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The Dollar in the 1990s: Competitiveness and the Challenges of New Economic Blocs

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Currency markets are not known for their long horizon. Far beyond their view, "the Dollar in the 1990s" is best left to academic speculators who can afford to look at fundamentals. And even here we must be cautious because "It's not over 'til it's over" as Yogi Berra has taught us to remember.

The topic is broad, ranging in interpretation from the international monetary system—fixed or flexible, with rules of the game and coordination—to the specific level of exchange rates as they are likely to emerge from adjustments that are overdue, trend inflation differentials and dynamic comparative advantage. There are three important reasons to expect a change in the international financial system in the next decade. They are respectively:

- dissatisfaction with the current system because of excess volatility, persistent misalignment and the lack of an adjustment mechanism;

- increased international financial intermediation resulting from domestic deregulation; and

- a major repositioning of 'the United States in the world economy as a consequence of the emergence of competing economic blocs.

I will speculate here on how these three factors are likely to shape

the international role of the dollar. Specifically I concentrate on two questions: what will be the value of the dollar in 1995 and what are the consequences of enhanced intermediation and competing economic blocs.

Problems of the current monetary system

The systemic problems of the post-1973 international monetary system have been amply discussed and need only a reminder. They are mainly three: volatility, misalignment, and the lack of an effective adjustment mechanism.

Excess volatility

Mussa (1986) and Stockman (1988) have drawn attention to the sharply increased level of real exchange *rate* volatility in the post-1973 monetary system. The variability of real exchange rates, which was practically absent under fixed rates, has become quite extraordinary as Chart 1 makes clear for the United States-Germany case.

Chart 1

Real Exchange Rate Changes
United States - Germany

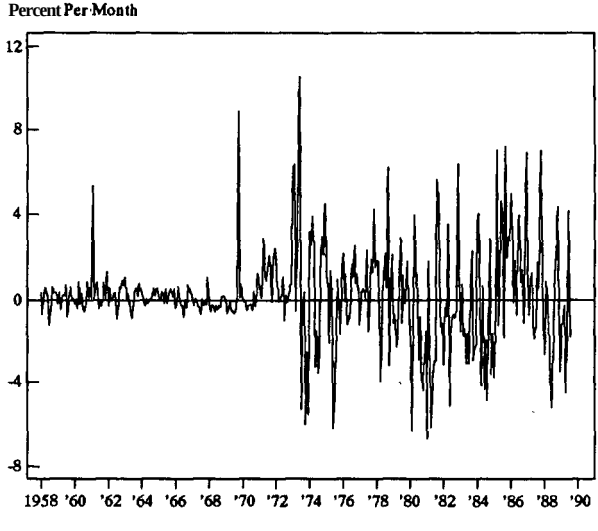


Chart 1 shows relative consumer prices measured in a common currency. Under the Bretton Woods system, real exchange rates fluctuated very moderately and there were only .rare spikes from adjustments in .the fixed rates. Since 1973, volatility has been the rule. The discussion has not closed on the question of whether the volatility reflects increased variability of the ***equilibrium real*** exchange rate as a result of increased variability of underlying fundamentals or simply instability that is visited on foreign exchange markets by the conjunction of relatively sticky goods prices and highly volatile nominal exchange rates. There is no proof that there might not be an equilibrium model to explain these facts, but none has been offered and the suspicion is by now pervasive that the volatility is contrived rather than of an ,equilibriumvariety.

It is interesting to observe that the higher volatility of real exchange rates is accompanied by higher volatility of real commodity prices, but not by increased volatility of U.S. nominal short-term interest rates. This is shown in Table 1.

Table 1
Volatility (Coefficient of variation)

	1958-71	1973-89	1979-89
U.S.-German Exchange Rate*			
Real	5.4	20.0	20.2
Nominal	4.9	17.1	19.7
Real Commodity Prices**	6.1	26.5	23.1
U.S. Interest Rates	37.4	34.1	31.4

*Using consumer prices
**IMF non-oil commodity price index deflated by U.S. CPI

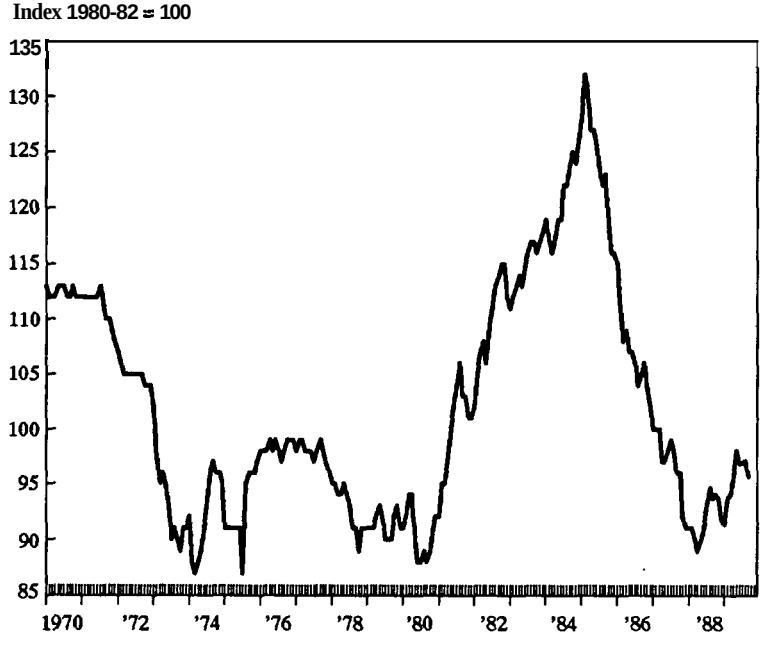
It would be interesting to trace further where else in the macroeconomy volatility has risen. If real variables have not, in fact, exhibited increased real variability, as Stockman and Baxter (1988) claim, then we should not expect on equilibrium grounds their higher real exchange rate variability. After all, why would all the adjustment be in real prices, and none in real quantities?

