ECONOMIC
COMMENTARY
Federal Reserve Bank of Cleveland

Merchandise Trade and the Outlook for 1988

by Gerald H. Anderson

Will this year's improvement in U.S. foreign trade be double, triple, or even quadruple last year's gain? Many forecasters think this will happen and are expecting that a major growth of real net exports will fuel further expansion of our economy. There are many factors, however, working against trade improvement of this magnitude, making it unlikely that the expectations of the more optimistic of these forecasters will be met.

Most forecasts for growth of the economy in 1988 depend heavily on the expectation that there will be a major increase in net exports.[1] Although real net exports have been increasing significantly, and made a strong gain in the first quarter of 1988, there are some important obstacles to achieving the degree of improvement that some of the forecasts call for.

Real net exports increased by $16 billion in 1987, but most forecasts for 1988 expect increases of nearly twice to more than four times that amount. For example, 21 economists who met in April at the Fourth Federal Reserve District Business Economists Roundtable generally look for a $34 billion rise in real net exports that will contribute 40 percent of the total growth expected in the economy in 1988. Other economists have similar expectations. The Blue Chip Economic Indicators panel of 52 forecasters expect a $45 billion increase, while one private consultant, Data Resources Incorporated (DRI), expects a $69 billion rise in real net exports.

■ Too Optimistic

While further growth in net exports is certainly likely this year, it may be difficult to achieve the tripling or quadrupling of last year's improvement that is included in many forecasts. After all, the net exports deficit has been remarkably stubborn and most forecasts for improvement in 1987 and 1986 turned out to be much too optimistic. This record of persistent overestimation suggests that the margin of error around net exports forecasts is quite wide. Thus, it is not unreasonable to expect that many forecasts for 1988 also may be too optimistic.

Real net exports reached a low point in 1986 third quarter, about a year and half after the dollar reached its peak and began to depreciate in early 1985. Between 1986 fourth quarter and 1987 fourth quarter, real net exports rose by $16.0 billion (table 1). However, all of that improvement occurred in the first quarter of 1987; during the remainder of the year, there was little change. Real net exports rose $16.7 billion in the first quarter of 1988. That strong performance has caused some analysts to conclude that the economy is on its way to a very large improvement in real net exports this year. However, analysts could have come to the same conclusion after last year's big first-quarter gain, and they would have been wrong. Changes in real net exports tend to be erratic, so judgements about likely improvement should be made by looking at underlying influences rather than at the changes in the most recent quarter.

Further depreciation of the foreign-exchange value of the dollar most likely will not be an important source of trade improvement this year. Of the forecasts cited above, only the one from DRI is explicit about the dollar. DRI looks for the dollar to depreciate slightly less in 1988 than in 1987. Certainly there is no consensus among forecasters for greater depreciation

ISSN 0428-1276

this year, and the governments of the major nations seem to have a strong commitment to avoid much further depreciation of the dollar.

In the first quarter of this year, the dollar depreciated only moderately (table 2). Even if the dollar were to depreciate substantially in the remainder of the year, the considerable delay between exchange-rate change and its effect on the real trade balance argues that further depreciation will not be a stronger source of trade improvement in 1988 than it was in 1987.

Last year's improvement in real merchandise trade was partially offset by a $1.5 billion deterioration of the services trade balance, which dropped another $2.8 billion in 1988 first quarter (table 1). An important element in the decline in the services balance is America's large current-account deficits that cause large net inflows of foreign capital. As our international net investment position deteriorates, foreign investment earnings in the U.S. grow faster than U.S. investment earnings abroad, narrowing the services trade surplus. This effect has been outstripping the benefits to trade in other services from the enhanced competitiveness brought about by dollar depreciation.

If the U.S. current-account deficit in 1988 requires a net capital inflow of, say, $115 billion and if average earnings on that capital are 8 percent, then, other things equal, the net international flow of current-dollar investment income would worsen by $9.2 billion, or roughly $8 billion in constant (1982) dollars.[2] Consequently, other things equal, it would take an $8 billion improvement in other trade categories just to avoid a deterioration in real net exports.[3]

Implications

Consider what that means for achieving the $45 billion improvement in real net exports expected in the Blue Chip Economic Indicators consensus forecast for 1988. If net capital inflow costs $8 billion more in interest outflows, and assuming a $2 billion net improvement in other services trade items, then for real net exports of goods and services to rise by $45 billion, the merchandise balance will have to rise by $51 billion.[4] If achieved, that would be nearly three times the $17.5 billion improvement in real merchandise trade realized in 1987.

The real merchandise trade balance, excluding petroleum imports, improved by $19.5 billion in 1987; including petroleum imports, it improved by $17.5 billion (table 1). In contrast, the current-dollar merchandise balance, excluding petroleum imports, improved by only $8.8 billion. When petroleum imports are included, the balance worsened by $4.0 billion. In 1988 first quarter, those balances improved by amounts ranging from $13.1 billion to $20.6 billion. Because the current-dollar trade balance is relevant for the current account balance, that is, for determining how much net capital inflow the U.S. requires, it is important, along with the real merchandise balance, in determining what growth there will be in real net exports.

