply of saving also must have played a major role. Indeed, there has been a decline in private saving, probably because of the recession, and a large decline in government saving, i.e., a large increase in the Federal budget deficit.

Although the decline in private and public saving is the most widely cited explanation for high real interest rates, other explana-

TABLE 2-3.—*Distribution of GNP by component, 1970–83*

[Percent]

Period	Personal consumption expenditures	Fixed investment	Government purchases of goods and services	Net exports of goods and services	Inventory investment
1970–79 average	62.4	15.3	21.0	0.6	0.8
1980	63.4	15.6	20.4	.9	−.4
1981	62.9	15.5	20.2	.9	.6
1982	64.8	14.3	21.1	.6	−.8
1983 [1]	65.2	14.4	20.9	−.3	−.2

[1] Preliminary estimates.

Source: Department of Commerce, Bureau of Economic Analysis.

tions are sometimes given. One is that an increase in uncertainty, usually ascribed to increased variability in the U.S. money supply, makes nominal dollar assets less attractive, so that they must yield a higher expected real return as a "risk premium" if they are to be willingly held. This argument could account for why real interest rates are high, but it cannot also be an explanation of the strength of the dollar. Any increased uncertainty attaching to dollar assets would cause a fall in demand for them and therefore in the price of the dollar, not a rise. Only increased uncertainty in *other* countries could induce the observed portfolio shift. Indeed that was one possible interpretation of the safe-haven argument discussed above.

THE CAPITAL ACCOUNT SURPLUS

The U.S. current account deficit in 1983 was nearly three times the previous record, which was set in 1978. The immediate connotation of the current account deficit, as of the trade deficit, is lost production in import-competing and export industries. But there is another way to look at it. The current account deficit is financed by a capital inflow from abroad. Foreigners have been investing in the United States, for example participating in the rising stock market and buying Treasury bills.

Relation to Crowding Out

This capital inflow has an important implication for the U.S. economy. Under the natural assumption that the capital inflow is not somehow offset by an equal decrease in domestic saving, it keeps real interest rates lower than they otherwise would be. As such, it allows those components of GNP that are especially sensitive to the real interest rate—housing, consumer durables, and business investment in plant and equipment—to be higher than they otherwise would be. Of course, the capital inflow has not been large enough to prevent real

interest rates from rising since 1980, as reported in Table 2-2, or investment as a share of GNP from falling, as reported in Table 2-3.

Table 2-3 also shows how two other components of demand, consumption and government expenditure, have risen since 1980 as a percentage of GNP. Indeed, it was the increases in these components of spending that drove up real interest rates and crowded out investment, as explained in Chapter 1. The important point regarding the inflow of capital into the United States from abroad is that it dampened the rise in the real interest rate, and thus reduced the degree of crowding out of investment. This bonus did not come free. The counterpart to the capital inflow is the appreciation of the dollar and the worsening of the trade deficit. In effect, much of the crowding out is now borne by the import-competing and export industries, with the consequence that less of it is borne by the construction, consumer durable, and capital goods industries.

In 1984 the U.S. current account deficit is forecasted to be roughly 40 percent the size of the Federal Government budget deficit. This means that a capital inflow from abroad is financing the equivalent of 40 percent of the budget deficit, and the crowding out of other sectors of domestic demand is reduced correspondingly. International capital flows of this magnitude are consistent with the increasing integration of world capital markets.

Benefits of the Capital Inflow and Dollar Appreciation

Is the inflow of capital and the associated strength of the dollar desirable? In one sense it is not; the appreciation of the dollar imposes great costs on import-competing and export industries in terms of lost income and employment. But the strong dollar has substantial benefits too. It keeps down the general price level, both directly through lower dollar prices of imports, and indirectly through lower prices for domestically produced goods that compete with goods produced abroad. The important question for policy is whether the costs of artificially reducing the capital inflow are greater than the costs of the existing trade deficit.

In the long run, expansion of potential GNP is limited by such factors as growth of the labor force and of the capital stock. Even in the short run, monetary policy puts a limit on the expansion of actual dollar GNP, because the Federal Reserve is currently committed to a monetary policy that avoids a resurgence of inflation. It follows that if the capital inflow were somehow shut off, the dollar allowed to depreciate, and export and import-competing industries stimulated to increase production, the gains in those industries would probably be offset by losses in other industries so as to leave total GNP unchanged. The mechanism whereby this would happen is an increase in the real interest rate; the industries that would lose include con-

struction and other interest-sensitive industries, whose customers are primarily firms undertaking investment.

There are two reasons why the investment sector should not have its share of the national pie reduced in favor of the export and import-competing sectors, as it would be if the capital inflow were shut off. The first is that there is no reason to think that the profitability of investment has fallen. Investment determines how big the national capital stock will be in the future, and thus how big output can be. It is true that a capital inflow, which constitutes the sale of assets to foreigners, represents a loss of future income in the form of capital earnings paid overseas. This loss in income is as great as the loss of returns to plant and equipment never built. Indeed if the United States continues to run current account deficits at anything like the rate forecasted for 1984, sometime in 1985 the Nation will pass from being a net creditor to being a net debtor, for the first time in 68 years. But from the viewpoint of maximizing domestic output and employment, it is better to have machines working in the United States, even if owned by foreigners, than not to have them at all.

The second reason for sharing economic expansion proportionately among sectors, to whatever extent possible, has to do with inflation. Expansion is often associated with an increase in inflation. Whether U.S. inflation is reignited depends, among many other things, on the distribution of expansion across sectors. It seems possible that industries that sell their goods and services primarily to the consumer and government sectors will begin to run into capacity constraints before the rest of the economy. At that point, any further increases in demand in those sectors are more likely to be reflected in higher prices than in higher production. In the industries that sell their products to firms undertaking investment, by contrast, there is still tremendous room for expansion. Some industries, such as nonresidential construction, have only begun to share in the recovery. The noninflationary payoff to expansion in these industries is large. But if the country had never had the capital inflow, the interest rate would be even higher, and production in the interest-sensitive industries would be lower without much gain in reduced inflation. The export and import-competing industries would be benefiting from a cheaper dollar. But they might now be starting to run into capacity constraints more quickly, with an adverse effect on the overall inflation rate.

MEASURES TO REDUCE THE TRADE DEFICIT

Four kinds of policy measures have at times been proposed to improve the trade balance: protectionism to keep out imports, foreign

exchange intervention to reduce the value of the dollar, capital controls with the same aim, and a change in macroeconomic policy. Each of these has costs. Of the four, protectionism is the most dangerous.

Protectionism

In a dynamic economy there are always some sectors expanding and others contracting because of technical change, shifting consumer tastes, and so forth. This is particularly true of an economy exposed to the rigors of competition in world markets. Earlier in its history, the U.S. economy, with its large domestic market, diversified economic resources, and geographic remoteness from Europe, was less dependent on international trade. But as domestic economies of scale were exhausted, as tariffs were reduced worldwide, and as declining transportation costs made geography increasingly irrelevant, international trade became increasingly important. The growth in exports allowed many U.S. sectors to expand rapidly that otherwise might not have been able to do so. Major examples in recent decades include agriculture, high-technology products, and services. But the increase in U.S. imports, which sooner or later must accompany any increase in exports, meant a loss in demand for other U.S. sectors. Some sectors that had previously had the domestic market to themselves found that their foreign counterparts could produce quality products at costs far below what they had become accustomed to receiving. Some major examples are the auto and steel industries.

The economic strains associated with long-term structural trends have always generated political pressure on the government to protect the adversely affected industries. In recent years temporary macroeconomic factors—the rise in unemployment during the last recession and the high value of the dollar—have exacerbated the economic difficulties of sectors vulnerable to import competition, and have intensified accordingly the political pressure to protect them. In addition, some exporters are finding that the strong dollar, and subsidies by some foreign governments, are making it more difficult to compete in foreign markets. This group traditionally forms a constituency for free trade but is now in some cases generating political pressures of its own for government action.

