

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## Are the Japanese to Blame for Our Trade Deficit?

by Owen F. Humpage

**A**mid charges and countercharges of unfair competition and trade restrictions attending the recent U.S.–Japanese trade dispute, many commentators have lost sight of important variations in these nations' saving and investment behavior. These differences ultimately sustain the large, persistent, mirror-image trade imbalances of both countries.

Fair and free market access is important to producers and consumers in Japan and the United States alike. Economists have long acknowledged that free trade can enhance both nations' standard of living. But we should realize that policies to pry open Japanese markets or to deny Japan access to our markets will have few lasting effects on either country's overall trade balance. Trade surpluses and deficits are proper, sustainable, and mutually beneficial responses to disparate saving and investment patterns among nations.

### ■ Balance of Payments

The U.S. balance of payments records all transactions between U.S. residents and the rest of the world. These fall into two broad categories: the current account, which consists mainly of trade in goods and services, and the capital account, which includes all types of financial transactions.<sup>1</sup> One can interpret current and capital account items as cross-border claims on existing and future world output, respectively.

As the name implies, the balance of payments always balances (see box). Every

international transaction creates both a debit and a credit entry in the ledger. If, for example, an American buys a Japanese car and pays for it with a check drawn against a domestic bank, the balance of payments records the imported car as a debit in the trade account and lists the Japanese claim on the U.S. bank as a credit in the capital account. Essentially, we have imported a car and exported ownership of the deposit.

Should the Japanese use the bank account to acquire something else, like U.S. corporate stocks or Treasury securities, additional offsetting debits and credits will enter the balance of payments. Suppose that Japan buys American rice with its claim on the U.S. bank. The balance of payments will record the export of rice as a credit item in the trade account, and the reduction in the Japanese claim on the U.S. bank as a debit item in the capital account. Essentially, we have exported rice and reimported ownership of that bank deposit.

Because of the double-entry nature of the accounts, surpluses or deficits can exist only in a subset of the transactions. Most often, analysts concentrate on the current account. Last year, the United States ran an estimated current account deficit of \$109 billion. A country that imports more than it exports must pay for the excess by drawing down its financial claims on the rest of the world or by providing financial claims on itself to the rest of the world. In doing so last year, the United States recorded a \$109 billion capital account

**Despite commonly expressed complaints about the persistent U.S.–Japanese trade imbalance, restricting Japan's access to our markets will not erase the trade deficit or surplus of either nation. Instead, trade imbalances are sustainable, beneficial, and proper reflections of domestic saving and investment decisions.**

surplus or, in economists' terms, a \$109 billion inflow of foreign capital.

As the counterpart to persistent U.S. current account deficits throughout the 1980s, foreigners continued to acquire financial claims on the United States. By 1989, foreign assets in our nation exceeded U.S. assets abroad, making America a debtor country. At the end of 1992, the last year for which data are available, U.S. debts equaled \$612 billion — approximately 10 percent of our GDP.

### ■ Saving and Investment Patterns

Economists often focus on the current account as a measure of the overall balance of payments because it and the associated foreign capital inflows draw attention to saving and investment patterns. The value of any country's production (its GDP) exactly equals both its national income and the value of its consumption, investment, government spending, and net exports of goods and services. A nation whose consumption, investment, and

## U.S. BALANCE OF PAYMENTS, 1993

(Billions of dollars)

Trade in Goods and Services	-76.8
Net Investment Income	0.1
Unilateral Income	-32.5
<b>Current Account Deficit</b>	<b>-109.2</b>
Capital Flows	82.5
Statistical Discrepancy	-26.7
<b>Total Capital Flows</b>	<b>109.2</b>

NOTE: 1993 data are preliminary. The statistical discrepancy is treated as unrecorded capital flows.  
SOURCE: U.S. Department of Commerce.

government spending exceed its production at any time necessarily runs a current account deficit. It essentially satisfies its excess demand for current world output through imports.

From the perspective of income, a nation with a current account deficit is spending on goods and services in excess of its national income. Consequently, its gross domestic saving (private and governmental) falls short of that necessary to finance its gross domestic investment. Since the early 1980s, private saving in the United States has been insufficient to finance both private investment and the budget deficit of the total government (federal, state, and local). The inflow of foreign capital associated with the current account deficit has served to bridge the gap between gross domestic saving and gross domestic investment (see figure 1). In Japan, on the other hand, private saving and the government budget surplus have exceeded that necessary to finance its domestic investments. Its excess savings spill out into world financial markets as Japan runs a current account surplus and a capital account deficit, or capital outflow.

Millions of individuals, both here and abroad, independently make the saving, investment, and trade decisions underlying these economic identities. Any tendency for saving, investment, the current account position, and capital flows not to balance brings about

changes in real interest rates and exchange rates that pull them back into line. If, for example, international trade and capital flows did not occur, any propensity for U.S. saving to fall below U.S. investment would cause a rise in real interest rates here. Increasing interest rates would encourage private saving and discourage investment and would continue until equilibrium between the two was restored. Similarly, in an economy open to trade and capital flows, exchange-rate adjustments offset any tendency for current account transactions not to equal capital account transactions.