Misalignment

Chart 2 shows the real exchange rate of the dollar (using the Morgan Guaranty data for the multilateral rate, including LDCs.) The argument for persistent misalignments centers on episodes such as 1980-85 where the real value of the dollar appreciated without, at least in the end phase, any plausible fundamentals. The rising real value of the dollar in 1988-89 is of much the same nature.

Chart 2

United States Real Exchange Rate



To have a firm view of whether an exchange rate is or is not misaligned it is, of course, necessary to have some model of the equilibrium exchange rate. What equilibrium rates might be is wide open to discussion, but plausible limits might be set. One possible and timely way was suggested by Krugman (1986) where the sustainability of external deficits was used as a rough criterion.

Any suggestion that market rates are anything but equilibrium rates, properly reflecting fundamentals, raises immediately very serious

methodological questions. To judge whether a rate is right we need a model. The commonly accepted model uses, beyond the structural equations, the assumptions of informed, rational speculation. On this basis, whatever the market yields must be right, even if an observer cannot understand what possible fundamentals the market sees to warrant apparently aberrant moves. It is tempting to reject the entire rational speculation paradigm, but two difficulties emerge. First, rejection is not enough since it has to be rejection in favor of an alternative paradigm and the fact is that we do not have a better one. Second, the rational paradigm is methodologically very powerful; a good example is the peso problem where events, not observed for a decade in the data, were in the minds of speculators who ultimately turned out to be rightly concerned.

But even though the rational paradigm is attractive, and alternatives are unavailable, there is now overwhelming evidence that the hypothesis of informed, rational speculation must be rejected. The important body of work by Frankel and Froot (1987) as well as the impressive evidence assembled by Ito (1988) simply reject as plausible this paradigm.

The search is on for a better model not only as a matter of intellectual curiosity, but more fundamentally, because if markets malfunction, intervention in one form or another becomes appropriate. Which form it should take depends on our understanding of how the market malfunctions. But even as the search for a better paradigm is on, it is tempting to look for immediate remedies. For some, specifically Williamson and Miller (1987), destabilizing speculation should be limited by target zones. Others, including Tobin, Summers (1989), and Dornbusch (1988) have suggested financial transactions taxes. The purpose of a financial transactions tax is to penalize short horizon speculation and that way, stretch traders' horizons; it is hoped that the longer horizon will lead them to support real exchange rates that more nearly reflect fundamentals.

Lack of an adjustment mechanism

In the 1960s, under fixed exchange rates, the lack of a constraint on U.S. inflation policy was seen as the chief defect of flexible exchange rates. Deficit countries had to adjust because of reserve shortages; surplus countries had to adjust because of import inflation, and the

U.S. could afford not to adjust because it was running the system.'

If flexible exchange rates were thought to resolve the adjustment problem, they certainly have failed to do so. Today, the main concern is that U.S. fiscal policy is not effectively checked. The spillover effect of the fiscal stance (via trade imbalances, real exchange rate misalignment, and real interest rates) is widely seen as a systemic problem. The reason the adjustment problem is present is that capital flows dominate real exchange rate movements and thus 'create interdependence effects. This applies, as was well known from theory, to fiscal policy. Perhaps surprisingly, the stickiness of prices or inflation made it even more true for changes in monetary policy.

The lack of an adjustment mechanism is typically cited for the case of the United States, but also for Germany inside the European Monetary System (EMS). The adjustment problem reflects the fact that economies are interdependent, whatever the exchange rate regime. As long as imbalances are regarded as "policy problems" there is an issue of coordination. One response is to argue that imbalances are not a policy issue: governments optimize fiscal policy intertemporally to achieve tax smoothing,[2] monetary policy has no real effects (except for noise and surprise) under conditions of rational expectations equilibrium economics, and fiscal policy likewise has no effects if households are appropriately Ricardian.

In such a world, imbalances reflect equilibrium responses to intertemporal tastes and opportunities. There is no reason for policy to interfere with imbalances since they are the outcome of intertemporal optimization decisions. One common rendition of this view is to argue that Japan's surpluses reflect predominantly demographic factors that are self-correcting over the next half century.

