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 per sonal consumption expenditures to rise this year three times as fast as last year (2.5 percent instead of 0.8 per cent). 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 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 magni tudes 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.

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**Notes**

1. The term “net exports” refers to the total balance of goods and services imported from the United States after subtracting foreign goods and services that are exported. 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 $216 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 $95 billion current dollar improvement in the current account, bringing it to roughly $115 bil lion. 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 at an annual $1.1 billion per year from a peak in 1980 to a trough in 1985. It rose $2.1 billion in 1986 and fell $0.3 billion last year.

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**ECONOMIC COMMENTARY**

**Merchandise Trade and the Outlook for 1988**

by Gerald H. Anderson

**Most forecasts for growth of the economy in 1988 depend heavily on the expectation that there will be a major increase in net exports.**

Though 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 forecasters call for.

Real net exports increased by $16 billion in 1987, but most forecasts for 1988 expect increases of nearly twice as much as in the last four times. For example, 25 economists who met in April at the Federal Reserve Bank (FED) District Business Economists Roundtable generally look for a $54 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 expects a $55 billion increase, while one private consultant, Data Resources Incorporated (DRI), expects a $60 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 opti mistic. This record of persistent over estimation suggests that the margins 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 by $16.7 billion in the first quarter of 1988. That strong performance has caused some analysts to conclude that the economy is in 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 judg ments 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 forecasters 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
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, for each investment earnings in the U.S. grow faster than U.S. investment earnings abroad, narrowing the services trade surplus. This 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, $15 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 be $1.2 billion, or roughly $6 billion in constant (1982) dollars. Consequently, other things equal, it would take an $8 billion improvement in other services from the enhanced competitiveness to avoid much further deterioration 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 to $71.5 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 foreseeable 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 5.5 percent in 1987 to 2.7 percent in 1988. Because those nations buy about two-thirds of U.S. exports, if that forecast of reduced demand growth is accurate, then, for a more rapid improvement in merchandise trade, exports to the NICs or others whose currencies have not risen much against the dollar. Moreover, Japan and others can buy lower priced export components from countries whose currencies have changed little against the dollar, thereby moderating costs in their export products. Price increases introduced by U.S. producers is another factor hampering merchandise trade balance improvement. The domestic goods prices, a relative price that has risen faster than 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 declines.

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 need to become more competitive 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 $5.2 billion, while the deficit with developing nations has actually deteriorated (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 reduction in import prices in 1988 due to the 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.
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 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, $15 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 be $12 billion, or roughly $2 billion in constant (1982) dollars.

Consequently, other things equal, it would take an $8 billion improvement in other service categories just to avoid a deterioration in real net exports.1

1 Implications
Consider what this means for achieving the $45 billion improvement in real net exports that Chip Economic Indicators consensus forecast for 1988. If net capital inflow costs $6 billion more in interest outflows, and assuming a $2 billion net improvement in other service 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.1 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 $15.3 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 merchandise trade balance? Further, what are the prospects for improvement in these 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 foreseeable to do. Real domestic demand in industrialized nations other than the U.S. is fostered by the Organization for Economic Cooperation and Development (OECD) to slow from 5.5 percent in 1987 to 2.7 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 may 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, 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 increases passed on to customers.

2) 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 (table 3). 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 1.5 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 but buy more from the NICs or other currencies whose currencies have not risen much against the dollar. Moreover, Japan

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.

Domestic goods prices, another factor in pricing increases obtained by U.S. producers, increased 5.1 percent from 1987 first quarter to 1987 fourth quarter. These increases have offset part of the competitive advantage provided by import price increases.

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 $5.2 billion, while the deficit with developing nations has actually increased (table 3). Of the latter, approximately half ($2.6 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 increase in import prices in 1988 as the laid off 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

<table>
<thead>
<tr>
<th>TABLE 1</th>
<th>Real Net Exportsa (billions of 1982 dollars)</th>
<th>Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1987</td>
<td>PQ b</td>
</tr>
<tr>
<td>Exports</td>
<td>65.2</td>
<td>21.8</td>
</tr>
<tr>
<td>Services</td>
<td>18.0</td>
<td>2.8</td>
</tr>
<tr>
<td>Merchandise</td>
<td>47.1</td>
<td>21.0</td>
</tr>
<tr>
<td>Imports</td>
<td>49.2</td>
<td>5.0</td>
</tr>
<tr>
<td>Services</td>
<td>19.5</td>
<td>3.6</td>
</tr>
<tr>
<td>Merchandise</td>
<td>29.6</td>
<td>1.4</td>
</tr>
<tr>
<td>Merchandise, excluding petroleum imports</td>
<td>27.6</td>
<td>0.5</td>
</tr>
<tr>
<td>Balance (net exports)</td>
<td>16.0</td>
<td>16.7</td>
</tr>
<tr>
<td>Services</td>
<td>-1.5</td>
<td>-2.8</td>
</tr>
<tr>
<td>Merchandise</td>
<td>17.5</td>
<td>19.6</td>
</tr>
<tr>
<td>Merchandise, excluding petroleum imports</td>
<td>19.5</td>
<td>20.6</td>
</tr>
</tbody>
</table>

a. Newly industrialized countries: Hong Kong, Korea, Singapore, and Taiwan.

TABLE 2 | Foreign Currency Appreciation Against the U.S. Dollar (percent) |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>1987</td>
</tr>
<tr>
<td>Currency</td>
<td>0 IQ</td>
</tr>
<tr>
<td>Trade-weighted average of 10 major currencies</td>
<td>69.5</td>
</tr>
<tr>
<td>Japanese yen</td>
<td>92.3</td>
</tr>
<tr>
<td>West German mark</td>
<td>87.5</td>
</tr>
<tr>
<td>British pound</td>
<td>57.4</td>
</tr>
<tr>
<td>Canadian dollar</td>
<td>3.2</td>
</tr>
<tr>
<td>Trade-weighted average of four NIC currencys</td>
<td>13.9</td>
</tr>
</tbody>
</table>

b. Newly industrialized countries: Hong Kong, Korea, Singapore, and Taiwan.

TABLE 3 | U.S. Trade Balances by Country (billions of current dollars) |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>1987</td>
</tr>
<tr>
<td>Developed nations</td>
<td>-92.2</td>
</tr>
<tr>
<td>Japan</td>
<td>-49.7</td>
</tr>
<tr>
<td>West Germany</td>
<td>-12.2</td>
</tr>
<tr>
<td>Developing nations</td>
<td>-53.4</td>
</tr>
<tr>
<td>East Asian NICs</td>
<td>-25.0</td>
</tr>
<tr>
<td>Centrally planned economies</td>
<td>0.8</td>
</tr>
<tr>
<td>Total</td>
<td>-142.8</td>
</tr>
</tbody>
</table>

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**Conclusion**

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**Footnotes**

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