Research Department
Federal Reserve
Bank of
San Francisco

January 27, 1984

FRBSF Weekly Letter

Export Crowding Out

The U.S. economic recovery continues at a brisk pace, with real GNP rising in 1983 by over 6 percent. Although the overall strength of the economy at this stage is fairly typical of earlier post-World War II expansions, the composition of output is substantially different. Namely, the export sector is far weaker in this recovery than in previous upswings. The U.S. current account deficit on international payments (goods, services and transfers) reached nearly $40 billion in 1983—the largest on record. This year's deficit will probably be larger, with forecasts ranging from $40 to $80 billion. This *Letter* identifies reasons for the deterioration in the U.S. export and import sectors, and explores the link between the resulting current account deficit and the massive credit demands posed by current and projected federal government budget deficits.

Cyclical weakness

Some weakness in the international trade sector usually develops during a business cycle upturn. The chart shows the trough of the downturn (marked on the timeline as "0"), three quarters preceding the trough and eight quarters following the trough, for the average current account balance from six previous business cycles and the current account balance in the present cycle. The diagram shows that a cyclical deterioration in the current account has been a normal development during economic recoveries in the post-war period. An upswing causes domestic income to grow faster than incomes abroad, spurring a greater demand for imports; the trade and current account balances consequently decline. It is primarily the pattern of demand in the U.S. and abroad, therefore, that causes the cyclical weakness in the "external" sector. The downturn in net exports usually runs its course after a period of several quarters and then stabilizes.

Current account deficits in the present recovery exceed the typical cyclical deterioration during a business upswing. While it is true that the U.S. recovery is leading that of the other major western industrial countries (excepting Canada) to an extent greater than usual, this alone does not explain the unprecedented deficits. The *drop* in the current account balance as a percent of GNP is almost twice as large as the average post-war decline, and it surpasses the decline in any individual previous cyclical upturn. In addition, the *absolute size* of the present current account deficit (in both dollar amount and as a percent of GNP) surpasses that of any previous post-war period, during a business cycle upswing or otherwise. Forecasts suggest that deficits through 1984 could stabilize at an unprecedented 1.5 percent of GNP or more, rather than at the rough balance which has been typical in the second year of most economic recoveries.

Strong dollar, weak exports

Thus, a large part of the current account deficit is related to non-cyclical factors, the most significant of which is the high real (price adjusted) value of the dollar in exchange markets. The dollar is currently more than 30 percent higher on a trade weighted basis, in both nominal and real terms, than it was in 1980. Dollar appreciation has raised dramatically the prices of U.S. goods in comparison to those of our foreign competitors. As a result, U.S. exporters have found it increasingly difficult to sell abroad, and U.S. producers at home have found it more difficult to compete with foreign imports. The current account balance therefore has deteriorated because our imports of goods and services have grown considerably faster than our exports (more than twice as fast between 1980 and 1982).

Research Department
Federal Reserve Bank of San Francisco

Why has the dollar remained so high in recent years? The answer lies largely with U.S. monetary and fiscal policies and their impact on credit markets. Beginning in 1979, the Federal Reserve slowed money growth to reduce inflation. For several years, money increased more slowly than prices, resulting in a progressive tightening of real liquidity that pushed up our real (inflation-adjusted) interest rates; this increase in real interest rates in turn raised the value of the dollar on the foreign exchanges. By mid-1982, however, the upward pull of monetary policy on interest rates and the dollar began to wane. As inflation fell sharply and money growth accelerated, real liquidity began to increase. At this point, however, growing federal government budget deficits (a $138 billion increase in fiscal 1983 over the 1981 level) added to private credit demands and prevented the fall in our real interest rates that would otherwise have occurred.

This explanation suggests that there is a basic economic link between government budget deficits and current account deficits. Consider the economy divided into three sectors: the government sector, the domestic private sector and the international sector. All together, the total supply of credit must balance the total demand for credit. When the government sector runs a net deficit, it has a net demand for credit that must be met by some combination of credit supplied from the domestic private sector (i.e., an excess of private domestic saving over investment) and the international sector. The latter source of credit results from a current account deficit. Because the present current account deficit represents the excess of U.S. purchases over sales of goods to foreigners, it reflects an extension of foreign credit to the U.S. and hence a *net* capital inflow into the U.S. economy; that is, foreign resources are being transferred to the U.S. to complement domestic production in meeting the growing government demand for goods and services.

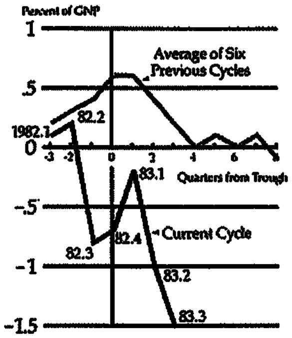
Since supply-sider hopes for a large jump in private domestic savings to augment credit supplies have yet to be realized, rising federal government budget deficits are to some extent being financed by foreign creditors via the U.S. current account deficit. They do so directly when they purchase U.S. government securities, and indirectly by lending to private U.S. entities. In a closed economy, without an external sector, increased government spending competes with private spending and to some extent "crowds out" domestic consumption and, especially, domestic investment. In an open economy such as that of the U.S., government spending will also crowd out resources destined for the export and import-competing sectors.