The alternative view is that imbalances do present a policy issue. If governments do not optimize in setting 'the intertemporal tax and debt policy, if money is not neutral or if households are not exhaustively Ricardian, then there is a policy issue. And it is enough for any of these conditions not to be met in one country for a worldwide coordination issue to arise. From the now extensive work on coordination, it is clear that there are no easy answers. Differences in

1 See Mundell (1968, 1971), Mundell and Swoboda (1968). and Officer and Willett (1969).

2 See Lucas (1988), and Barro (1989).

economic structure, beliefs about the model, objectives, structure of games all come together, as Frankel has shown, to leave the adjustment and coordination problem wide open. Once again, unless there is a good model of what is wrong with the way the economy operates (including policymakers), it is difficult to argue how to do better.

There is little evidence to support the equilibrium model, but it is hard to define the alternative, preferred paradigm. Without such a paradigm, prescription of exact guidelines, as in Williamson and Miller (1987), is hard to rationalize. Discussion of the problem of coordination has rapidly gone to the point of recognition that there is certainly no easy answer.[3]

In summary, once more with Yogi Berra, whatever the exchange rate regime there is a sense of "deja vu, all over again." In the 1960s the United States was blamed for overall deficits; this time round, it is the current account deficit. In either event, the system does not work to keep deficits and spillovers in limits.

We move from here to a discussion of two central questions underlying an analysis of the dollar in the 1990s: is the dollar overvalued today and what will happen when U.S. fiscal correction ultimately occurs.

Dollar overvaluation

The question of the long-run value of the dollar is simply this: can the U.S. achieve a reduction in the fiscal deficit—which I assume will be accomplished over the next five or six years—at the current real exchange rate under conditions of full employment? Adherents of PPP exchange rate theory believe that the question is basically misplaced, while students of trade theory would argue that real depreciation is required to affect a transfer as is implied by a reduction in net foreign borrowing.

There are two views on the current level of the dollar. One is that the dollar is ***probably*** overpriced, that it will decline significantly, and that policy should not seek to interfere with depreciation. This view has been argued by Feldstein (1988, 1989), or Dornbusch and

3 See Cooper and others (1989), Federal Reserve Bank of Boston (1989), and Frankel and Rockett (1989).

others (1989). The second view, advocated primarily by McKinnon (1988, 1989), is that the dollar is undervalued relative to the deutsche mark and the yen, that dollar appreciation is appropriate, and that it should be brought about by tighter U.S. monetary policy? Following appreciation, the dollar should be fixed in this view. We first review the PPP model.

PPP and equilibrium exchange rates

The large decline of the dollar since 1985 has led some observers to argue that, on PPP grounds, the dollar is broadly in the right place today, if not, in fact, overvalued. Indeed, as noted above, McKinnon and Ohno have argued that the dollar is undervalued.

Since Cassell invented PPP the theory has not failed to be controversial.[5] Some have argued that, more often than not, it gives the wrong indication of where equilibrium exchange rates should be. It must be remembered that the theory emerged during massive wartime changes in relative national price levels. When-price level divergences are moderate and real disturbances are large, the theory is certainly a poor guide. From trade theory it is accepted that changes in fundamentals (tastes, technology, resource endowments, real government spending, and the like) do have effects on equilibrium real exchange rates. Whenever these changes take place, exchange rates should move away' from PPP patterns to allow adjustments in equilibrium relative prices. The PPP view, contrary to *trade* theory, implicitly holds that these relative price changes are unnecessary as part of any adjustment, that they are quantitatively negligible, or that there were no significant real disturbances in the first place.

A close relative of PPP is the relative wage view. Here it is argued that changes in relative unit labor cost or simply in absolute hourly compensation (measured in a common currency) are now such that the dollar is properly aligned.

Both approaches are thoroughly misleading because they implicitly assume that the underlying real economies do not experience divergent trends in fundamentals. I will argue, on the contrary, that these divergent trends were, in fact, very important.

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4 See, too, Ohno (1989).

5 For a review, see Dornbusch (1989).

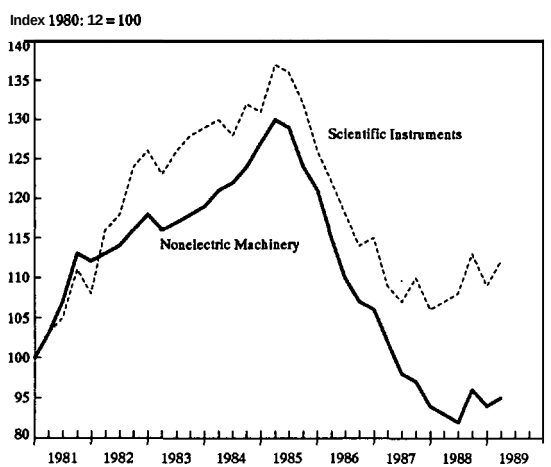
Consider first the relative PPP theory. The equilibrium exchange rate derived by McKinnon, for example, is based on the trends in prices of a basket of traded goods in the United States and in Japan. Using a benchmark year, the required depreciation or appreciation, relative to the base year, of the dollar is measured by the inflation differential.