The Administration's stated policy is to resist these pressures. Protectionism usually succeeds in increasing the income of the sector seeking protection. However, it imposes costs on other sectors that more than outweigh the benefits for the protected sector. These costs are of three kinds. First are the effects on the purchasing power of consumers. A tariff or quota on imports cannot succeed in raising the prices received by domestic producers without at the same time raising the prices paid by domestic consumers. Second are the effects on other industries that use the output of the sector in question as an

input into their own productive process. Protection for the steel industry raises costs for the auto industry, protection for sugar growers raises costs for candy manufacturers, and so forth. Third are the effects on export industries. The dollars that foreign countries earn by selling to the U.S. market are useless to them unless, sooner or later, they spend them on U.S. exports. If the United States cuts off imports of foreign goods, foreigners will not have the dollars to buy U.S. exports. Usually it is difficult to identify the specific U.S. export industry that would benefit from increased trade. When the dollars come back to the United States, it will not necessarily be in the form of spending by the same foreigners that originally earned them, nor in the same year. But in one recent example, the connection is clear: China has indicated that if the United States cuts off imports of textiles from it, China will cease purchases of agricultural products from the United States.

The American public retains a broadly based commitment to the ideals of free trade. Nearly all political factions support free trade in principle. But there is a common fallacy that the arguments for free trade are theoretical arguments that lose applicability if other countries are not practicing free trade, that market distortions imposed by trading partner governments automatically warrant retaliation by the U.S. Government.

The desire to retaliate against a foreign government that is, for example, subsidizing exports, is understandable. Such retaliation has two effects, one predictable and one unpredictable. The predictable effect is to impose immediate costs, on domestic consumers and other domestic producers, that exceed the immediate benefits for the protected sector. It is irrelevant to this effect why foreign producers were underselling domestic producers, whether it was because of government subsidies, the level of the exchange rate, or lower labor costs. Export subsidies by foreign governments are in essence income transfers—i.e., foreign aid—to the importing country.

The unpredictable effect is the reaction of the foreign government. If the foreign government were to respond by removing its subsidies in exchange for the domestic country removing its measures, then both sides would be better off. All too often, however, the foreign government retaliates with more of the same. U.S. measures must be well targeted and explicitly temporary if they are to have the desired effect on foreign governments. There are no winners in a trade war.

The issue of the duration of protectionist measures is an important one. Frequently, measures that are originally adopted as temporary, such as quotas imposed to protect a domestic industry "just until it can get back on its feet," turn out later to be very difficult to remove.

Often protection encourages the industry to delay making needed adjustments, rather than to speed them up.

Foreign Exchange Intervention

A second measure that has been proposed to improve the trade balance is intervention in the foreign exchange market by the monetary authorities to force down the value of the dollar and thus to restore price competitiveness to American industry. At the beginning of August 1983, and later in the year, U.S. authorities did intervene on a small scale, buying marks and yen in exchange for dollars, in cooperation with monetary authorities in other countries. The intervention did not noticeably depress the value of the dollar, nor was it intended to. It is U.S. policy to intervene only to calm disorderly markets.

There are two kinds of foreign exchange intervention, known as *sterilized* and *unsterilized.* Sterilized foreign exchange intervention occurs when the central bank, at the same time that it is buying foreign currencies with domestic currency, sells Treasury securities in the market in order to take the domestic currency back out of circulation. The point of sterilizing the foreign exchange intervention is to keep the domestic money stock unchanged. This is the type of intervention the U.S. monetary authorities undertake when they do intervene.

Unsterilized intervention has the effect of increasing the domestic money supply. This would have a strong downward effect on the value of the domestic currency. But like any other increase in the money supply, it can be inflationary.

The effect of sterilized intervention is much less clear than the effect of unsterilized intervention. The 1983 summer intervention amounted to $254 million on the part of U.S. authorities. This was only 1 percent of the flow through the U.S. interbank foreign exchange market on a typical day in 1983. It was even less significant relative to the trillions of dollars in funds that investors around the world can commit to the foreign exchange market if they think that the exchange value of the dollar has been temporarily pushed below the true market level. Investors will move in quickly to exploit the potential profit opportunity, buying dollars, and thereby returning the price of the dollar to its previous level. This process ensures that, unless monetary authorities are prepared to intervene on a massive scale, any effects on the exchange rate will be transitory. After the Versailles Summit of 1982, a working group with representatives of the seven Summit countries was set up to study exchange market intervention. Its report, released in April 1983, concluded in part, that there was "broad agreement that sterilized intervention did not generally have a lasting effect."

If monetary authorities were prepared to intervene on a sufficiently massive scale, there could conceivably be some permanent effect on the exchange rate, even if the intervention were sterilized so as to leave the money supply unchanged. But to the extent that sterilized purchases of foreign currency were successful in reducing the value of the dollar, they would also be successful in raising the U.S. interest rate. The reason is that sterilized intervention does not leave market participants holding any more dollar currency than before; it leaves them holding more dollar Treasury securities than before. The interest rate would have to rise to induce the market to hold a greater quantity of Treasury securities, just as it does whenever the government sells large enough quantities of Treasury securities. The exporting and import-competing industries would be happy with the lower value of the dollar. But the capital goods, construction, and other interest-sensitive industries would be unhappy with the higher interest rate.

Capital Controls

The third kind of measure that has been suggested to reduce the U.S. deficit is the adoption of an international "interest equalization tax" or other restrictions on the international mobility of funds. The aim would be to shut off or reduce the inflow of capital and thus reduce the exchange value of the dollar.

The case against restrictions on the international flow of capital is analogous to the case against restrictions on the international flow of commodities, i.e., the case for free trade. Controls on international borrowing and lending interfere with the efficient allocation of capital among countries. The Administration is opposed to capital controls as a matter of general principle.

What effect would controls on capital inflow in the United States have in the present context? As with exchange market intervention, there are two possibilities. One possibility is that the controls would not even be effective. The experience of the United States in the 1960s, and of other countries today, is that there are many ways to circumvent capital controls. The alternative possibility is that the controls would be strong enough to reduce the capital inflow, and thereby reduce the value of the dollar. But if so, the reduced supply of saving from abroad would also raise the real interest rate and, once again, concentrate all the crowding out in the interest-sensitive sectors.

Macroeconomic Policy

The fourth kind of measure that has been suggested to reduce the U.S. trade deficit is a change in macroeconomic policy.

One possibility is a more expansionary monetary policy. This would clearly reduce the value of the dollar. In the short run, before prices throughout the economy had time to adjust, it would reduce the value of the dollar not only in nominal terms, but in real terms as well. Thus it would succeed in stimulating the demand for U.S. products. Unfortunately, a more expansionary monetary policy would also have adverse consequences for inflation. In the long run, when prices have had time to adjust, there would probably be no effect on the real exchange rate or real output, only an increase in the general price level. Because of the inflationary consequences, the Administration does not advocate using expansionary monetary policy to depress the value of the dollar.

On the other hand, for those who are concerned that monetary policy should be *tightened,* it is worth taking note of the undesirable consequences for the exchange rate in the short run. The fact that the price of the dollar in foreign exchange markets remained high throughout 1983 is a clear signal that the market had confidence in the Federal Reserve and that the money growth rate was not excessive.

The last possibility is a policy of reducing the budget deficit. Measures to reduce the budget deficit would lower real interest rates and thus allow the investment sector to share more fully in the recovery that is now taking place primarily in the government and consumer sectors. But, further, it would also lower the real value of the dollar and thus allow the exporting and import-competing sectors to share in the recovery as well. Of course, just as there are costs to the other proposed measures to improve the trade balance, there are also costs to reducing the budget deficit, whether by reducing government expenditure or by raising taxes.

DEVELOPMENTS IN OTHER INDUSTRIAL COUNTRIES

One of the challenges facing the world economy is the uneven geographical distribution of the recovery. Among the industrialized countries, only in Canada is real growth in 1984 expected to be as strong as in the United States. The implication for U.S. trade is negative: slower growth among trading partners than in North America means slower growth in U.S. exports than in U.S. imports. As Chart 2–3 shows, U.S. trade with both Europe and Japan is deteriorating.

EUROPE

The 1983 recovery in the United States and Canada is in the process of spreading to Europe as well. The United Kingdom and West Germany seem to have embarked on a path of renewed growth. Ex-

pansionary policies in France in 1981 postponed the recession there, but deteriorating inflation and balance of payments situations led to the adoption of austerity measures. Though the French trade balance improved in 1983, worries about inflation remained serious enough to keep a lid on expectations of future French expansion. In Italy and most of the smaller European countries there was no significant recovery for 1983 as a whole, although there were some signs of a pickup in economic activity toward the end of the year.