In the absence of international trade and capital flows between the United States and Japan, higher interest rates would prevail here and lower rates there. Consequently, our balance of payments pattern benefits both countries: Americans enjoy more investment at lower interest rates, while the Japanese profit from greater savings at higher rates. The persistent current account imbalance between the two countries has served to channel Japanese savings (via world financial markets) into the United States.

### ■ Divergent Saving Patterns

Current account developments in both Japan and the United States since 1991, which have heightened recent trade tensions, largely seem to reflect a faster pace of economic recovery here than in Japan. In the United States, investment spending has risen faster than national saving as the recovery has gained momentum; in Japan, however, investment spending has fallen with economic activity in general, while national saving has remained relatively flat. These divergent cyclical patterns are likely to reverse themselves when economic growth rates between the two countries resume a more typical pattern.

Although recent cyclical developments have produced marked effects on the U.S. and Japanese current accounts, substantial imbalances have persisted in both countries since the early 1980s. Economists generally offer two structural explanations for this.<sup>2</sup> One focuses on demographic patterns, which are likely to adjust only slowly in the

future. Japan's population is older relative to most other industrial countries and in the past has acquired assets to finance its eventual retirement.<sup>3</sup> The Japanese tend to start saving when relatively young and continue to do so for a comparatively longer time. Moreover, older generations in Japan, instead of completely consuming their lifetime savings in their old age, have tended to leave large bequests.<sup>4</sup>

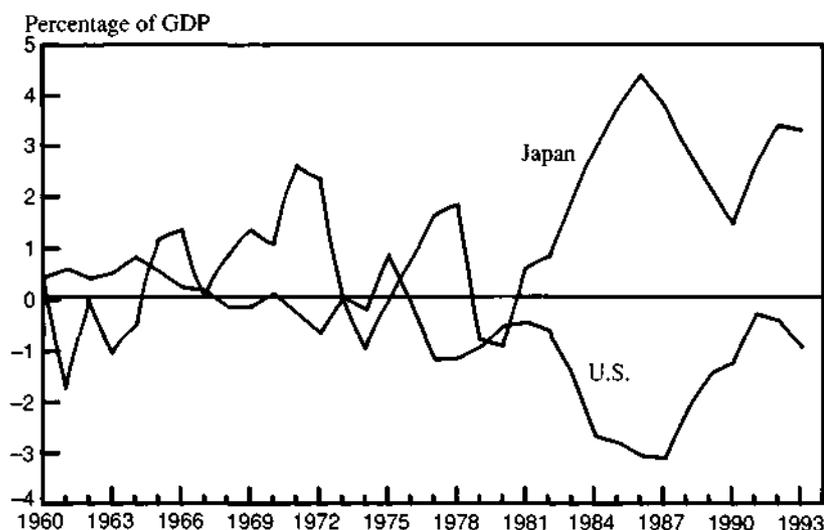
The other structural factor affecting the trade balances is policy related. Many economists believe that differences in the U.S. and Japanese government budget balances explain the saving and investment gaps in both countries.<sup>5</sup> Since 1983, Japan has shifted its government budget balance from a deficit to a surplus; all else equal, this will increase overall gross domestic saving. Over this same period, the U.S. budget deficit has remained large, tending to subtract from gross domestic saving.

### ■ Fiscal Policy and Saving

The possible connection between fiscal balances and gross domestic saving has led many Americans to criticize Japan for running a budget surplus and to encourage the nation to adopt an expansionary fiscal policy. (Similar critiques of the role played by the U.S. budget deficit seem less frequent.) But the relationship between fiscal policies and the trade account is more complex than the twin surplus/twin deficit hypothesis often allows. It depends on differences between public and private consumption patterns and on how government policies affect saving decisions.

To examine the influence of fiscal policies, assume that domestic saving equals investment in all countries (no current account imbalances) and consider increases in government spending financed by a rise in lump-sum government taxes.<sup>6</sup> This balanced-budget increase in government spending transfers purchasing power from the private sector to the government sector. How it affects overall economic activity depends on whether changes in government spending are temporary or permanent.

FIGURE 1 JAPANESE AND U.S. SAVINGS GAP



NOTE: Savings gap equals gross domestic savings (private plus government surpluses) less gross domestic investment.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and International Monetary Fund.

Individuals, by saving part of their current income or by borrowing against future earnings, try to avoid abrupt changes in consumption patterns over time. Consequently, when tax burdens rise unexpectedly, they reduce both current consumption and saving (future consumption). When the government's fiscal package is temporary, the net effect is likely to be greater demands (public plus private) on current output, reduced saving, and, therefore, a trade deficit. Rising imports and falling exports (a current account deficit) would satisfy the temporarily increased demand for output, while foreign capital inflows (a capital account surplus) would bridge the gap between lower gross domestic saving and investment. But this effect depends strictly on the temporary nature of government spending. Permanent government programs might not impact saving, because they involve a permanent transfer of resources from the private to the public sector, which consumers cannot offset by shifting consumption from the future to the present.

