
FRBSF WEEKLY LETTER

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The Trade Balance and the Economic Outlook

Since the value of the U.S. dollar peaked in February 1985, economic commentators have been waiting anxiously for the U.S. trade balance to improve. The failure of the trade balance to turn around has been held responsible for dampening GNP growth, while continued expectations of its eventual improvement form the basis of optimistic forecasts of future GNP growth.

Unfortunately, the discussion of the relationship between the trade balance and domestic economic growth has generally failed to specify clearly the driving forces behind the expected trade improvement. This *Letter* attempts to clarify the relationship between the trade balance and the level of domestic economic activity by focusing on three possible factors that have figured prominently in recent discussions: U.S. fiscal policy, U.S. monetary policy, and policy actions by our major trading partners — Japan and West Germany in particular.

Depending on which of these fundamental forces is causing the economy to adjust, an improved trade balance and more rapid growth may develop. But an improved trade balance and less rapid growth is a combination that can also easily arise. Moreover, this latter outcome is particularly likely to be produced by expenditure cuts designed to reduce the federal budget deficit.

In general, no systematic relationship between net exports and economic growth should be expected. The chart shows the annual growth rate of U.S. real GNP since 1970 together with the real value of the current account. The current account is equal to the net trade balance of goods and services plus net remittances, pensions, and other unilateral transfer payments. Strong output growth has been associated with both an improving current account, as in 1978, and a worsening current account, as in 1984.

Reasons

If we wish to draw the correct implications

about a current account improvement for GNP growth, it is necessary to understand the forces bringing about the current account improvement.

First, though, a word about the most frequently mentioned reason to expect a rise in our net exports — the fall in the value of the dollar. As the dollar declines in value against other currencies, U.S.-produced goods become cheaper relative to foreign-produced goods. This will tend to increase U.S. exports as foreigners increase their demand for cheaper U.S. goods; and it will tend to decrease U.S. imports as U.S. consumers substitute U.S. products for the more expensive foreign goods. Net exports should eventually rise in response to the fall in the value of the dollar.

The problem with this explanation is that it fails to specify the reason for the fall in the dollar's value! As will be seen from the examples discussed below, a falling dollar and rising net exports can be associated with stronger real economic growth, or with weaker growth. It all depends on what causes the exchange rate, the trade balance, and real growth to adjust.

U.S. fiscal policy

Changes in the stance of fiscal policy in the U.S. will affect the value of the dollar, U.S. net exports, and the level of domestic economic activity. To understand the effects of fiscal policy, it is useful to distinguish between current policy changes and expected future policy changes.

A contractionary fiscal policy designed to reduce the current federal budget deficit is one example of a policy that is likely to improve the trade balance, yet lead to slower real growth. For example, a reduction in government purchases of goods and services will directly lower the demand for domestic output and reduce the borrowing needs of the government. A decline in the government's borrowing needs will tend to put downward pressure on market interest

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rates. As U.S. interest rates decline relative to rates of return available in other countries, so will the value of the U.S. dollar.

The resulting decline in the dollar will tend to stimulate U.S. exports, but not to the extent of offsetting the contractionary effect of the fiscal policy. Slower growth will result in the short-run.

This scenario is the reverse of what many analysts claim occurred during the first half of the 1980s. At that time, expansionary fiscal policy, consisting of tax cuts in 1981 and the rapid increase in defense spending, generated high real interest rates, a strong dollar, and a trade deficit at the same time that it helped move the economy out of the 1982 recession. Thus, faster growth was accompanied by a deterioration in the trade balance.

Perhaps more pertinent to our understanding of the effect of fiscal policy in the current environment are the effects, not of *current* fiscal actions to reduce the budget deficit, but of expectations of *future* actions to reduce the budget deficit. Over the last year, forecasters have generally lowered their deficit projections for the rest of the 1980s and into the 1990s. Instead of projections of \$200 billion deficits for many years to come, projections show the federal deficit declining gradually over the next several years.

If actual fiscal policy changes affect current short-term interest rates, then the expectation of a change in future deficits should affect expectations of future short-term interest rates. Interest rates on long-term assets reflect both current short-term interest rates and the market's expectations of future short rates over the life of the long-term asset. Consequently, changes in expected future short-term rates will influence the current level of long-term rates.

Through this "expectational" channel, expectations of future contractionary fiscal policy are likely to reduce the current level of interest rates in the U.S. Since investing in U.S. financial assets would become less attractive, the fall in interest rates would also lead to a depreciation of the dollar against other currencies. This fall in the dollar would eventually produce a rise in net exports.

Because the dollar would not be declining as the result of a reduction in any other component of

the demand for U.S. goods and services, the rise in net exports would represent a net increase in the demand for our output. The rise in net exports also would stimulate U.S. production and lead to stronger growth. This case differs from the effects induced by a current fiscal contraction since the actual decline in government spending occurs in the future, that is, there is no simultaneous decline in government purchases to offset the rise in net exports.

U.S. monetary policy

U.S. monetary policy can also affect the trade balance. For example, an expansionary monetary policy that temporarily lowers U.S. interest rates will also tend to produce a fall in the value of the dollar. The dollar's fall, in turn, will stimulate U.S. exports and reduce our imports by making foreign goods relatively more expensive.