Effects on Europe of U.S. Economic Developments

Inflation has declined in all the larger European countries since 1980. This accomplishment has not been easy. The weakness of their currencies against the dollar has meant higher prices for oil and other imports in Europe. To limit the damage from both domestic and imported inflation, most European countries have accepted higher real interest rates than they would have accepted otherwise. Indeed, this is the mechanism through which recession was transmitted to Europe in 1981. Just as capital flowing into the United States has kept real U.S. interest rates lower and U.S. investment higher than they would otherwise be, so has capital flowing out of some European countries probably kept real European interest rates higher and European investment lower than they would otherwise be. In effect, the low U.S. rate of private and public saving is crowding out investment not just in the United States, but in the rest of the world as well.

The counterpart to a capital outflow is a current account surplus. This is the positive side of the ledger from the viewpoint of the European countries. Their depreciated currencies give their exporting and import-competing industries a competitive advantage in world markets. Until now, the Europeans have not on the whole considered that they were benefiting from the strength of the dollar and the U.S. trade deficit, despite their sizable share of it illustrated in Chart 2–1. Some have found it politically convenient to focus exclusively on the negative aspects of the exchange rate movement. The world current account discrepancy may also be part of the explanation: it is as if each country thinks it is running a deficit in goods and services, and someone else must be running the surplus.

In any case, in 1984 U.S. growth will lead to greater demand for European goods and thus is likely to help pull Europe out of its recession. The prospective reversal of the 1980–83 appreciation of the dollar is another development to which the Europeans can look forward. If the dollar depreciates, as many expect, the reduction in import prices will make the task of fighting inflation easier in Europe. Of course, the reversal in the gain in European competitiveness would also lead to an eventual reversal in the gain in net exports to

the United States. But it might allow European monetary authorities to bring down interest rates and stimulate domestic demand, at least in those countries such as West Germany and the United Kingdom that have relatively strong current account and inflation positions. The weaker-currency countries in Europe would find it difficult to expand on their own. The French franc, for example, might come under renewed pressure within the European Monetary System if a prospective world portfolio shift out of dollars were accompanied by a portfolio shift into marks.

Structural Problems in European Labor Markets

Regardless of what happens in the international financial markets, the problem of 18 million unemployed workers still plagues Western Europe. Indeed, in 1983 the unemployment rate continued to climb throughout Europe. In sharp contrast to the United States, Western Europe employs about the same number of workers, on an absolute basis, as it did in 1968. The most commonly cited cause of the bleak employment picture is excessive labor costs. Due to wage contracts indexed to consumer prices, and other less institutionalized social forces, real wages in Europe never adjusted in the 1970s to reflect the negative effect of oil shocks on the productivity of labor. Some observers argue that the greater rigidity of real wages in Europe than in the United States explains European governments' lack of enthusiasm for expansionary demand policies, despite low growth. For example, some European governments have taken steps to reduce government expenditure. They have also expressed the wish that the United States would reduce its budget deficit. Whether or not it is correct that expansion requires real wages to fall, it seems likely that any expansion of employment in Europe will greatly lag expansion of output. The implications for investment and long-term growth are also disturbing.

JAPAN

Economic performance in Japan has been impressive by the standards of most countries, even though the 1980–82 world recession was reflected in Japan as a clear slowdown in real growth. The Japanese trade account moved into substantial surplus again in 1983, as declining oil prices reduced the import bill and recovery in the United States and some others of Japan's trading partners boosted exports. Domestic demand remained somewhat sluggish.

Trade with the United States and Japanese Commercial Policy

As Table 2–1 shows, the U.S. trade deficit with Japan, known as a bilateral trade deficit, is larger than with any other single country.

Trade relations between the two countries are a source of special concern, and warrant a careful analysis.

To some extent the bilateral trade imbalance follows naturally from three other facts:

1. Japan usually runs a merchandise trade surplus with the rest of the world, as a consequence of its high rate of saving and its deficit in services.

2. The United States usually runs a merchandise trade deficit, as a consequence of its low rate of saving and its surplus in services.

3. Japan and the United States are the two largest market economies in the world and account for large shares of each other's trade.

There is an important reason why, even if Japan's overall trade balance were zero, it would still run a large bilateral trade surplus with the United States, and a very large surplus in manufactured goods in particular. Japan has few natural resources, and is dependent on imports for its supply of primary products, especially oil and other mineral fuels. It must earn the foreign exchange to pay for the oil by exporting other goods. If the United States were willing to sell enough Alaskan oil to Japan, for example, the bilateral trade imbalance would be reduced. As it is, Japan buys its oil elsewhere, running a large bilateral deficit with OPEC countries. And Europe normally runs a bilateral deficit with the United States. It is as though the United States sells to Europe in order to be able to buy from Japan, Japan sells to the United States in order to be able to buy from OPEC, and so forth around the circle of trading partners.

The important point is that it is neither necessary nor desirable that any two countries' bilateral trade be in balance, any more than it is necessary or desirable for an auto manufacturer to be in bilateral balance with its steel supplier, or a household with its plumber. One looks at the overall balance of a household, company, or country, not at bilateral balances, to see if it is earning more—from all its trading partners together—than it is paying out.

One widely held belief is that Japanese trade policy is responsible for the fact that Japan does not buy as much from the United States as the United States buys from it. Because the Japanese have accelerated tariff reductions agreed to in the Tokyo Round of multilateral trade negotiations, their tariffs are now lower than those of the United States and the European Community. But the Japanese maintain a number of nontariff barriers against imports that are a source of friction with the United States. These include import quotas for some agricultural products, and less tangible barriers to imports of manufactured goods, such as inspection requirements and government purchasing policies. Recent negotiations between the two governments in such areas as beef and citrus products, metallur-

gical coal and natural gas, cigarettes, and telecommunications equipment, have made some progress in reducing these barriers. But frictions remain.

Import barriers in every country protect those sectors that would not have the comparative advantage in a fair fight, at the expense of those sectors that would. In the Japanese case, it is agriculture that is easily the least competitive sector and therefore the most protected, with beef and citrus products the most highly visible examples. Japan already imports a lot of agricultural products; indeed, it is the largest customer of U.S. agricultural exports. But, in general, a high observed degree of "import penetration" does not preclude the existence of a high degree of protection. In fact, import penetration is often the cause and protection the effect, rather than the other way around. Many countries invoke national security arguments as a justification for protectionist measures; it should be noted that Japan does so on behalf of its agricultural sector.

It would be in the Japanese interest to reduce or remove the agricultural barriers because they can import these products far more cheaply than it costs to produce them domestically. Japanese liberalization would, of course, also be in the interest of U.S. farmers. It probably would not be in the interest of the U.S. manufacturing sector, however. In view of Japan's deficits in oil and services, it must run surpluses in its trade in other goods. If Japan were to start importing more agricultural products, its trade balance would not simply worsen by the same amount. Rather, the yen would eventually depreciate in order to generate the required trade surpluses in other sectors, i.e., manufactures. The point is that Japanese protectionism, like all protectionism, distorts the pattern of trade in such a way as to hurt both countries on net; but it is not a major source of the Japanese trade surplus.

The Yen Exchange Rate and Japanese Foreign Exchange Intervention

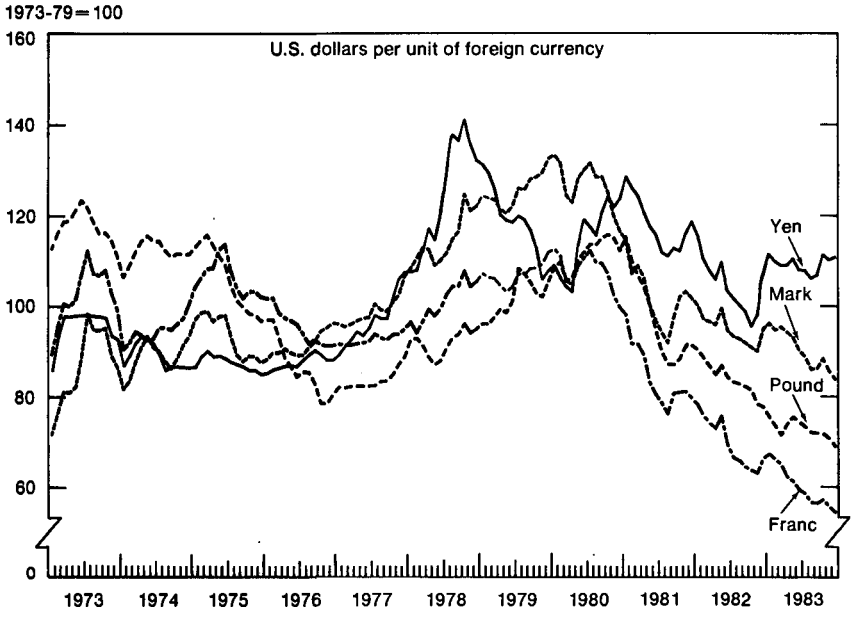
Another common claim is that an undervalued yen is the source of the trade problem. One version of this view is that the Japanese are deliberately keeping the yen undervalued, presumably either through foreign exchange intervention or through capital controls. No aspect of this view stands up well to the facts, however.

