

September 7, 1979

World Payments Imbalances

Few economic problems have vexed international policy-makers as much as the massive payments imbalances recorded by the U.S. and its trading partners over the last five years. The U.S. current-account deficit of the 1977-78 period has frequently been blamed for last year's decline of the dollar. The surpluses run by Germany and Japan have prompted others to accuse them of aggravating the unemployment problems of their neighbors. And the payments deficits of oil-importing developing nations (LDC's) have led them to borrow heavily from private banks in the industrial nations, raising fears of a world financial crisis.

These concerns might suggest that a prudent nation will seek to balance its international payments by buying no more, and no less, from abroad than it sells. If so, present current-account imbalances represent an unsustainable condition which must ultimately be corrected. However, such a view runs counter to the fact that nations frequently have sustained large imbalances for long periods without encountering serious economic difficulties. The U.S., for example, was in deficit for much of the 19th century. This suggests that the appropriate, sustainable, current account is not necessarily a balanced one. What factors, then, determine whether a nation is in deficit or surplus, and whether an imbalance can be sustained in the long run?

Current account

A nation's current-account balance is simply the difference between its receipts for goods and services sold to foreigners, less its payments to foreigners for goods and services. In addition to the merchandise-trade balance, the current account includes the following: exports less imports of transportation, tourism, and other services; net receipts from abroad of interest, dividends, and workers remittances; as well as gifts, foreign aid and other transfers to and from foreigners.

Any nation that runs a current-account deficit must borrow from abroad to cover the excess of its payments over receipts, while surplus countries are by definition net lenders to abroad. For example, the U.S. current-account deficit in 1978 — \$14 billion — was effectively financed by foreign central banks' purchases of \$31 billion in claims on U.S. residents. (Indeed, this very large increase in foreign official claims meant that private U.S. citizens increased their net lending abroad by more than \$14 billion.) However, the amount a nation borrows from abroad is also equal to the difference between its domestic investment and the savings of its residents — individuals, businesses, and government. That is, domestic investment must be financed from national savings or, if these are insufficient, from the savings of foreigners through borrowing from abroad. For this reason, nations with current-account deficits are referred to as "capital importers," while those in surplus are "capital exporters." Thus the current account can be viewed in two ways, either as the sum of the trade and other component balances, or as the difference between national savings and investment.

At any given time, a nation's current-account balance is the product of both cyclical and secular factors. Cyclical factors are simply those that vary with the business cycle. Probably the most important are the fluctuations in investment and savings resulting from business-cycle expansions and contractions in real GNP growth. During expansions, investment tends to rise relative to savings, pushing the current account toward deficit, while the opposite occurs when income growth contracts. Secular factors, on the other hand, can be thought of as those determining the balance when the nation is following its long-run *full-employment* growth path. Since this balance is the difference between national savings and investment, the question becomes, what

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determines full-employment savings and investment?

Savings and investment

National savings are influenced by a variety of factors, including citizens' incomes, their willingness to forego present for future consumption, and the portion of the population that is young or old. Not surprisingly, savings rates vary widely among nations. In the U.S., for example, gross national savings (i.e., including depreciation) has averaged about 19 percent of GNP, compared to 35 percent for Japan and 27 percent for Germany. Generally — although there are exceptions — countries with relatively low per-capita incomes tend to have lower savings rates than those with high per-capita incomes (see chart), perhaps because a substantial portion of their population lives at or near subsistence levels, and is thus unable to save.

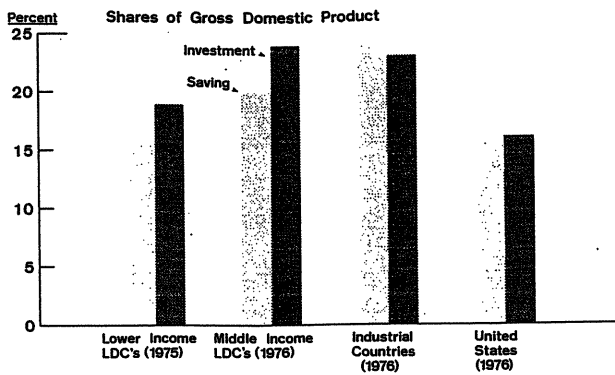
National investment is heavily influenced by the potential profit a nation can offer to investors, foreign as well as domestic. All other factors equal, investment in a particular country will be more profitable the lower the cost of its productive factors — labor, raw materials, power, etc. — and the higher the price that can be obtained for the output produced. Thus countries with relatively cheap labor can often attract foreign capital, particularly to industries where labor is the most important productive factor. Indeed, this is a major reason why Korea, Taiwan, and the Philippines — and in an earlier period, Japan — have been able to develop strong textile and other labor-intensive industries. Similarly, incentives to invest in a country are enhanced when the prices of the goods it produces rise relative to their production costs and relative to the prices of goods produced abroad. For example, investment in copper-producing countries is encouraged when copper prices rise relative to the prices of other goods, because prospective profits from engaging in copper production (rather than other activities) are enhanced. This is one reason why investment in primary-metals-producing LDC's rose sharply in 1974, after an upsurge in metals prices.

It should now be obvious why a nation's current account need not be balanced, even in the long run: generally a nation's savings will not exactly match the investment opportunities it offers. Capital will then tend to flow from those nations with relatively abundant savings to those with relatively plentiful investment outlets. Indeed, if there were no barriers to the international movement of capital, the size of a nation's current-account deficit would be limited only by its ability to borrow abroad at a rate no higher than the yield on its domestic investments. Nations might then persistently incur very large deficits, because national savings would not be a constraint upon domestic investment.

