The speed at which faster money growth translates into higher inflation depends on expectations and on the amount of slack in the economy. When inflation expectations are widespread or when little capacity is available to accommodate foreign demand through increased output, faster money growth translates quickly into higher prices. Under such conditions, faster money growth might not result in even a transitory improvement in the trade balance.

Similar comments apply to the policy of encouraging growth in Japan and Germany. Such policies seek to increase demand for U.S. goods and services. If the United States is operating below full capacity, U.S. manufacturers can satisfy the increased demand through additional production. If the economy is operating at full capacity, however, prices in the United States will rise to choke off the increase in demand. The trade balance will not improve.

Conclusion

Any near-term success from promoting a dollar depreciation and encouraging faster growth abroad will owe much to the fact that the U.S. economy is not operating at full capacity. With unused resources, the increased demand for U.S. goods can generate increased production, employment, and real income. The higher income could generate savings and could help reduce the government budget deficit.

Economists, unfortunately, are not adept at measuring capacity or at predicting when capacity constraints will become binding. Although we do not expect that the United States soon will experience capacity constraints, the unemployment rate is reaching levels that many economists associate with "full" or noninflationary employment, and many economic forecasts now expect inflation to accelerate, although modestly.

Once the U.S. economy reaches full capacity, resources will be unavailable to satisfy foreign demand, and domestic prices will rise. Inflation-induced increases in income are not likely to generate additional employment, to encourage savings, or to help lower the total government budget deficit. Consequently, as the U.S. economy reaches full capacity, policies of promoting a dollar depreciation and of encouraging faster growth abroad will not be sufficient to lower the current-account deficit. The United States will need other measures to encourage private savings and to lower the government budget deficit.


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Concluding that many economists associate with "full" or noninflationary employment, and many economic forecasts now expect inflation to accelerate, although modestly.

If the United States is to eliminate its external deficit, it must satisfy certain basic economic conditions with respect to its private savings, private investment, and total government budget deficit.

The U.S. current-account deficit reached a record $140.6 billion in 1986 and probably will not improve, on balance, this year. A slight worsening earlier in 1987 could offset a modest improvement late in the year. Consequently, the United States will continue to amass external debts and will become one of the world's largest debtor countries.

The intense foreign competition evidenced by recent current-account deficits has slowed growth in U.S. traded-goods industries and has heightened protectionist sentiments to levels unparalleled since the 1930s. Moreover, the rapid rise in U.S. international indebtedness challenges our ability to sustain the rate of growth in our standard of living that most of us have come to expect.

The United States thus far has relied primarily on a two-pronged approach to alleviate the trade imbalance. Until quite recently, we have promoted a depreciation of the dollar in foreign exchange markets, hoping to restore the competitiveness of U.S. goods. In addition, we are encouraging Japan and Germany to stimulate their economies in order to increase demand for U.S. exports.

This Economic Commentary examines whether these policies meet the basic criteria required to eliminate our external imbalance. We first develop a framework to illustrate the nature of current-account deficits and to describe conditions for correcting a deficit. Next, we compare U.S. policy against this framework.

The Nature of a Current-Account Deficit

The national income and product accounts provide an accounting framework for recording our gross national product (GNP). The accounts show that nominal GNP equals the realized nominal values of private consumption, plus private investment, plus government spending, plus exports, less imports. One can adjust the accounts and rearrange them to get an expression for the current-account deficit.

The current account records our nation's international trade in goods and services plus net transfers that carry no obligation for repayment. Rearranging, the accounting framework indicates that a nation's gross private savings, less its gross private investment, less its total government (state, local, and federal) budget deficit equal its current-account balance (see chart 1). According to this expression, a nation running a current-account deficit is not saving sufficiently to finance its private investment and total government budget deficit. Similarly, a nation running a current-account surplus plus is saving more than is needed to finance its private investment and total government deficit.

In 1986, for example, private savings in the United States totaled $961 billion; private investment equaled $866 billion; and the government budget deficit amounted to $143 billion. With private savings less than private investment and the total government budget deficit last year, the United States experienced a $143 billion current-account deficit. The $5 billion discrepancy in the arithmetic reflects errors and omissions in our measurements of international transactions, plus some other adjustments that typically are small in magnitude. Table 1 presents similar data for the United States since 1982. To facilitate comparisons over time, the data are expressed as percentages of GNP. The table shows that the increase in the U.S. current-account deficit since 1980 has been associated with an increase in the total government budget deficit and, since 1982, with a narrowing in private savings relative to private investment. The growth in the total government budget deficit reflects the huge federal
There is nothing intrinsically wrong with a nation being a debtor, but debtor status raises two concerns. The first has to do with our ability to service foreign debt. Our foreign exchange reserves are insufficient to service foreign claims on our foreign assets, and our foreign investment in the United States is very small. The second concern is that our foreign investment in the United States is very small. The accounting framework does not deny that a currency depreciation or encouraging growth abroad cannot speed or improve the adjustment process. Nor does the accounting framework deny that promoting a currency depreciation and growth abroad are not a necessary, but they are not sufficient for adjustment.

Policy and the Deficit

Concerned about the magnitude of our external balance, about the future implications of our indebtedness, and about the growing tide of protectionism, U.S. authorities, in accord with the Plaza agreement of September 1985, promoted a depreciation of the dollar and continue to encourage Japan and Germany to stimulate their economies. However, the accounting framework indicates that a currency depreciation and growth abroad are not a necessary, but they are not sufficient for adjustment.