The value of the yen has indeed fallen in terms of dollars since 1980, though this movement was largely reversed in late 1982. As of December 1983, the yen had depreciated 3 percent, relative to the 1980 average. This depreciation has not been an offsetting reaction to different rates of inflation. Rather, the opposite is the case: because of superior inflation performance, the gain in Japanese competitiveness over this period has been 13 percent, as measured by consumer prices.

However, the dollar has appreciated against all foreign currencies, not just the yen. Chart 2-4 shows the value of the yen, mark, franc, and pound, each in terms of dollars. The mark, franc, and pound are all clearly down in value by more than the yen. In fact, relative to the 1973–79 average, the yen has actually *risen* in nominal terms by more than 10 percent against the dollar. It is difficult, given Chart 2-4, to single out the yen as the troublemaker.

Chart 2-4

Bilateral Exchange Rates



Source: International Monetary Fund.

The bilateral exchange rate between the yen and the dollar remains a source of difficulty for U.S. businessmen who compete with Japan in domestic or foreign markets. Have the Japanese intervened to keep the yen at a lower level against the dollar than it otherwise would be? Although the Japanese authorities practice occasional exchange market intervention, their intervention has, if anything, prevented a further decline of the yen relative to the dollar. The Japanese monetary authorities have long followed a policy of trying to dampen fluctuations in the exchange rate, known as "leaning against the wind." In 1977 and 1978 when the dollar was weak against the yen, the Japanese authorities bought dollars to dampen the down-

ward movement of the dollar against their own currency. In the period since April 1981, when the dollar has been strong against the yen, the Japanese have sold dollars to dampen the upward movement of the dollar against their own currency. The intervention does not appear to have been effective at moderating the swings in the yen/dollar rate. But it has worked in that direction.

Liberalization of Japanese Capital Markets

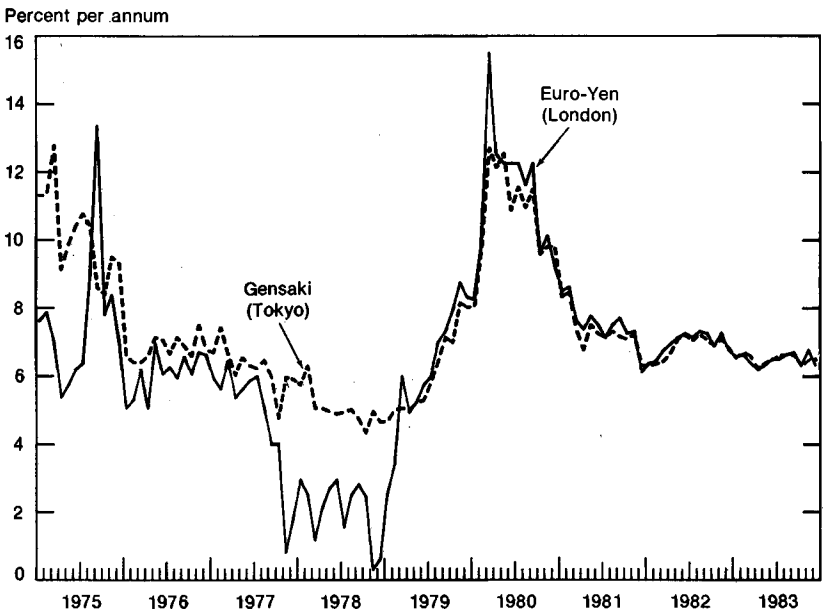
The cause of the decline in the exchange value of the yen against the dollar since 1980 is the flow of capital out of Japan and into the United States. A primary reason for this capital flow is the high real U.S. interest rate. But it has been suggested that Japanese restrictions on the international flow of capital may also be a factor.

Japan, like the United States and European countries, maintained into the 1970s controls on the international flow of capital that had originated under the fixed exchange rate system. After the shift to floating exchange rates in 1973, the United States, West Germany, and the United Kingdom, one by one removed their capital controls. As recently as 1978, Japan still retained formidable barriers to both inflow and outflow. For example, foreigners were not allowed to hold many Japanese securities, such as gensaki, a 3-month repurchase agreement. Chart 2–5 shows the Tokyo gensaki interest rate and the London 3-month Euro-yen interest rate. The fact that the Tokyo gensaki rate exceeded the London Euro-yen rate in 1978 is clear evidence that capital controls were operating to reduce capital inflow into Japan. Otherwise foreign residents would not have been willing to hold Euro-yen in London when a higher interest rate was available in Tokyo. The yen was then at an all-time high against the dollar and the Japanese were trying to dampen its appreciation by keeping capital from flowing into the country.

When the yen depreciated rapidly in 1979, the Japanese moved quickly to remove controls on capital inflow, making it possible for foreigners to hold Japanese securities. Japan's Foreign Exchange and Foreign Trade Control Law of December 1980 established a presumption that international capital flows are permitted. Chart 2–5 shows that the *de jure* liberalization took place *de facto* as well. The differential between the gensaki and Euro-yen rates dropped sharply. In fact, the differential, though small, became negative in 1979 and 1980. This is evidence that Japanese controls on the inflow of capital were liberalized more quickly than controls on capital outflow. If some barriers to capital outflow had not remained, Japanese investors would not have been willing to hold assets in Tokyo when a higher interest rate on comparable yen securities was available in London. Thus those capital controls that remained were more a force keeping capital inside the country than outside, and thus more a

Chart 2-5

Interest Rates on the Yen



Source: Morgan Guaranty Trust Company of New York.

force keeping the yen value up than keeping it down. By 1983 the gensaki-Euro-yen differential was so small as to suggest that Japanese capital markets for short-term negotiable instruments were as open as, for example, European capital markets.

The governments of both Japan and the United States recognize that the yen/dollar exchange rate remains a source of concern, particularly insofar as it heightens protectionist pressures in the United States. One proposal is that the Japanese government take positive action to bring about some capital inflow. In 1984 some Japanese government-affiliated agencies plan to issue foreign currency bonds in New York. However, the governments of both countries feel that more direct measures, such as reinstatement of some of the controls on capital outflow, even if they were effective, would be counterproductive to the longer term goal of completing the integration of Japan into world financial markets.

In the past the yen has not occupied a place in world financial arrangements that is commensurate with Japan's importance in world

trade. For example, the yen's share in world official holdings of foreign exchange, though it has risen rapidly, still falls short of, not only the dollar's share, but the mark's share as well. Similarly, the percentage of Japan's exports that are denominated in its own currency, though it has risen rapidly, is still below the corresponding percentage for other large industrialized countries. At the time of the President's trip to Japan in November 1983, the Japanese agreed to promote increased "internationalization" of the yen. This includes such concrete measures as relaxing the rules that previously restricted use of the yen forward exchange market to transactions arising from foreign trade. There is no reason to expect such measures to have a noticeable upward effect on the value of the yen in the short run. Nevertheless, in the long run an enhanced role for the yen in world financial markets is considered by some to be desirable in that it reflects Japan's importance in the world economy, and is hoped to contribute to some increase in its exchange value against the dollar as well.

A related goal is continued deregulation of *domestic* Japanese capital markets, which lags behind deregulation in the United States. Here the major beneficiary of liberalization would be Japanese households, who in the past have not been paid competitive interest rates on their savings. But it is also sometimes argued that, if interest rates rose in Japan, there might be a decline in capital outflow from Japan and an appreciation of the yen.

Changes in the Japanese-U.S. Trade Balance

The Japanese government is not using either foreign exchange intervention or capital controls to keep the yen "undervalued." Indeed, it would be more accurate to say that the dollar is "overvalued" than to say that the yen is "undervalued." The other major currencies are down against the dollar to a greater extent than is the yen. One would expect that the U.S. bilateral trade balance with Japan would not have worsened more than the bilateral trade balance with other countries.