Outlook

Since federal deficits in 1984 will probably grow despite the cyclical expansion, large government credit demands (in the absence of a substantial increase in net savings from the private sector) will likely keep real interest rates and the dollar at high levels. This will generate continued large foreign capital inflows and current account deficits. It appears, therefore, that the export- and import-competing sectors will continue to remain weak spots in an otherwise robust economic recovery.

The longer-term outlook for the international sector is less clear, however, assuming that large budget deficits persist. One view is that large current account deficits are not sustainable for an extended period because foreigners are not willing to increase their U.S. claims indefinitely. This implies that the real value of the dollar must eventually decline to bring the current account balance back to a more sustainable level. The upshot of this argument is that a large part of persistent government budget deficits cannot continually be financed from abroad, and will eventually crowd out domestic spending in a way analogous to the closed economy case. In this circumstance, U.S. interest rates would remain both stubbornly high

Current Account
and the Business Cycle



and significantly above world levels. (The interest rate differential represents a risk premium needed to induce foreigners to hold an increased share of their wealth in U.S. assets.)

An alternate view holds that foreigners will be willing to increase their U.S. investments substantially over an extended period, making large current account deficits sustainable. Political stability and the U.S. policy allowing international capital to flow in and out of our borders virtually unrestricted are two major reasons foreigners may readily increase their investments in this country. In addition, U.S. current account deficits amount to less than 10 percent of the gross savings of foreign industrial countries as a whole, and to a much smaller fraction of their wealth. Moreover, given the dollar's standing as an investment and international reserve currency, foreigners may consider investments in dollars to be as safe, if not safer, than investments in their own currencies. As long as the Fed maintains an anti-inflationary monetary policy, advocates of this alternative view believe that there is no apparent reason why the U.S. cannot continue to run very large current account deficits as long as budget deficits remain high.

This second argument suggests that foreigners will be willing to finance large U.S. current account deficits for the foreseeable future, and without any significant risk premium. If so, continuing foreign capital inflows should eventually relieve pressure on domestic financial markets, bringing U.S. real interest rates down.

Does this imply that the dollar's value can be expected to fall back to its pre-1980 real level with stable or somewhat lower real interest rates in the U.S. compared to those abroad? Not necessarily. Proponents of the second argument point out that the dollar's value is not only determined by relative interest rates in financial markets. Over the longer term, the real value of the dollar must also be consistent with the supply and demand for goods in the economy. In particular, a strong dollar may well be necessary to keep the current account in deficit—to effect the transfer of real resources from abroad to the U.S. that is needed to finance our budget deficit. For this reason, a significant part of the dramatic rise in the value of the dollar since mid-1980 may be maintained, even in the face of moderate interest rate declines, for the foreseeable future. In essence, this view suggests that we may be witnessing a permanent upward shift in the value of the dollar—a shift caused by the new stance of fiscal policy in the United States. This shift can be thought of as reflecting the fact that fewer U.S. goods will be available to foreigners in the future since more will be absorbed domestically because of our fiscal deficits.

In short, both views point to substantial crowding out of the private sector if budget deficits persist. They differ in the industries that will suffer the most. The first view suggests that interest-sensitive sectors such as business fixed investment, housing and consumer durables will bear the major burden. The second view implies that U.S. export and import-competing industries will suffer most. In either case, deficits must be financed and the private sector bears the cost.

Michael Hutchison and Charles Pigott

Editorial comments may be addressed to the editor (Gregory Tong) or to the author.... Free copies of this and other Federal Reserve publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

Research Department
Federal Reserve
Bank of
San Francisco

Alaska • Arizona • California • Hawaii
Idaho • Nevada • Oregon • Utah • Washington

FIRST CLASS MAIL
U.S. POSTAGE PAID
PERMIT NO. 752
San Francisco, Calif.

FIRST CLASS

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/4/83	Change from 12/28/83	Change from year ago Dollar	Change from year ago Percent
Loans, Leases and Investments[1] [2]	155,317	670	3,065	2.0
Loans and Leases[1] [5]	175,984	1,145	2,263	1.3
Commercial and Industrial	45,832	622	– 172	– 0.3
Real estate	58,877	– 108	692	1.2
Loans to Individuals	26,630	– 116	1,873	7.6
Leases	105	0	1	1.0
U.S. Treasury and Agency Securities[2]	12,506	1,470	1,316	11.8
Other Securities[2]	8,161	NA	NA	NA
Total Deposits	190,988	NA	NA	NA
Demand Deposits	49,232	3,616	3,785	8.3
Total Transaction Deposits	62,006	NA	NA	NA
Demand Deposits Adjusted[3]	31,578	NA	NA	NA
Other Transaction Balances[4]	12,774	NA	NA	NA
Total Non Transaction Balances[5]	128,982	NA	NA	NA
Money Market Deposit Accounts—Total	39,596	NA	NA	NA
Time Deposits in Amounts of $100,00 or more	38,169	– 393	– 15,176	– 28.4
Other Liabilities for Borrowed Money	22,978	2,936	– 1,095	4.5

Weekly Averages of Daily Figures	Week ended 1/4/84	Week ended 12/28/83	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	333	367	297
Borrowings	57	224	21
Net free reserves (+)/Net borrowed(–)	276	142	276

Footnotes
1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes deposits of U.S. government and commercial banks in U.S. and cash items in process of collection
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowings from Federal Reserve banks, treasury tax and loan notes, federal funds purchases and securities sold under agreements to repurchase, and other borrowed money
6 Includes items not shown separately