In practice, barriers to foreign investment exist in many countries, ranging from official impediments (such as foreign-exchange controls and discriminatory tax treatment) to more subjective obstacles (such as the uncertainties of operating in an unfamiliar culture). These factors tend to constrain the allocation of domestic savings to investments located within the nation's borders, and to limit a country's ability to borrow abroad. Such barriers are probably responsible in part for the fact that investment as a fraction of GNP — like the savings/GNP share — tends to be lower for most LDC's than for industrial countries.

Capital importers/exporters

By viewing the current account in savings-investment terms, we can understand several features of present current-account imbalances. For example, many analysts have expressed concern that (oil-importing) LDC's current-account deficits are endangering private banks in the industrial countries, which hold an increasing fraction of LDC debt. However, LDC's have typically run current-account deficits, averaging 2-3 percent of GNP, over the last twenty years. This simply reflects the fact that these nations, while recording relatively low savings rates, also offer comparatively plentiful investment outlets because of their cheap labor and often abundant natural resources. In this respect, many of these nations resemble "young".



Source: World Bank, *World Development Report, 1978*

growing firms that initially finance much of their expansion from external sources. Furthermore, the transfer of capital between developed and developing countries allows investors in the former to earn a higher yield than would be possible if they were confined to their own nations — and the transfer also promotes growth and helps raise living standards in poorer countries.

Savings and investment trends also help explain the evolution of world payments imbalances since the 1973-74 OPEC oil-price increases. Those increases effectively transferred billions of dollars of purchasing power from oil-importing to oil-exporting countries. But because it takes time to adjust spending patterns, importing nations at first financed their increased oil bills by reducing savings, while the OPEC nations initially invested much of their increased earnings abroad. As a result, savings fell sharply relative to investment in the importing countries — by about 2.5 percent for LDC's and roughly 0.5 percent for industrial countries. This pushed the industrial nations into deficit and ballooned the LDC's current-account deficits.

These oil-price increases also substantially changed the way in which LDC current-account deficits were financed. Prior to 1974, surplus investment funds were generally transferred directly from developed to developing countries, primarily through official sources. During the next several years, oil-exporting nations displaced industrial countries as the primary suppliers of surplus investment funds. However, LDC's were forced to borrow these funds indirectly, via banks in the industrial nations, because the OPEC nations tended to invest their surpluses in the Euro-markets and in securities issued by the governments of the major developed countries. The result was a substantial build-up of LDC debt to private industrial-country banks, which raised fears about the solvency of those banks.

However, world payments imbalances have diminished significantly in recent years, as oil importers have reduced their spending while

oil exporters have increasingly devoted their earnings to development projects within their own borders. Indeed, according to World Bank projections, LDC current-account deficits could fall back to an average of 2.8 percent of GNP over the next six years — not far from the 2.4-percent figure recorded during the 1968-73 period — while industrial countries as a group have moved back into surplus in recent years. These trends are likely to be interrupted, but not permanently reversed, by the recent oil-price increases. Thus, any strains encountered by banks in lending to LDC's should ease somewhat in coming years.

Finally, this analysis provides a perspective on the U.S. current-account deficit, as well as the surpluses of Germany and Japan. To a large extent, these imbalances are cyclical — that is, they reflect the fact that the U.S. economy has been operating closer to full-employment than have other major economies since 1975. Indeed, Japan's balance has recently slipped into deficit while the U.S. is expected to record a surplus next year, largely because growth has slowed here while picking up abroad.

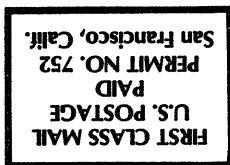
But what are these nations' balances likely to be when the world as a whole resumes full-employment growth? Since the oil-exporting countries collectively are likely to continue to save more than they invest domestically, the oil-importers collectively should remain in deficit, although the magnitudes involved are likely to be well below those recorded in 1974 and 1975. Thus, the U.S., which prior to 1974 was nearly always in surplus, may have to live for sometime with a small *secular* current-account deficit. On the other hand, Japan's savings rate remains among the highest in the world, while the profitability of investing there has probably declined as Japan's development has led to rapidly rising wages. This suggests that Japan may remain a capital exporter, although on a smaller scale than in recent years.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding 8/22/79	Change from 8/15/79	Change from year ago @	
			Dollar	Percent
Large Commercial Banks				
Loans (gross, adjusted) and investments*	131,005	510	18,221	16.16
Loans (gross, adjusted) — total#	108,149	482	17,074	18.75
Commercial and industrial	31,377	82	4,171	15.33
Real estate	39,723	170	8,246	26.20
Loans to individuals	22,241	117	NA	NA
Securities loans	1,997	173	NA	NA
U.S. Treasury securities*	7,538	- 19	- 921	- 10.89
Other securities*	15,318	47	2,068	15.61
Demand deposits — total#	42,158	- 1,076	2,718	6.89
Demand deposits — adjusted	30,496	- 753	1,273	4.36
Savings deposits — total	30,563	54	2	- 0.01
Time deposits — total#	52,266	572	6,329	13.78
Individuals, part. & corp.	43,926	602	7,437	20.38
(Large negotiable CD's)	18,926	406	1,306	7.41
Weekly Averages of Daily Figures	Week ended 8/22/79	Week ended 8/15/79	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	11	9	- 26	
Borrowings	230	121	38	
Net free reserves (+)/Net borrowed(-)	- 219	- 112	- 64	
Federal Funds — Seven Large Banks				
Net interbank transactions	+ 242	+ 436	+1194	
[Purchases (+)/Sales (-)]				
Net, U.S. Securities dealer transactions	- 718	- 246	+ 347	
[Loans (+)/Borrowings (-)]				

* Excludes trading account securities.

Includes items not shown separately.

@ Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.

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