This is indeed the case. As Chart 2-3 and Table 2-1 show, the bilateral balance with Japan has worsened. But the deterioration in the U.S. bilateral trade balance with Japan represents less than one-eighth of the total 1981–83 decline in the overall U.S. trade balance. The deterioration in the bilateral balance is less severe, as a proportion of U.S. imports from Japan, than the 1981–83 deterioration in the overall U.S. trade balance. The deterioration in the U.S. bilateral trade balance with Japan is also far less severe, on either an absolute or relative basis, than the deterioration in the U.S. bilateral trade balance with Mexico over the same period.

This is not to say that U.S. trade with Japan does not remain a source of concern. The point is that the trade balance with Japan has deteriorated for the same reasons as the balance with other countries.

THIRD WORLD DEBT PROBLEM

The decline in the U.S. trade balance is good news for many trading partners. In the cases of Canada, Japan, and Europe, it represents a pickup in exports that has helped to pull their economies out of recession. But in the cases of the third world countries, particularly those in Latin America, the changing pattern of trade represents something quite different. As seen in Chart 2-3, the decline in the U.S. trade balance with Latin America is much greater in magnitude than the decline in the U.S. trade balance with other parts of the world. The increase in their trade balances is not good news for the Latin Americans; it is the reverse. It is a symptom of the severe debt problem that afflicts most of these countries, and many in Asia, Africa, and Eastern Europe as well, and of the wrenching adjustments that they are finding it necessary to undertake.

THE NATURE OF THE PROBLEM

Recent Developments in the Debtor Countries

Although there had been previous isolated cracks in the international debt terrain, it was not until 1982 that the problem erupted in dramatic proportions. In August of that year, Mexico announced that it was unable to meet its debt obligations to foreign creditors, although it was taking steps to rectify the situation. In response, the U.S. Government mounted a rescue operation, involving the creditor banks, the International Monetary Fund (IMF), and other creditor governments. The package included a strict program of adjustment for the Mexican economy and a rescheduling of much of the debt. Nervous banks began to cut back lending to other countries that appeared to be heavily indebted, with Brazil the most obvious target. As long as the banks had been willing to continue lending, the debtor countries had had the foreign exchange necessary to continue servicing their accumulated debt, i.e., making scheduled payments of interest and amortization of principal. As the banks cut back, the debtors found debt-service obligations increasingly difficult to meet. One by one, Brazil, Argentina, and many other debtor countries found it necessary to seek debt relief from their creditors, while implementing programs of economic adjustment monitored by the IMF.

The most important result of these programs of adjustment has been a sharp improvement in trade balances, so that interest pay-

ments do not have to be met entirely out of new loans, but can be largely met out of foreign exchange earnings from international trade. In 1983 the adjustment efforts of several of the most troubled debtors were successful to the point of achieving significant surpluses in their balances of trade. By the end of the year the situation looked considerably brighter, especially in Mexico. If all concerned parties continue their efforts, and there are no unforeseen calamities, the system can be expected gradually to work its way back to normalcy.

The increases in debtors' trade balances have been achieved largely by cutting imports. Cutting imports is the only practical way of achieving a large increase in the trade balance in a short period of time. But, past a certain point, it is difficult to sustain. It means that the population's standard of living is falling, inventories of raw materials and spare parts have been exhausted, and investment is at a standstill. In some cases, inadequate supplies of imported inputs have forced firms to curtail production, even firms producing for export markets. Beginning in 1984 further progress will depend most critically on expansion of exports, rather than further contraction of imports. Only then will adjustment be compatible with a world of economic growth.

Liquidity Versus Solvency

Central to an analysis of the current debt problem is the distinction between liquidity and solvency. Because countries do not go out of business, as do firms, the distinction is not absolute but is rather a matter of degree. A country might be defined as insolvent if it is likely to find servicing its debt increasingly difficult over time, and eventually to have to default. A country is merely short of liquidity if its economy is believed to be fundamentally sound and its debt-servicing difficulties are believed to be temporary. In that case, continued lending to keep the country liquid is justified, so as not to cause unnecessary damage to the local economy, and so as not to risk more drastic solutions, with their adverse economic and political repercussions. In the case of insolvency, however, there would be no point in the country making it through another year, only to face the same difficulties next year that much further into debt; more drastic solutions would be called for.

Argentina, Brazil, and Mexico are the three debtor countries that have dominated the discussion, not only because of their size, but also because of the acuteness of their financial distress. One indication of their difficulties is that in all three cases, debt-service obligations (interest and amortization, including short-term debt, as originally scheduled) exceed 100 percent of exports of goods and services. This means that even if the countries could somehow cut their imports to zero, their export earnings would not be sufficient to serv-

ice the debt in the absence of continued new lending. But many healthy, developing countries borrow abroad to finance their development, and would be hard put to meet their debt obligations if for some reason they were suddenly cut off from new lending. Furthermore, debt-service numbers are particularly sensitive to yearly fluctuations in interest rates. A longer term measure of "how far in over their heads" the debtor countries have gotten is the ratio of debt to exports. This ratio is reported in the first row of Table 2–4 for Argentina, Brazil, and Mexico taken together. The ratio increased rapidly between 1981 and 1982, and now exceeds 300 percent. If the debt/export ratio were expected to continue to increase in the future, the countries could be considered insolvent.

ORIGINS OF THE PROBLEM

The solvency issue is analyzed below. But to evaluate the future, it helps first to recount the past.

The 1970s: Incurring the Debt

The present pattern of lending to third world countries, with its heavy concentration on bank lending, is only 10 years old. In the aftermath of the 1973–74 oil price shock, banks "recycled" billions of dollars of savings that the OPEC countries could not in the short run absorb. World inflation rates were high and real interest rates very low—even negative—through the remainder of the decade, signaling a high level of savings in search of investment opportunities. The funds went, not to all the third world countries that were having difficulty paying their higher oil bills, but mainly to those judged to have good prospects for future growth, and thus good prospects for full repayment of the debt.

This lending seemed sensible at the time. The high world inflation rates and low real interest rates meant it was advantageous for the countries in question to borrow, and that servicing the debt did not look difficult. A high level of indebtedness is not necessarily a source of concern, as long as the borrowing countries are expected to grow. Corporations whose income is expected to grow in the future often have a high ratio of debt to earnings. Countries do the same. The United States in the 1880s had debt/export ratios as high as those in Table 2–4. Nor were the banks' expectations of high growth rates in the debtor countries in the 1970s disappointed. The rate of growth of exports from 1975 to 1980 was as great as the rate of growth of debt, in Argentina, Brazil, and Mexico taken together. Thus the key measure, the debt/export ratio, did not rise during this period.

Prior to 1970, private capital flows to third world countries had predominantly taken the form of foreign direct investment, bonds issued for specific projects, and short-term trade credit for specific

imports. The pairing of loans to projects has the virtue of ensuring that the sum of the lending equals the sum of the investment. The bank lending of the 1970s was more often for general balance of payments financing. There is nothing wrong with this in itself. But it allowed total lending to exceed total project investment. The fact that a large number of banks were involved, and that good aggregate statistics on lending did not at first exist, added to the confusion. The banks may not have realized the extent of their collective investment.

The debtor countries also made policy mistakes. The mistakes fall into two broad categories: overexpansion of demand and overvaluation of currencies. Both kinds of mistakes led to excessive trade deficits and therefore excessive borrowing to finance those deficits. But beyond this observation, generalization is difficult. In many countries the government sector expanded too quickly, especially in the form of credit to inefficient state enterprises. Often government deficits were monetized, and the currency was not devalued fast enough to keep up with inflation; then the loss in competitiveness of export industries led to trade deficits that were financed by borrowing from abroad. The end result was the same as when the governments financed their deficits by borrowing from abroad directly. Though much of the money was used for profitable investment, some went to unwise projects, to consumption, and to capital flight out of the countries involved.

In some countries, a capital inflow and consequent real appreciation of the currency were the unintended effects of favorable developments. For example, the discovery of oil in Mexico brought about an increase in indebtedness—financing the investment necessary to develop the oil. Furthermore, the monetary inflow added to inflationary pressures, and the loss in price competitiveness had an adverse effect on the exports of other industries, especially the manufacturing sector on which previous hopes for growth had been pinned.

In other countries the simultaneous adoption of an array of monetarist and free market policies did not prevent indebtedness. Monetary stabilization made the country's assets seem attractive to hold, trade liberalization increased the trade deficit, and removal of capital controls allowed foreign capital to flood in. In several countries, real overvaluation of the currency was an intentional element of the plan to reduce inflation quickly. The magnitude and duration of the loss in export competitiveness that followed were not intentional.