The analysis above is simple and skirts many issues; it does not consider similar tax distortions or the effects of policies on investment and production. Nevertheless, it stresses that the key aspect of fiscal policy with respect to changes in the current account is not the government's budget surplus or deficit itself,

or the general level of spending or taxing. Instead, it emphasizes that the relationship between fiscal policies and current account imbalances may be substantially more complicated than generally supposed, and directly associated with private saving incentives.

#### ■ Trade Restraints

Various policies, such as tariffs, can alter spending patterns between domestic and foreign goods, but may also induce offsetting changes in prices and exchange rates that eventually negate them.<sup>7</sup> Trade restraints (a tariff, for example) cause consumers to shift spending patterns away from the affected imports. This shift immediately creates a heightened demand for domestic goods and an excess supply of the foreign products under the tariff. Prices and exchange rates, however, will respond to shifts in demand, making domestic goods more expensive than foreign products. The tariff may reduce imports of, say, Japanese goods, but it will encourage imports of British, French, and German goods. Other policies, such as import targets or quotas, could have similar offsetting price and exchange-rate effects, which would create inefficiencies.

To affect the current account balance, trade policies must alter saving patterns. Although some types of restraint may temporarily do so, this result is not certain. What is sure, however, is that restraints introduce production and consumption inefficiencies that lower the standard of living and that foreign retaliation could worsen.

#### ■ Yen Appreciation

In response to the U.S.-Japanese trade imbalance, some analysts have called for a yen appreciation. Exchange rates do not change on their own, and so these analysts must specify a policy to alter them. Although many of the actions discussed above would affect exchange rates, those conducted by central banks would seem to have the most direct impact.

Unfortunately, although monetary policy can influence a nation's exchange rate, it cannot permanently alter its trade balance.<sup>8</sup> To force an appreciation of the yen relative to the dollar, the Federal Reserve must increase money growth in the United States relative to Japan, but this will also generate inflationary pressures here at home. Most economists believe that unanticipated monetary policy changes affect the exchange rate prior to domestic prices, so some temporary benefit is conceivable. Eventually, however, higher U.S. prices would offset any competitive advantage that the dollar's depreciation might have afforded.

#### ■ Sustainable, Beneficial, and Proper

While both the United States and Japan may have legitimate complaints about the access of specific goods to the other's markets, the long-term trade imbalance of each country stems neither from product restrictions nor from any competitive advantage. Trade imbalances are merely the international reflections of domestic saving and investment decisions. The United States has a trade deficit because we save *less* than we invest domestically. Japan has a trade surplus because it saves *more* than it invests domestically. The capital flows that are the counterparts to the

trade balances of each country accommodate the gap between saving and investment both here and in Japan, benefiting the citizens of each nation.

To be sure, the United States cannot indefinitely acquire international debt relative to its ability to service that debt (typically proxied by GDP). Although our current level of international indebtedness is not obviously unsustainable, at some point the U.S. trade deficit must shift to a surplus to prevent further increases. The process by which this occurs may embody increased real U.S. interest rates and a depreciation of the dollar, which will cause individuals to reevaluate their spending and saving plans. But the evidence of the past decade suggests that the adjustment process does not pose an immediate threat to economic stability.

#### ■ Footnotes

1. Because goods and services trade usually dominates current account developments, I use the terms *current account* and *trade account* synonymously.
2. Other explanations for the high rate of Japanese saving include high housing prices, difficult requirements for mortgages, and the favorable tax treatment of capital income.
3. For some recent evidence, see Paul R. Masson, Jeroen Kremers, and Jocelyn Home, "Net Foreign Assets and International Adjustment: The United States, Japan, and Germany," *Journal of International Money and Finance*, vol. 13, no. 1 (February 1994), pp. 27–40.
4. See Fumio Hayashi, "Explaining Japan's Saving: A Review of Recent Literature," Bank of Japan, *Monetary and Economic Studies*, vol. 10, no. 2 (November 1992), pp. 63–78.
5. The effect of a government's budget surplus or deficit on overall saving also depends on how it influences private saving decisions. If a government budget deficit, for example, leads to greater private saving, gross domestic saving may be unaffected.
6. Lump-sum taxes are straightforward assessments on individuals as opposed to being proportional to income, wages, or spending.

They do not influence saving behavior. While unrealistic, this assumption lets us focus solely on the distortionary effects of balanced-budget spending changes.

7. Gerald H. Anderson and Owen F. Humpage discuss the welfare losses associated with trade policies in "A Basic Analysis of the New Protectionism," Federal Reserve Bank of Cleveland, *Economic Review*, Winter 1981–82, pp. 2–19.
8. Exchange-market intervention that does not alter money growth can, at best, have only a temporary effect on the exchange rate. See Owen F. Humpage, "Central-Bank Intervention: Recent Literature, Continuing Controversy," Federal Reserve Bank of Cleveland, *Economic Review*, vol. 27, no. 2 (1991 Quarter 2), pp. 12–26.

*Owen F. Humpage is an economic advisor at the Federal Reserve Bank of Cleveland.*

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

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