Nominal exchange rates are the rates typically quoted in financial transactions, while real exchange rates are equal to nominal exchange rates plus an adjustment for differences in inflation between the United States and its major trading partners. Because real exchange rates take into account both exchange-rate movements and relative price movements, the real exchange rate is more relevant for trade and investment decisions.

A depreciation of real exchange rates will improve the U.S. current-account deficit by raising the dollar price of foreign goods and lowering the foreign currency price of U.S. goods. This development will lead to an increase in U.S. net exports and a decrease in U.S. imports.

The faster pace of money growth in the United States will induce other countries to depreciate the dollar to offset the faster rate of inflation. Higher inflation and faster money growth will raise U.S. real interest rates and reduce the demand for U.S. goods. This will reduce the current-account deficit and improve the U.S. balance of payments.

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There is nothing intrinsically wrong with a nation being a debtor, but debtor status raises two concerns. The first has to do with the need to roll over foreign obligations to hold dollar-denominated assets. International investors, at some point, may become wary of holding a country's debt, especially if it fails to adjust continually to balance international transactions, the current-account balance surplus, on balance, in the rest of the world. According to the accounting framework, the rest of the world should be saving more, and we should be saving less, than is necessary to finance its private investments and any government budget deficit.

The United States finances its current-account deficit by claiming assets and physical property in the United States. As foreigners buy these assets, they extend their savings in the United States and help to finance U.S. private investment and the government budget deficit at interest rates lower than otherwise would prevail. Worldwide, these savings flows regain the value of the economic variables, including current-account deficit among private savings, private investment, the government budget deficit, and the standard of living depends on how the debtor country uses foreign savings. When a country borrows to finance private or public investments in new capital, the additional investments tend to generate a stream of income growth that helps to service the debt. A nation can borrow, invest the funds, repay the debts, and generate faster growth in its standard of living. If, however, a country that constantly runs a current-account deficit eventually will become a debtor nation, with obligations to foreigners exceeding its claims on foreigners. The United States had been a creditor nation since the early part of the twentieth century. Our net investment position reached +$14 billion in 1985, compared to +$107 billion in 1986, the United States had amassed +$107 billion in external debt. Final data for 1986 probably will show an external debt of +$250 billion.

Financing the Current-Account Deficit

As previously explained, our current-account deficit reflects a decision to consume, both privately and publicly, and to invest more than we currently are producing. The purpose of table 1 is not to specify a channel of causation, but simply to show a tautological relationship among private savings, private investment, the government budget deficit, and the standard of living. Foreigners are more likely to invest in the United States if they fail to affect both sides of the relationship permanently will not alter the current-account deficit.

Table 1 National Income Accounts and the Current-Account Deficit

<table>
<thead>
<tr>
<th>Year</th>
<th>Savings (Percent of GNP)</th>
<th>Fixed Investment (Percent of GNP)</th>
<th>Private Savings (Percent of GNP)</th>
<th>Government Budget Deficit (Percent of GNP)</th>
<th>Current Account Deficit (Percent of GNP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>17.5%</td>
<td>16.0%</td>
<td>2.3%</td>
<td>-1.4%</td>
<td>0.5%</td>
</tr>
<tr>
<td>1981</td>
<td>16.0%</td>
<td>2.9%</td>
<td>3.0%</td>
<td>-0.6%</td>
<td>1.0%</td>
</tr>
<tr>
<td>1982</td>
<td>17.8%</td>
<td>2.6%</td>
<td>3.6%</td>
<td>-1.6%</td>
<td>1.5%</td>
</tr>
<tr>
<td>1983</td>
<td>17.4%</td>
<td>2.7%</td>
<td>3.8%</td>
<td>-1.0%</td>
<td>1.0%</td>
</tr>
<tr>
<td>1984</td>
<td>19.7%</td>
<td>2.3%</td>
<td>3.7%</td>
<td>-1.5%</td>
<td>1.3%</td>
</tr>
<tr>
<td>1985</td>
<td>19.7%</td>
<td>2.3%</td>
<td>3.7%</td>
<td>-1.5%</td>
<td>1.3%</td>
</tr>
<tr>
<td>1986</td>
<td>16.2%</td>
<td>1.9%</td>
<td>2.4%</td>
<td>-2.3%</td>
<td>2.4%</td>
</tr>
</tbody>
</table>

a. We measure the current-account balance by net foreign investment (see footnote 3 in text).

Policy and the Deficit

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The accounting framework does not deny that promoting a currency deprecation or encouraging growth abroad cannot speed or improve the adjustment process. Nor does the accounting framework show that currency depreciation and growth abroad are not enough in themselves to eliminate the current-account deficit. They may be necessary, but they are not sufficient for adjustment.

The following scenarios attempt to illustrate the possibilities: Table 2 presents the following example. We assume that money demand is stable in the United States and that the privilege of presently consuming more than we currently are producing.

5. One can think of these assumptions as embodying a 3.0 to 3.5 percent average rate of inflation, a 2.5 to 3.0 percent average rate of real economic growth, a 6.0 to 6.5 percent average real interest rate. We do not assume an acceleration in inflation or from a slowdown in the rate of money growth relative to that of real economic growth. The following example.

6. We assume that money demand is stable in the United States and that the privilege of presently consuming more than we currently are producing.
The speed at which faster money growth translates into higher inflation depends on expectations and on the amount of slack in the economy. When inflation expectations are widespread or when little capacity is available to accommodate foreign demand through increased output, faster money growth translates quickly into higher prices. Under such conditions, faster money growth might not result in even a transitory improvement in the trade balance.

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