1980–82: A Change in the International Environment

As of 1980, there was little reason to doubt the ability of most of the debtor countries to sustain high rates of growth. If the international economic environment had remained favorable, it is possible that the debtor countries could have gone for years without having to

adjust their policies. But beginning in 1980, they were buffeted by several blows not of their own making. First, inflation rates fell and real interest rates rose in the United States and in other countries. Because the percentage of the debt that was short term had been increasing, and most of the rest carried floating interest rates, the rise in the market rate of interest showed up quickly in debt-service requirements.

Second came the 1980–82 world recession. The export earnings of the debtor countries fell sharply. The demand for the primary products that many of the countries produce has always been highly sensitive to income in the industrialized countries. The years 1981 and 1982 saw sharp drops in the prices of these products relative to goods produced in the industrialized countries. In addition, the nontraditional exports that had grown rapidly in the 1960s and 1970s were hurt by the increased application of protectionist measures in the industrialized countries. Protectionist measures sometimes operated to limit exporters to their past levels of sales, in which case exports from the "new arrivals" in the market were hurt disproportionately. In Argentina, Brazil, and Mexico, total export revenue fell about 8 percent in 1982 in dollar terms.

A third factor that contributed to the debtors' loss in export revenue was the large appreciation of the dollar. The strength of the dollar was in particular a source of the fall in primary product prices when expressed in dollars, which is the appropriate measure because most of the debt is denominated in dollars.

A fourth factor for some countries was the decline in dollar oil prices after 1981 (which in turn derived partly from the other three factors). The oil price decline of course helped the oil-importing countries, which are the majority. But it added to the list of problem debtors a number of oil-exporting countries, OPEC members such as Venezuela and Nigeria, as well as nonmembers such as Mexico.

The loss in export earnings attributable to the world recession shows up immediately in the denominator of the debt/export ratio. The higher interest payments show up immediately in the current account deficit, which in turn shows up over time as a rise in the numerator of the debt/export ratio. As seen in Table 2–4, the ratio rose sharply in 1982.

It is worth noting that virtually all the major Latin American countries got into trouble, the oil exporters as well as the oil importers, those that followed monetarist and free market policies as well as those that increased the money growth rate and expanded the role of the government in the economy. This suggests that in retrospect the key factor, which they all shared, was getting deeply into debt in the first place.

TABLE 2–4.—*Debt/export ratios for Argentina, Brazil, and Mexico aggregated, 1974–83*

Item	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
(1) Debt/export ratio	2.1	2.6	2.8	2.7	2.8	2.7	2.4	2.7	3.2	3.2
	Billions of dollars									
(2) Interest payments	2.7	3.4	4.3	4.9	6.6	10.3	15.1	22.6	28.4	26.2
(3) Trade deficit [1]	7.6	8.9	5.0	0.6	1.8	6.6	10.4	7.8	−6.5	−20.3
(4) Debt [2]	43.4	52.5	63.9	75.7	95.0	118.7	143.2	185.1	205.3	213.9
	Percent									
(5) Implied interest rate (2)/(4)	6.2	6.5	6.7	6.5	6.9	8.7	10.5	12.2	13.8	12.2
(6) Trade deficit/debt (3)/(4)	17.5	17.0	7.8	0.8	1.9	5.6	7.3	4.2	−3.2	−9.5
(7) Current account deficit/debt (5)+(6)	23.7	23.4	14.5	7.3	8.8	14.2	17.8	16.4	10.7	2.8
(8) Change of exports to next period	−2.8	16.6	22.8	18.6	30.1	34.6	16.5	−7.9	4.6	11.5

[1] Trade deficit on goods and services excluding interest.
[2] Gross debt including short-term debt.
Sources: International Monetary Fund, Morgan Guaranty Trust Company of New York, and Council of Economic Advisers.

It is, however, true that South Korea and other Asian countries that had become as indebted as many of the Latin American countries, as measured by debt/output ratios, encountered less severe problems in the 1980s. What distinguishes South Korea and other Asian debtors from most Latin American countries is not the degree of government intervention in the domestic economy, but the degree of export-orientation. Exports of goods, services, and private transfers are 44 percent of GNP in South Korea, as the result of 20 years of vigorous export promotion. By contrast they are 17 percent of GNP in Mexico, 16 percent in Argentina, and just 8 percent in Brazil. Indeed, of the major Asian debtors, the one to run into the most serious problems, the Philippines, also has the lowest ratio of exports to output. While many other factors are relevant, a debtor country with a high ratio of exports to GNP is less likely to get into debt-servicing difficulties than an otherwise similar debtor country.

WILL DEBT/EXPORT RATIOS IMPROVE?

Argentina, Brazil, and Mexico are all expected to receive new loans in 1984. One point of view is that this is throwing good money after bad, that the loans will never be repaid, that the problem is one of insolvency rather than illiquidity. According to this view, the present case-by-case approach is unrealistic, and should be replaced by some sort of general write-down of the debt. This view is accompanied by widely ranging degrees of sympathy for the debtors. Some observers call for a new agency to buy the written-down debt and extend more favorable terms to the debtors. Others believe that the countries should be left to fend for themselves.

An evaluation of the insolvency versus illiquidity issue is critical. The question is what debt/export ratios are likely to do over the course of the next decade. Ever-rising debt/export ratios imply insolvency. Ratios that decline over time, and eventually reach reasonable levels, imply that the difficulty is only one of liquidity.

The debt/export ratio will decline if the rate of growth of debt is less than the rate of growth of exports. The growth of the debt can be identified with the current account deficit. (In the past, current account deficits could also to some extent be financed by foreign direct investment and temporary drawing-down of international reserves. In the long-term future, a successful resolution of the debt problem would include a revival of foreign direct investment. But, as of 1984, in many countries there is now little likelihood of a continuation of these flows.) The current account deficit consists of interest payments plus the deficit in merchandise trade and non-interest services and transfers. Rows 5 and 6 in Table 2–4 report interest payments and the trade deficit, respectively, each as a percentage of the level of the debt. If the expected rate of growth of exports is greater than the sum of these two numbers, i.e., greater than the current account/debt ratio reported in row 7, then the debt/export ratio can be expected to decline over time. This criterion was easily met by the 25 percent average annual growth rate in exports that prevailed from 1975 to 1980.

The sharp increases in interest rates after 1980 made the criterion much more difficult to meet. If the trade balance had remained in deficit or had been zero, the criterion would not now be met. But Argentina, Brazil, and Mexico succeeded in switching their trade balances from deficit to surplus by 1983. Comparing expected export growth with the average interest rate being paid on the debt (the number in row 5, 12.2 percent in 1983) alone would be too strict a criterion. It would not give the countries credit for the adjustment they have accomplished. But the total current account deficit/debt ratio in row 7 was only 2.8 percent in 1983. This is a more reasonable target against which to compare the rate of export growth.

What is export growth expected to be in coming years? The answer depends on the growth rate in the industrialized countries, among other factors. Even assuming the industrialized world's real growth rate has now returned to that of the late 1970s, there is little likelihood of the growth rate of export earnings returning soon to the 25 percent average annual rate of the earlier period. The quantity of debtor country exports demanded is expected to respond less favorably to this recovery than to past recoveries, in part because in recent years the debtors had come to rely to a greater extent on exports to each other and to OPEC, and strong recovery in the near

term is expected only in the industrialized countries. But, allowing for some improvement in the dollar prices that the debtor countries are paid for their products—and the improvement might be large over the next few years if the dollar depreciates—there does not seem to be much doubt that the rate of growth of export revenue will exceed 2.8 percent by a comfortable margin in 1984 and into the indefinite future. Thus there is not much doubt that the debt/export ratio will decline. Eventually, as export growth and lender confidence are restored, the debtors can be expected to return to the trade balance deficits appropriate to developing countries.