The essential difficulty here comes from two directions. First, the obvious point that the base year need not represent an equilibrium situation. More importantly, the calculation assumes constant equilibrium relative prices. But, of course, the point is that the equilibrium relative price may need to change for one of two reasons. Foreign goods may have become better in some quality attribute or, as of given attributes, consumer tastes may have shifted from home to foreign goods. In either event, the real price of foreign goods should rise (barring very special cost conditions) and that means the real exchange rate of the dollar has to depreciate. If goods were identical, their real prices would be unchanged. But in a world of product diversification, changes in relative prices are to be expected.

Going beyond this argument, it is also important to note that, in fact, the decline of the dollar since 1985 has not even restored competitiveness pervasively. Chart 3 shows the relative price of exports

Chart 3

Relative Traded Goods Prices



in terms of imports for.scientific instruments and for nonelectric machinery in the United States. For the former, there is a loss in competitiveness relative to 1980; for the latter, there is a moderate gain. It is true that since 1985 the United States has gained competitiveness, but compared to 1980 for example, that is not uniformly the case. Indeed, in many industries, import prices today are even below their 1980 levels while U.S. export prices have increased significantly. If we look at the 1980s as a period where developing countries and Japan have made major progress in manufacturing, the return to the 1980 level of relative prices is entirely insufficient. Table 2 shows the U.S. bilateral trade balance in manufacturing with developing countries. The data leave little doubt that there is massive structural change underway. The debt crisis accounts for some, but most of the change reflects the extraordinary manufacturing performance in Asia.

Table 2
U.S. Manufacturing Trade with Developing Countries
(in Billions of $)

	Exports	Imports	Balance
1981	67.3	39.1	28.4
1988	78.0	108.8	−30.8

Source: U.S. Department of Commerce, ***Highlights*** of ***Foreign Trade***

Just as price comparisons, wage-based PPP is misleading. Consider the data in Table 3 on hourly compensation measured in U.S. dollars. On the surface, the United States, at current exchange rates, is a low wage country compared to Germany. In that perspective, the dollar has gone far enough. But two adjustments are essential: what is labor productivity and what is produced. On the second point, Germany produces high value added, upper level products (BMWs, Mercedes, and so forth), whereas the United States produces a much less desirable range of goods. The high German wage is justified by the fact that workers sell differentiated products that can command rents in a way that U.S. firms today cannot rival. Thus the U.S wage

may well be too high, considering what U.S. workers produce today. It is true, foreign direct investment here may change that, but for the time being, wage comparisons are not enough.

Table 3
Hourly, Compensation in Manufacturing
(1988 Wage in U.S. $, Index U.S. = 100)

United States	100	Korea	18
Germany	130	Taiwan	19
Italy	93	Hong Kong	17
Japan	95	Singapore	19
France	93	Mexico*	12
United Kingdom	76	Brazil*	11
Spain	63		

*1987 data

Adjustment for productivity is shown in Table 4. The productivity adjustment leaves the impression of a very favorable development for U.S. labor costs over the past decade. But once again, the question must be asked about what is being produced.

Table 4
Unit Labor Costs in Dollars
(Index 1977=100)

	United States	Germany	Japan	Korea
1970	71	43	59	53
1977	100	100	100	100
1980	131	150	117	146
1985	143	101	107	130
1988	142	180	188	158

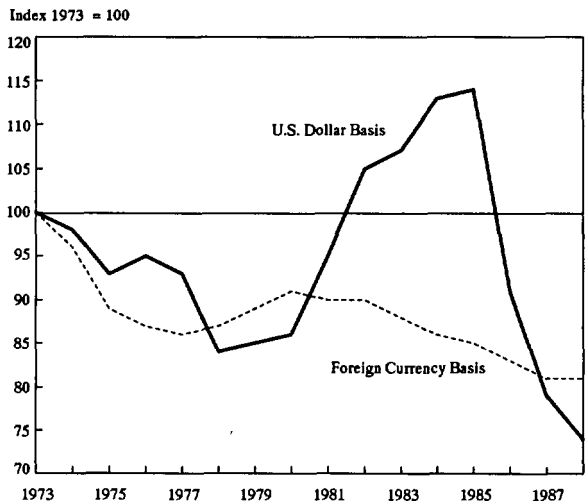
Source: U.S. Department of Labor

Data such as those shown in Table 4 have been used to argue that

the United States has had a substantial improvement in competitiveness. Chart 4 (from the U.S. Bureau of Labor Statistics) tries to makes that point.

Chart 4

United States Manufacturing Unit Labor Costs Relative to 11 Competitors, 1973 - 88



The measurement of productivity includes adjustment for quality. In the United States, these adjustments are sophisticated and overstated. When that consideration is taken into account, most of the U.S. superior productivity performance in the 1980s vanishes and with that also, the foundation for arguing that U.S. relative cost performance has been strong. If we add the fact that there may have been a large change in the relative demand for foreign-type goods (based on characteristics and learning) the argument is further weakened.