Why has there been so little improvement in the current dollar merchandise balance, and indeed, considering the magnitude of the dollar's depreciation, why has there been relatively little improvement in the real merchandise balance? Further, what are the prospects for improvement in those balances?

Merchandise exports have shown solid growth recently. Last year, real merchandise exports increased by 18 percent or $47.1 billion. However, they are unlikely to grow much faster this year, their 28 percent annual rate of increase in 1988 first quarter notwithstanding. In fact, export growth could be retarded if the growth rates of some of our major trading partners slow, as they are forecast to do. Real domestic demand in industrialized nations other than the U.S. is forecast by the Organization for Economic Cooperation and Development (OECD) to slow from 3.5 percent in 1987 to 2.75 percent in 1988. Because those nations buy about two-thirds of U.S. exports, if that forecast of reduced demand growth is accurate, then hope for more rapid improvement in merchandise trade must lie with U.S. exports capturing a larger *share* of world markets and with a reduction, or at least slower growth, of imports in U.S. markets.

Real merchandise imports increased by 7 percent in 1987, despite the large depreciation of the dollar in recent years. Several factors have supported the continuing growth of imports and are likely to continue to do so, despite the optimism that some analysts feel because imports grew at only a 1 percent annual rate in 1988 first quarter. Perhaps most important is the fact that import prices have risen at a much slower rate than other currencies have risen against the dollar. Measured on a trade-weighted average basis, 10 major currencies rose almost 70 percent against the dollar between 1985 first quarter, when they bottomed against the dollar, and 1987 fourth quarter (table 2).

Nonfuel import prices, as measured by the Bureau of Labor Statistics, in contrast, rose only 22 percent in the same period. Foreign exporters apparently have been willing to reduce their profit margins to limit price increases passed on to customers.

NIC Currencies

Also, some foreign currencies have either appreciated substantially less against the dollar than the 10 major currencies in the trade-weighted index, or have actually depreciated. The currencies of the newly industrialized countries (NICs) (South Korea, Taiwan, Hong Kong, and Singapore) are important examples. Those four currencies on average rose only 13.9 percent against the dollar between 1985 first quarter and 1987 fourth quarter.

Moreover, that average increase didn't begin until seven months after increases in the major currency index. Most of the rise in the NIC currencies has also been very recent, which will limit its impact on the trade balance in 1988. U.S. importers can buy less from the major countries and buy more from the NICs or others whose currencies have not risen much against the dollar. Moreover, Japan

TABLE 1 **Real Net Exports**[a]
(billions of 1982 dollars)

	Changes	
	1987 IVQ/IVQ	1988 IQ
Exports	65.2	21.8
Services	18.0	0.8
Merchandise	47.1	21.0
Imports	49.2	5.0
Services	19.5	3.6
Merchandise	29.6	1.4
Merchandise, excluding petroleum imports	27.6	0.4
Balance (net exports)	16.0	16.7
Services	-1.5	-2.8
Merchandise	17.5	19.6
Merchandise, excluding petroleum imports	19.5	20.6

a. Seasonally adjusted at annual rates.
SOURCE: U.S. Department of Commerce.

TABLE 2 **Foreign Currency Appreciation Against the U.S. Dollar (percent)**

Currency	1985:IQ to 1987:IVQ	1987:IVQ to 1988:IQ
Trade-weighted average of 10 major currencies	69.6	2.6
Japanese yen	92.3	4.6
West German mark	87.5	3.2
British pound	57.4	2.3
Canadian dollar	3.2	3.5
Trade-weighted average of four NIC currencies[a]	13.9	2.4

a. Newly industrialized countries: Hong Kong, Korea, Singapore, and Taiwan.
SOURCES: Board of Governors of the Federal Reserve System; Bank of America; Bankers Trust; and Federal Reserve Bank of Cleveland.

TABLE 3 **U.S. Trade Balances by Country**
(billions of current dollars)

	Levels			Changes in 1987
	1985	1986	1987	
Developed nations	-92.2	-103.2	-100.0	3.2
Japan	-49.7	-58.6	-59.8	-1.2
West Germany	-12.2	-15.6	-16.3	-0.7
Developing nations	-51.4	-54.1	-68.0	-13.9
East Asian NICs[a]	-25.0	-30.8	-37.7	-6.9
Centrally planned economies	0.8	-2.3	-3.3	-1.0
Total	-142.8	-159.6	-171.3	-11.7

a. Newly industrialized countries: Hong Kong, Korea, Singapore, and Taiwan.
NOTE: Imports cost, insurance, and freight (CIF); exports free alongside ship (FAS).
SOURCE: U.S. Department of Commerce, International Trade Administration, from 1987 *U.S. Foreign Trade Highlights.*

and others can buy lower-priced export components from countries whose currencies have changed little against the dollar, thereby moderating cost increases in their export products.