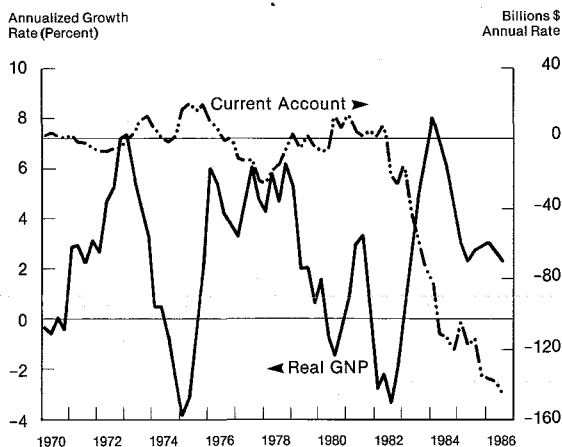
The improved trade balance that would result from an expansionary U.S. monetary policy represents a net increase in the demand for U.S. output. Domestic production will rise in response. This exchange rate-induced improvement in the trade balance is one of the channels through which a monetary expansion leads to increased economic growth.

Foreign economic expansion

Recent press accounts on the trade deficit have stressed the attempts by the Reagan Administration to pressure Japan and West Germany into adopting more expansionary policies. Increased growth in these two major economies would presumably increase the demand for U.S. goods and services and thereby cut our trade deficit and stimulate growth in the U.S. "For U.S. exports to grow, the economies of our trading partners must grow", according to President Reagan in this year's *Economic Report of the President*. However, this rosy outcome may depend crucially on the economic policies those countries use to generate increased growth.

A Japanese fiscal expansion, for example, would lead to the desired result of a reduced trade deficit and increased economic growth for the U.S. The Japanese expansion would tend to raise interest rates in Japan and drive up the value of the yen. By making Japanese-produced goods more expensive, the stronger yen would reduce U.S. imports of Japanese goods, while simultaneously increasing the demand by Japan for U.S. goods. This increase in our net exports, since it would not be offset by a decline in any

No Systematic Relationship Between the Current Account and Economic Growth



other component of demand, would stimulate growth in the U.S.

The outcome could be quite different if Japan decided to stimulate its economy through the use of expansionary monetary policy. In recent months, some U.S. officials have suggested that the Bank of Japan should cut its discount rate. On February 23, the Bank of Japan announced a reduction in its discount rate from 3 percent to 2½ percent. Such a cut will tend to reduce the general level of interest rates in Japan and produce a drop in the value of the yen. But a fall in the yen makes Japanese goods less expensive and tends to reduce U.S. exports to Japan while increasing our imports from Japan. The results are a worsening of our trade balance and a slowing of U.S. growth.

The adverse effect on our growth and our trade balance of a foreign expansion fueled by monetary growth would be offset somewhat by the effects of the expanding income abroad. The above-mentioned expansion in Japan generated by monetary policy would tend to produce a rise in U.S. exports as income in Japan rises. This rise in U.S. exports may dominate the impact of the falling yen, and lead to an improvement in U.S. net exports. Clearly, the expansionary effect on the U.S. of greater growth abroad will depend crucially on the particular policies our trading partners adopt to expand their economies.

Lessons

A fall in the value of the dollar should improve our trade balance, but whether that improvement is associated with faster GNP growth will depend on the cause of the dollar decline. Fiscal action to reduce the current federal budget deficit will contribute to a rise in net exports, but such a policy will also tend to slow real growth. Expected fiscal deficit reduction in the future or current expansionary monetary policy will both work to lower the trade deficit and to stimulate real growth.

The effects of an economic expansion among our trading partners on U.S. growth will depend on the particular policies used by those countries. More expansionary fiscal policy in Japan and/or Germany should improve our trade balance and stimulate growth in the U.S. An expansion induced by monetary growth, however, may lead to a much smaller improvement in net exports and could even worsen our trade deficit.

These separate policies can be combined in ways that may contribute to an improved trade balance while strengthening real growth. For example, a tighter domestic fiscal policy accompanied by easier domestic monetary policy would work towards reducing the trade deficit without producing the slower growth that would result from a fiscal contraction alone.

Understanding the connection between movements in the trade balance and the outlook for growth requires a consideration of the forces causing the current fall in the value of the dollar. These forces may include expectations of tighter U.S. fiscal policy in the future and current market perceptions of some monetary stimulus. In principle, such a policy combination implies that the induced fall in the dollar and rise in net exports should result in a net gain for U.S. growth.

However, because the future eventually becomes the present, policymakers must eventually take the contractionary fiscal steps necessary to reduce the budget deficit. To avoid producing slower growth and to improve the trade balance further, such steps may require the simultaneous implementation of an easier monetary policy.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount	Change	Change from 2/12/86	
	Outstanding 2/11/87	from 2/4/87	Dollar	Percent ⁷
Loans, Leases and Investments ^{1 2}	205,365	- 824	3,292	1.6
Loans and Leases ^{1 6}	184,344	- 790	1,838	1.0
Commercial and Industrial	54,339	- 461	1,362	2.5
Real estate	67,845	100	1,768	2.6
Loans to Individuals	38,059	- 19	2,325	- 5.7
Leases	5,459	- 29	229	- 4.0
U.S. Treasury and Agency Securities ²	13,943	10	2,729	24.3
Other Securities ²	7,078	- 45	1,276	- 15.2
Total Deposits	206,749	- 2,333	6,502	3.2
Demand Deposits	51,611	- 2,116	5,270	11.3
Demand Deposits Adjusted ³	35,741	- 504	3,310	10.2
Other Transaction Balances ⁴	19,269	- 361	4,331	28.9
Total Non-Transaction Balances ⁶	135,869	145	3,099	- 2.2
Money Market Deposit Accounts—Total	46,909	13	1,336	2.9
Time Deposits in Amounts of \$100,000 or more	32,431	91	6,661	- 17.0
Other Liabilities for Borrowed Money ⁵	24,824	141	751	- 2.9
Two Week Averages of Daily Figures	Period ended 2/9/87	Period ended 1/26/87		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	111	67		
Borrowings	6	15		
Net free reserves (+)/Net borrowed(-)	106	52		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

⁷ Annualized percent change