All this suggests that a much closer scrutiny of the data is required. One simple possibility is that the mix of products has shifted over the years, and the mix of demand. Even at a very high value of the deutsche mark or the yen, their goods continue to be sold. On that interpretation, imbalances must be corrected by expenditure changes combined with real exchange rate changes that assure a market for U.S. goods that do not sell well even when they are relatively cheap.

PPP and full employment

The preceding discussion has turned on whether the dollar is over or undervalued; all participants in the debate, at least implicitly, accept that market valuation can depart from the equilibrium rate. The difference in view, therefore, is primarily a difference of the equilibrium different observers have in mind and a difference as to what role the exchange rate is to play.

For McKinnon and Ohno, the PPP exchange rate view is a policy prescription as to the level at which the dollar should be fixed once and for all. Monetary policy is then charged with defending the chosen parities by appropriate rates of credit expansion, and fiscal policy looks after balanced trade. In this assignment, there is no policy variable that assures full employment! Specifically, in the current U.S. context, a tightening of money (resulting in dollar appreciation) combined with fiscal tightening might balance trade, although that is not clear, but the combination would definitely create unemployment. In this sense, the McKinnon-Ohno recommendation would seem a questionable policy. To see a more complete picture, we have to look at the transfer issue.

Transfers and real exchange rates

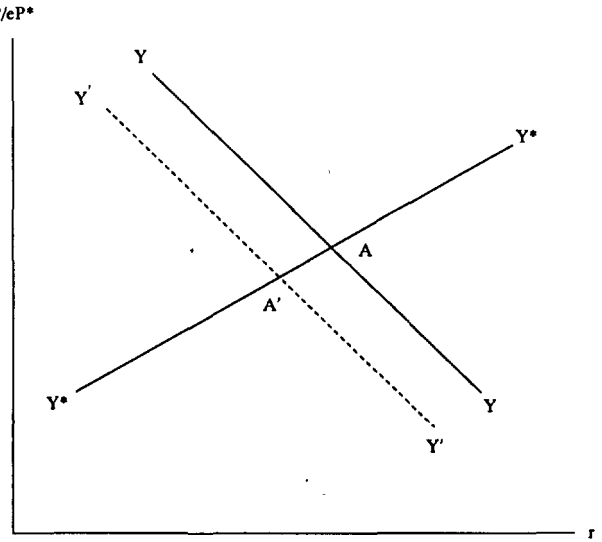
Consider now a simple two-country model where excess demand in each country (at full employment) depends on the real interest rate, the real exchange rate, and on fiscal policy:

(1) $Y(R,r,f)=0$

(2) $Y^*(R,r,f^*)=0$

where $R = P/eP^*$ is the real exchange rate, r the real interest rate and f and f^* denote a measure of the structural fiscal posture. It is assumed that home real depreciation increases demand for domestic output and reduces demand for foreign goods while higher real interest rates reduce demand in each country. Figure 1 shows the internal balance schedules YY for the home country and Y^*Y^* for the rest of the world. Point A represents the initial full employment equilibrium.

Figure 1



A restrictive fiscal policy at home will create an excess supply and therefore requires, for full employment, either layered real interest rates or a real depreciation. This is shown by the shift of the home country's internal balance schedule down and to the left to Y'Y'. In the new full employment equilibrium at A' both countries' goods markets are, once again, in balance.

The transfer exercise has two important lessons to offer. The first is negative: under current fiscal policy, an easy money policy in the United States and resulting real depreciation from A to a point like A' is undesirable. Abroad, it would leave employment unchanged as the U.S. gain in competitiveness and trade deficit reduction is offset by higher investment spending, (that is, we move along Y*Y*). But in the United States, because fiscal policy has not changed, both real depreciation and lower real interest rates are expansionary. As a result there will be excess demand for goods and inflation. Thus calling for a lower dollar via easy money (or even at an unchanged real interest rate, if that were possible) is poor policy. advice.

The second important lesson is that when and if fiscal policy in the U.S. is contracting, the resulting slack needs to be corrected by a combination of lower world real interest rates and by a real depreciation of the dollar. The view that fiscal correction can be achieved

at full employment without any change in competitiveness is difficult to understand? .

What level for the dollar?

If the argument is accepted that U.S fiscal correction will take place, and that U.S. full employment is desirable and that real exchange rate adjustments are required to accommodate the change, how much must the dollar fall? The extent of dollar decline depends on three factors. A first element is the extent to which foreign direct investment in the United States will create demand for U.S. labor. The higher direct investment, the less real depreciation is required. Of course, in making that statement it is assumed that direct investment replaces, at least in significant part, imports rather than other domestic production.