SHARING THE BURDEN

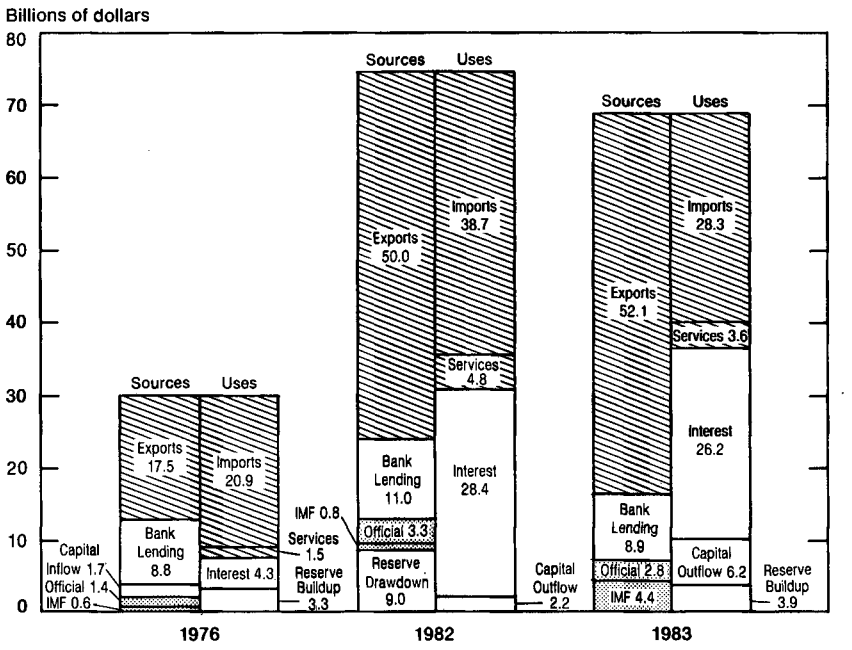
Because the debt problem seems to be one of liquidity rather than one of solvency, i.e., continued lending will permit exports to grow more quickly than the debt burden, it is important to keep the lending going. Chart 2-6 illustrates the amount of foreign exchange available to Argentina, Brazil, and Mexico taken together. In the 1970s imports exceeded exports, that is, they ran trade deficits. Because the prospects for future growth looked good, voluntary private lending was sufficient to finance both the trade deficit and interest payments on previously incurred debt. By 1983 interest payments had become very large and—because of worsened prospects—banks had become reluctant to extend enough new lending to cover the interest payments, let alone any trade deficit. It was only as part of a cooperative effort among the debtors, banks, industrialized country governments, and the IMF that the debtor countries were able to get through the year. The next four subsections consider in turn each of the four parties to this cooperative effort.

Adjustment by the Debtor Countries

By far the greatest share of the burden was borne by the debtors themselves. Between 1981 and 1983 the three Latin American countries taken together succeeded in improving their aggregate trade balance in goods and services (excluding interest) by $28 billion. In the larger debtor countries, most of the change was accomplished by cutting imports sharply, mainly by contracting income and expenditure, although partly by devaluation and other methods. From 1981 to 1983 imports were slashed about 52 percent in Argentina, 30 percent in Brazil, and 66 percent in Mexico. All three countries have had to suffer severe recessions in order to reduce expenditure on traded goods. Real GNP has been falling rapidly. In these and other countries, unemployment is very high, and the standard of living of most of the population, including the middle class, has deteriorated sharply.

Chart 2-6

Sources and Uses of Foreign Exchange: Argentina, Brazil, and Mexico Aggregated



Notes:
Capital Inflow/Outflow: Nonbank long-term lending from private sources and non-debt-creating flows (such as foreign direct investment); net (of capital flight).
Official: Long-term borrowing from official sources, official transfers, and reserve-related liabilities (such as loans from the Bank for International Settlements).
IMF: Use of Fund credit.
Services: Net payments for services, excluding interest, less private transfers.
Source: International Monetary Fund.

Calls for solutions to the debt problem through adjustment by the debtor countries must acknowledge the fact that an enormous amount of adjustment is already taking place. Indeed, it was the large swing in the trade balance from deficit to surplus that allowed the debt/export ratio to begin falling.

New Bank Lending

As can be seen from Chart 2–6, the increase in the debtor countries' trade balances in 1983 was still not enough to pay for all of the interest they owed. In other words, most of them ran current account deficits. The largest source of financing of the deficits was the banks. New bank lending to Argentina, Brazil, and Mexico in 1983 was about $9 billion.

The role of the banks has been controversial. One commonly expressed point of view is that the banks made unwise loans, and they now deserve to suffer the consequences. A related viewpoint is that, regardless of whether in the 1970s one could have foreseen the debt crisis, a necessary part of the discipline of the marketplace is the taking of losses when things go wrong, unmitigated by help from national or supranational government institutions. Proponents of this philosophy will be skeptical of solvency calculations like those in Table 2–4. They may ask why it is necessary for the IMF, and the United States and other governments, to get involved, if the loans are profitable and repayable.

In the current international financial system, an individual bank, particularly one of the many smaller banks, has an incentive to discontinue new lending to a problem debtor. A new loan adds to the amount of capital the bank has at risk. Yet—if the bank's share is small relative to the total—a new loan does not visibly add to the debtor's ability to remain current in its payments on its previously incurred debts. If all the banks, as part of a package, continue new lending, this does add significantly to the ability of the country to service its debt on schedule. But an individual bank has no incentive to take into account that its actions might contribute to the failure of the package, and thus precipitate the default that it fears. Left to itself, the bank would be a "free rider," allowing the quality of its portfolio to benefit from the new loans of others, without putting up any new money itself. This free-rider problem is one justification for a role for the IMF and other public institutions.

The International Monetary Fund

The IMF is the third of the four legs, after the debtors and the banks, on which responsibility for managing the debt problem rests. In 1983 the Administration sought, and eventually won, congressional approval for the U.S. share of an increase in resources for the IMF.

The IMF lends money to any of its 146 member governments that are in balance of payments difficulty. No member has ever defaulted on an IMF loan. In the past the two biggest borrowers have been the United Kingdom and the United States.

The IMF has increased total lending in the 1981–83 period of financial distress in the third world and tight liquidity worldwide, as it did in the aftermath of the 1973 oil shock. However, the magnitude of the resources supplied by the Fund is often less important than its role as a catalyst. In the past this has meant giving a "seal of approval" to countries that have agreed to follow particular programs of needed policy changes, enabling them to borrow from banks and other sources. In the financial packages of the past 2 years, the Fund

has gone a step further. In these cases, as a precondition to the IMF stamp of approval to a particular debtor country and to the availability of IMF resources, not only must the country agree to a set of policies, but the banks to which the country is indebted also must agree to extend new loans. In this sense, the IMF is "bailing in" the banks, rather than bailing them out. Chart 2–6 shows that the total amount of Fund lending to Argentina, Brazil, and Mexico in 1983, about $4 billion, is less than half the amount of new bank lending, which is in turn less than the reduction of net imports achieved by the three countries.

In recent years, the Fund, recognizing that many countries' balance of payments problems require more than short-term stabilization policy and short-term financing, has at times extended financing for longer term structural adjustment. However, longer-term development loans remain the special province of the Fund's sister institution, the World Bank. Neither institution offers substantially concessional interest rates. Only the World Bank affiliate, the International Development Association (IDA), provides "soft" loans to poor countries. The recipients of IDA loans are not the debtors with which this chapter has been concerned. The debtors were rapidly growing economies until recently. Most of the IDA recipients are African and Asian countries that are poor and have always been poor. They do not have big debt problems because banks in the past have not been willing to lend to them.

Thus the purpose of the IMF is neither to bail out banks, nor to give foreign aid. The IMF is rather, as the President has described it, "the linchpin of the international financial system."

The Role of National Governments

The fourth leg in the cooperative effort to resolve the debt problem, after the debtor countries themselves, the banks, and the IMF, is the governments of the creditor countries. Besides supporting the IMF, there are two ways in which the governments play a crucial role in the process: direct credit and trade policy.

In a variety of ways, credit is extended directly by governments to the debtors that are the most afflicted and the most important to them. First, a crisis sometimes comes up so quickly that an IMF package cannot be assembled in time. Then the Bank for International Settlements (the "central bank for central banks" in Basle, Switzerland), or monetary authorities in the industrialized countries acting on their own, may extend a short-term "bridge loan," to tide the debtor over until the longer term financing and adjustment program are in place.

Second, most industrialized countries have government trade credit agencies that grant short-term trade credit to countries buying

their exports. Many U.S. firms that normally export to the debtor countries, especially Mexico and Brazil, are currently unable to do so, as trade credit from private sources has disappeared. The U.S. Export-Import Bank, as currently constituted, has a mandate to raise its levels of credit in these circumstances, when reasonable assurance of repayment exists. Such credit simultaneously increases the ability of U.S. firms to export, and the ability of the debtor countries to import. Other wealthy countries' trade credit agencies are granting corresponding credits for their own firms' exports to the large debtor countries.