Price increases introduced by U.S. producers is another factor hampering merchandise trade balance improvement. The domestic goods price deflator, a measure of the price increases obtained by U.S. producers, increased 5.1 percent from 1985 first quarter to 1987 fourth quarter. These increases have offset part of the competitive advantage provided by import price hikes.

Consumer Attitudes

Still another factor working against trade improvement is the belief among many U.S. consumers that imported products have superior qualities that make them attractive despite price increases. Finally, many of the developing nations with which the United States trades have difficulty servicing the debt resulting from the billions of dollars that they have borrowed from abroad. To obtain funds for debt service, those nations have an incentive to vigorously promote their exports, some of which become U.S. imports.

The impact of some of these factors can be seen in the changing pattern of U.S. trade balances. In 1987, the U.S. trade deficit with the developed nations was reduced by $3.2 billion, while the deficit with developing nations rose by $13.9 billion (table 3). Of the latter, approximately half ($6.9 billion) is accounted for by the four Asian NICs. An improved balance of trade with the NICs is needed to help improve the overall trade balance, but so far there has been no turnaround in U.S. trade with them.

The real merchandise trade balance will benefit from the likely further rise in import prices in 1988 in delayed response to past dollar depreciation. Indeed, the price response may be greater than in the past because foreign exporters' profit margins have already been reduced, so there is less scope for squeezing them further. Inventories of imports probably grew involuntarily in 1987 fourth quarter and will need to be worked off by slowing import growth this year.

On the other hand, faster growth of U.S. consumer spending will stimulate imports of consumer goods. Economists at the Fourth District Business Economists Roundtable look for personal consumption expenditures to rise this year three times as fast as last year (2.3 percent instead of 0.8 percent). In addition, strains on domestic manufacturing capacity will stimulate imports of scarce materials, such as some steel products, although quotas will limit imports in some cases.

U.S. exports will be aided by delayed responses to past increases in their price competitiveness as compared to German and Japanese exports. For example, in the four quarters ending in 1987 third quarter, the ratio of the prices of German exports of general industrial machinery to the prices of U.S. exports of similar products rose by 15.8 percent. The comparable Japan-U.S. ratio increased by 3.1 percent. For all exports, the Germany-U.S. ratio rose by 9.3 percent and the Japan-U.S. ratio increased by 4.4 percent.

These changes should help U.S. exports gain larger shares of the markets for imports in nations where the U.S. competes with Germany and/or Japan. However, the magnitudes of these improvements in price competitiveness are much smaller than the improvements seen in the preceding four quarters, so unless the delays are rather long, the gains to U.S. trade could be smaller this year than last. Moreover, these gains in price competitiveness will be offset, to some degree, by the difficulty for exports that will be caused by the slower growth of foreign developed nations that was mentioned earlier.

Conclusion

While further substantial improvement in trade is likely in 1988, there are many reasons to be skeptical about forecasts that call for the real merchandise trade balance and real net exports to improve three or four times as much in 1988 as they did in 1987.

Gerald H. Anderson is an economic advisor at the Federal Reserve Bank of Cleveland.
The author would like to thank Mark Sniderman for helpful comments, and to thank John B. Martin and Christine M. Dingledine for research assistance.

Footnotes

1. The term "net exports" refers to the total balance of goods and services exported from the United States after subtracting foreign goods and services that are imported. Net exports is the sum of the goods (merchandise) trade balance and the services trade balance. The trade in goods and services can be measured either in "current" dollars (that is, at current prices), or in "constant" or "real" dollars by adjusting for the effects of inflation since 1982. Net exports that are measured in constant (1982) dollars are referred to as "real net exports."

2. The current-account deficit was $160 billion in 1987. If real net exports rise by $45 billion, as forecast by the Blue Chip Economic Indicators consensus forecast, that would be roughly a $45 billion current dollar improvement in the current account, bringing it to roughly $115 billion. This is a rather optimistic forecast compared to the April 1988 IMF forecast of $141 billion for the 1988 current-account deficit.

3. The required improvement would be less if some of the capital inflow reflects federal government borrowing from abroad because, under national income accounting conventions, government interest payments to foreigners are not considered to be payments for imported services.

4. The trade balance in other services fell an average $3.1 billion per year from a peak in 1981 to a trough in 1985. It rose $2.1 billion in 1986 and fell $0.3 billion last year.

Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

BULK RATE
U.S. Postage Paid
Cleveland, OH
Permit No. 385

Address Correction Requested:
Please send corrected mailing label to the Federal Reserve Bank of Cleveland, Research Department, P.O. Box 6387, Cleveland, OH 44101