The second qualification comes from the direction of market access. Today markets in many developing countries and, of course in Japan, are closed to U.S. exports. If market opening policies are successful then this is, of course, a preferred alternative to real depreciation. It creates demand for U.S. goods and services and hence, for U.S. labor. As a result, it would help accommodate a restrictive fiscal policy in the U.S.[7]

A third qualification concerns currency blocs. Relative to which currencies can the dollar depreciate? There is little prospect of increased lending to Latin America and as a result, that bloc will stay with the dollar and so will Canada. That leaves only half or less of U.S. trade to be affected by currency depreciation. The real depreciation relative to these trading partners—Japan and Europe—will have to be substantially larger so that the average comes out right. If a 15 percent real depreciation of the dollar is required to yield full employment after fiscal tightening, then 30 percent relative to the yen and the deutsche mark will be appropriate. Moreover, with ongoing inflation differentials of 3-4 percent (reinforced by the direc-

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6 I believe Ohno (1989) argues that U.S. home goods prices might decline even through relative traded goods prices remain unchanged. That raises the question of why internal deflation should be preferred to exchange rate movements.

7 Some caution must be taken about what happens to the resources released abroad by the market opening. It is assumed that they are directed to meeting the increase in real demand that results from the real income gain abroad.

tion of exchange rate trends) there is an extra 15 percent depreciation just to keep real exchange rates constant over a five-to-six-year horizon. The combination, without much strain, leads to the conclusion that the dollar-yen exchange rate will have to move upward of 45 percent in the next few years.

What will assure that the rate, in fact, moves the required amount? If monetary policy is devoted to full employment and fiscal policy to balancing the budget, then rates will fall as easy money accommodates fiscal tightening. The only risk is that fiscal policy balances the budget and monetary policy is overconscious of inflation. In that case, the dollar could remain overpriced and unemployment would be the certain result. Ireland in the 1980s offers a striking example of this inappropriate policy mix.

Crowding in and intermediation

An important question in the context of U.S. fiscal adjustment in the coming years is how it will affect the external balance. Will budget cuts translate into trade improvement or into increased domestic investment? Our standard answer would be that capital markets are integrated internationally and that real interest rates cannot move far apart internationally over any significant period of time. This leads to the conclusion that real exchange rate changes would have to do at least part, and perhaps most, of the crowding-in of demand. An entirely different view on this subject has been developed by Feldstein.[8]

Feldstein and Horioka discovered a surprisingly tight link between national saving and investment rates. This is shown in Chart 5 for the 26-year averages for industrialized countries. The finding says that if a country increases its saving rate, then (on average) its investment rate will rise by a significant portion of the increase in saving. In other words, increased savings are retained nationally; they do not flow out into the world capital market. On latest estimates, three-quarters of the increase in saving would be retained in higher investment and only one-third would flow out. That implies U.S. budget cutting has only minor current account effects and primarily raises investment.

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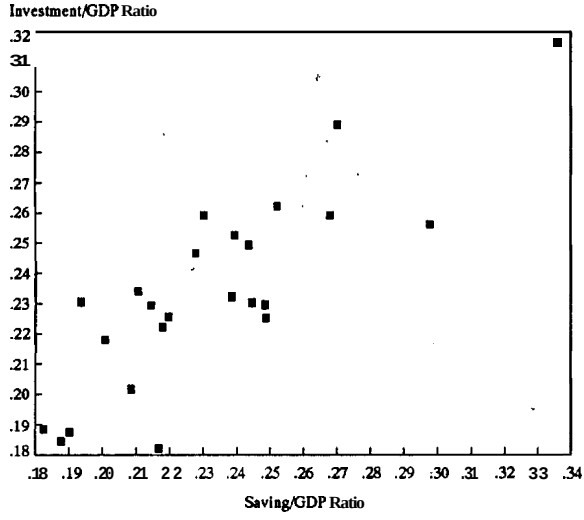
8 See Feldstein (1983), and Dooley and others (1987).

Chart 5

'Investment and Saving 1950 - 1986 Averages for 23 OECD Members



At question today is the interpretation of the strong saving-investment correlation. The most plausible story is that capital markets work on two levels: there is a wholesale market which is intensely integrated at the international level and a retail market which has few, if any, linkages. A good example might be the U.S. housing market. In the 1960s, U.S. housing was dominantly intermediated by ***local*** saving and loan institutions which attracted ***local*** deposits and made ***local*** housing loans. This housing finance was virtually nontraded. Today, housing loans are administered by local financial institutions, but the homogeneous claims are traded nationally, packaged for the wholesale market. As a result of the deregulation, saving from anywhere can go to housing investment anywhere.

Thus the Feldstein finding may well tell us that a central feature of the world capital market is its extreme segmentation. This is, of course, a very striking suggestion since all casual evidence points in exactly the other direction: intense speculation across borders at the slightest sign of capital gains. But the housing example is useful because it is clear that in the U.S. capital market of the 1970s, non-traded mortgages coexisted with a highly efficient wholesale market.