Third is the Paris Club, a forum where debtor countries can negotiate debt-relief terms on credits extended by, or guaranteed by, official government agencies. Paris Club rescheduling, along with the other forms of direct credit from national governments, is a significant element in the financing picture for many of the problem debtors.

Government financing for Argentina, Mexico, and Brazil, was about $3 billion in 1983. This amount, like the IMF lending, is much smaller than the shares of the burden borne by the banks and the debtors themselves, as Chart 2-6 shows.

In the longer run, more important than the role of the national governments in lending may be their role in trade. Currently, for the debtor countries to meet their debt obligations, they must necessarily run trade surpluses. Up until now they have mainly been cutting imports, but in the future they will have to boost exports. Even in the short run, the promise of future export growth is necessary to keep private capital flowing in.

In order for these countries to export, the industrialized countries must import from them. Real growth in the industrialized countries is the most important determinant of imports from the debtor countries. The 1983 U.S.-led worldwide recovery was the best possible development for the debt problem. While policies that bring down real interest rates and sustain the recovery are desirable in any case, their implications for the debt problem make them doubly desirable.

Trade policy in the industrialized countries is the second most important determinant of imports from the debtor countries. The industrialized countries have a variety of tariff and nontariff barriers against imports from these countries. It would be inconsistent for the industrialized countries to expect the debtors to meet their debt obligations, and at the same time expect their trade balance with the debtors not to turn negative. It is essential to the successful resolution of the current international debt problem that the industrialized countries not shut out the products that these countries wish to sell.

The soundness of the current four-way strategy, and its success to date, do not mean that future crises, even major ones, cannot occur. It would take a major unforeseen event, such as a sudden end to the world recovery, to change the outcome of the debt/export calculations; but it might take somewhat less than that for the four-way cooperation to fall apart.

The breakdown of the strategy could hypothetically come from either of two directions: (1) declaration of default and withdrawal of lending, by nervous banks, or (2) suspension of payments or even repudiation of the debt, by suffering debtor countries. Both of these worst-case scenarios are unlikely. Nevertheless, there is an undesirable all-or-nothing element to the present system. From the viewpoint of the creditor nations, a default or repudiation means that the value of the loans drops essentially to zero. From the viewpoint of an individual debtor country it might mean ostracism from the world system of trade and finance. Not only would many years pass before the debtor could resume the long-term borrowing necessary for economic development, but it would be subject to legal entanglements and probably cut off even from the short-term banking services necessary to carry on trade. Ways might be found to reinforce the current strategy that, although not necessarily altering the distribution of gains and losses in an average sense, would take some of the instability out of the system.

Credit Terms Versus the Level of Financing

One way to ease the burden on the debtor countries would be to increase the level of financing, and thus allow them to import more. The obvious drawback to allowing too high a level of financing is that it leaves the accumulated debt that much higher at the end of the year and reduces the pressure on the country to adjust.

There is a more promising alternative to ease the burden of adjustment that is being implemented for the case of Mexico in 1984. The banks, rather than increasing new lending to Mexico in 1984, are reducing it below 1983 levels, but are agreeing to lower the interest rate and loan fees charged. This tradeoff reduces the banks' total exposure relative to what it would otherwise be, and at the same time increases the probability that they will eventually be repaid in full. Mexico's financial position is improved because, for a given trade surplus, lower interest payments mean a lower current account deficit and thus a lower level of indebtedness at the end of the year.

Any easing of terms on bank lending must be tied to good performance on the part of the debtor. If the criterion for granting reduced interest rates were the seriousness of the country's difficulties,

as measured for example by debt-service figures, then the incentives facing the debtor governments would be perverse. Reducing the costs of economic mismanagement can make it more likely to occur. One possibility is to use as the criterion an improvement in the trade balance to the point of a substantial surplus in the balance on goods and (non-interest) services. This would ensure that the benefit is limited to those countries that have serious debt problems *and* have taken the necessary steps to adjust.

Expenditure-Reducing Policies Versus Relative Price Policies

The level of financing and the level of interest payments together determine the trade surplus that a debtor is obliged to run to generate the foreign exchange needed to make interest payments. These levels still leave open the question of whether to attain that trade surplus through high levels of exports and imports, or low levels of exports and imports. The course up until now has been closer to the latter: expenditure on imports has been cut, largely through cuts in government expenditure and in national expenditure generally. Both Mexico and Brazil appear to have cut imports in 1983 below the levels that had been agreed upon with the IMF. The price has been low levels of output, income, employment, consumption, and investment. Particularly in the cases of the larger countries, where imports are a small share of expenditure, cutting expenditure is an inefficient way of cutting net imports.

The alternative strategy is to slow the rate at which budget-cutting and other expenditure-reducing policies are implemented, and to substitute policies that raise the prices of traded goods relative to the prices of nontraded goods. Such "supply-side" policies would provide the incentives for labor and capital to shift into the production of the now more profitable traded goods. (In the case of Brazil, for example, a shift of resources into export production equal to 4 percent of gross domestic product would itself be enough to pay all the interest on the debt.) At the same time, such policies would provide the incentives for consumers to switch expenditure away from traded goods. The trade balance, which is the difference between the production and consumption of traded goods, would increase without a drastic decline in the level of output.

The obvious way to raise the prices of traded goods relative to nontraded goods is to devalue the currency. Devaluations cause immediate corresponding increases in the prices of traded goods, at least in the case of agricultural and mineral products. But there is no reason why devaluations need to be reflected as fully or as quickly in wages and the prices of nontraded goods. It is always easier to provide firms the incentive to export by reducing wages relative to the

prices of traded goods, rather than by reducing wages relative to the general price level.

Three arguments are heard against an approach of substituting some increases in the relative prices of traded goods for some decrease in the level of expenditure. The first is that devaluation is contractionary because of its negative effects on real wages, the real money supply, and the balance sheet of firms with dollar-denominated liabilities. But this argument applies more strongly to the approach of attaining a given trade surplus through expenditure reduction than to the relative-price approach.

The second argument is that devaluation is a "beggar-thy-neighbor" policy that is unlikely to be effective when other countries are trying to do the same thing. This argument, however, applies equally to the alternative expenditure-reduction approach. In other words both the "contractionary" and "beggar-thy-neighbor" arguments are really arguments for allowing smaller trade surpluses through increased financing; they are not arguments about the best way to attain a given trade surplus.

The third argument is that devaluation would result in a higher inflation rate than would expenditure reduction. Inflation is undesirable, and overexpansionary policies in the past were to some extent responsible for both the inflation and the debt problem. But it does not necessarily follow that there is an ironclad connection between continuous progress on the inflation problem and progress on the debt problem. The need to generate foreign exchange to meet interest obligations and the need to put a limit on the rate of decline of production, consumption, and investment, would seem to be absolute constraints. This calls for a judicious mix of policies that reduce expenditure *and* policies that change relative prices.

CONCLUSION

The strong U.S. recovery is creating jobs both at home and abroad. It is helping to pull the other industrialized countries out of recession, and is providing markets for the exports of the debtor countries as well. For the first time since the 1973 oil shock, Canada, Japan, and the European Community are all running current account surpluses. Many of the debtors are showing sharply improved international payments positions; a few such as Mexico have even attained current account surpluses. The United States is acting as an engine of growth in the world economy.

The composition of the recovery remains lopsided as a result of high real interest rates. If real interest rates can be brought down in the United States, it will alleviate the pressure for capital inflow and

for current account deficits vis-a-vis Japan, Europe, and other trading partners. At the same time, lower real interest rates would alleviate the debt-service burden on the debtor countries, thus reducing the trade surpluses that they must run and making things easier for all concerned.

In the meantime, the greatest danger, in the United States as elsewhere, is that the desire to boost exports and reduce imports will be reflected in protectionist measures. The only sound way to improve the U.S. trade balance is to adopt macroeconomic policies consistent with a recovery in which all sectors of the U.S. economy share. The only sound way to promote world trade is to adopt policies consistent with a recovery in which all members of the world economy share. In particular, it is essential to the favorable outcome of the debt problem that the debtor countries be allowed to increase exports to the industrialized countries. The liberal world trading system can only lose if its members resort to heightened barriers to the international flow of goods, services, capital, and labor. All parties can only gain if the debtor countries are restored to health.