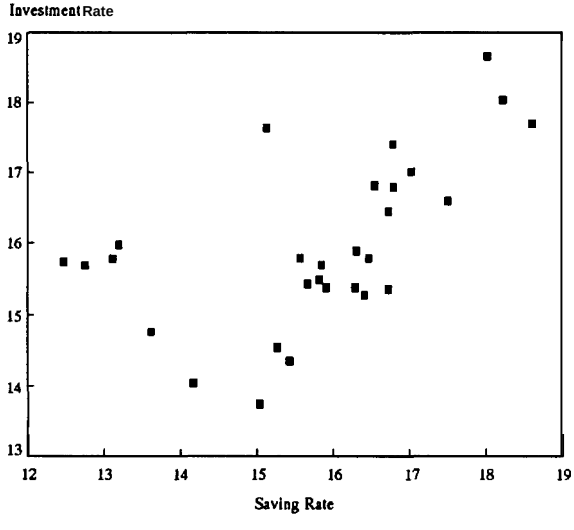
If the Feldstein finding reflects primarily nontraded credit there is another striking implication: financial deregulation and competition will give low saving countries access to the saving pool of high saving regions. As a result, the world economy will operate more in allocating credit by interest rates and world credit rating and less by local availability.

Chart 6 shows the U.S. saving and investment rates in the 1960-86 period. The black dots refer to the 1980s. We note the striking discrepancy between the 1980s (marked as black dots) and the earlier period. It is clear that the general positive correlation observed in the period averages in 1960-86 broke down in the United States in recent years. Current account deficits have become large as the decline in the national saving rate was not matched by a corresponding decline in the investment rate.

It is interesting to speculate whether this new development reflects a worldwide breaking down of reluctance to cross-border lending or whether it is peculiar to the U.S. case. The latter could be argued if foreign investors care which country they finance. It may make a difference whether the decline in saving occurs in a large country

Chart 6

United States Saving and Investment Rates Percent of GNP



with a developed financial market or in a small country with little scope for uncomplicated cross-border investment. Moreover,.it may make an important difference whether the decline in saving arises in the private sector or in the public sector. With a developed market in government debt there may be scope for easy cross-border financing while a decline in private saving may require more complicated intermediation.

More thorough going financial integration may be removing the strong positive correlation of saving and investment that used to be the rule. Perhaps, in the tradition of Goodhart's rule, the Feldstein regularity disappears just as it is firmly established. In the U.S. case, European and Japanese saving are finding their way into the U.S. capital market as large institutional investors start looking at world outlets for their local saving pool.

In the context of Europe 1992, financial integration will have a major bearing on saving-investment relations. There will be a leveling effect introduced so that high saving countries may retain much less of their saving. If imperfect international capital mobility is, in fact, the basis for the observed correlations, we would expect more organizations to develop means of overcoming the risks that stand in the way of capital flows. It may be risky to borrow for 30 years in dollars in the United States in order to make yen loans in Japan. But multinational corporations who operate in multiple markets are natural agents for diversifying away the 'risks and thus exploit cost of capital differences. Direct foreign investment, which is becoming very sizable, may then be a reflection of the cost of capital differentials arising from cross-border reluctance of portfolio capital flows.

We noted above that for the United States in the 1980s the saving-investment correlation seems to be diverging from the traditional pattern. The two complementary interpretations are that the saving reduction was due, in part, to budget deficits and hence, more easily financed in the world market and that the United States was increasingly deregulating the nontraded credit market. As a result, low saving has translated increasingly into deficits rather than local crowding out. By implication, crowding in will not be the automatic counterpart of increased public sector saving. .Hence, once again, real exchange rate changes will be necessary.

The other implication of this analysis is to recognize that domestic

financial deregulation will increasingly affect the domestic vs. external crowding out induced by budget deficits. Specifically, if the Japanese saving rate falls, in a deregulated financial setting, a relatively large external balance effect could be expected. Is that sufficient comfort to expect that the Japanese surplus is self-liquidating? We argue in the next section that this is not the case.

New world economic blocs

U.S. fiscal adjustment over the next few years is not the most important determinant of dollar prospects and of the role of the United States in the world economy. The more decisive development is that the United States will become "smaller"—the emergence of an Asian co-prosperity area and Europe 1992 offer the prospect of two large, competing blocs that are inward looking, with a tight internal exchange rate link. These areas are bad news for U.S. trade prospects, and they create for the first time, serious competition for the dollar as an international asset.

The Japan problem

Japanese external capital flows have macroeconomic, microeconomic, and political implications. The macroeconomics keep the dollar overly strong and postpone adjustment; the microeconomics run the other way, financing U.S restructuring of U.S. industry and thus, lessening the need for even more massive dollar realignment. The political implications are plain: Japan will want to buy a front seat at the negotiating table of world politics. It is difficult to decide which is the more lasting, decisive, and divisive factor.

There are three major scenarios for international capital flows. First, a major U.S. adjustment of the national saving rate and as a result, (with the help of dollar depreciation) an end to the U.S. deficit. Second, the formation of three relatively closed trade and financial blocs; one would be centered in Asia around Japan, one in an enlarged Europe driven by Europe 1992 and the irresistible integration tendencies this forces on adjacent countries, and the third built around the United States. Finally, there is the alternative of a drop in Japanese saving rates and a phasing out of Japan's external surpluses.

Is all this temporary? A good starting point is an assessment of

the changing pattern of net foreign assets: the United States is rapidly becoming a large net debtor; Japan is on the other side of the swing, acquiring an increasingly large piece of the world economy. Estimates by the International Monetary Fund report the massive change in net foreign investment positions, including portfolio investment as well as direct foreign investment. (See, too, Chart 7.)

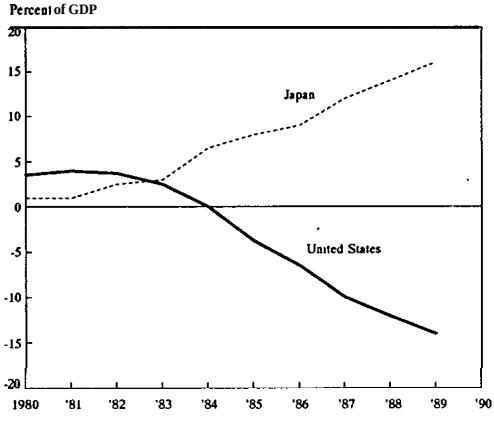
Table 5
Net External Assets
(in Billions of $)

	1982	1989
Canada	−107	−172
United States	126	−710
Japan	24	419
France	−12	−10
Germany	27	233
Italy	−21	−37
United Kingdom	56	143

Note: These data include not only the net position in government ddbt, but also private portfolio and direct investment.
Source: IMF *World Economic Outlook*

Chart 7

Net External Assets



The question today is whether we must extrapolate these trends into an ever widening U.S. net debtor status and an ever increasing Japanese accumulation of claims and assets from Hawaii to Detroit, from Manila to Seoul. The immediate instinct ought to be a memory of the 1970s. At that time, many observers predicted that by the early 1990s the oil producing countries of the Middle East would own not only London and New York but most of the world. The oil producers have disappeared as an economic force as fast as they came on the scene; will the same happen with Japan?

The Japanese role in world trade and payments, unlike that of Saudi Arabia, is irreversibly on the rise. The ascent of Japan is built not on the throw of a dice in commodity markets (or even more fragile, on a cartel), but rather on the firm foundations of a massive accumulation of human capital, progress in manufacturing, and an extraordinary closed system that protects the gains from progress against sharing with other countries. It is conceivable that the Japanese miracle might be brought down—the most obvious way is if world competition is forced onto the Japanese domestic distribution system, on land pricing, and on the fantastically inefficient agriculture. But that is not about to happen, even with Super 301 action by the United States. Japan simply will not push all the way the measures that would bring down the high Japanese saving rate.

Table 6
Gross National Saving Rates
(Percent of GNP/GDP)

	1960-79	1980-86
United States	19.8	17.1
Japan	34.4	31.0
Europe	24.5	20.8

Source: OECD *Historical Statistics*

There will, no doubt, be some internationalization of the Japanese economy, but there is little chance that the Japanese model will fall apart. Those who see cracks in the Japan, Inc. model are overly optimistic; the central fact remains that Japan is a closed, insular economy that is looking backward to the memories of vulnerability in the 1930s (however imagined), the aftermath of the oil crises, and

the Nixon commodity shocks. Such an economy does not embrace full-scale economic revolution, throwing out the structure that has protected the economy and society in the last few decades.

The reality, then, is a continuing high rate of Japanese saving and, as a counterpart, growth of Japanese acquisition of assets worldwide. But if that is the case, in which directions will Japan expand?

US. Adjustment? So far, there is no friction; the United States has large deficits and low private saving and Japan provides the matching finance. The United States has strong demand and overspends and Japan delivers both the goods and the finance. U.S. deficits thus appear an almost essential counterpart to the Japanese surpluses. Can one exist without the other? What happens if the United States adjusts?

Today the United States saves less than in any previous decade and the prominent budget deficit is only half the bad news. More disturbing is the extraordinarily low private saving rate. We do not even know why net private saving has declined from 7.6 percent of GNP in 1950-79 to only 5.6 percent in the 1980s. The reasons for low private saving are poorly understood and therefore, there is little reason to believe that anything will change. And public policy in the form of incentives is a poor way to help out; private saving would rise, but this would come at the cost of a more-than-offsetting increase in the budget deficit. The brunt of the adjustment will, therefore, have to come from budget correction.

The most plausible scenario involves a major, early U.S. adjustment in the budget. It is not difficult economically to achieve the higher saving; the difficulty is "only" on the political side. Economically, the adjustment is not difficult because taxation is broad-based and tax administration is highly efficient. As a result, taxation produces very little disincentives. At low marginal tax rates there is little disincentive from taxation on work effort, saving or investment and only a very moderate rise in marginal rates would suffice to balance the budget. The introduction of a 5 percent value added tax would accomplish the same even better. But, of course, the politics is not easy. ("Read my lips"!) The consensus is that it will take a crisis to change the nation's attitude and perhaps a major dollar collapse might be the trigger for more responsible policy. Until further notice, the United States will, therefore, borrow and that means Japan, or someone else, will lend.

But when budget adjustment does take place we would need

crowding in: at that time lower interest rates and a sharply lower dollar would close the external gap and with it the need for external borrowing. With the United States disappearing as a borrower in world capital markets Japan's net lending would have to go elsewhere, whether it be Asia or Latin America. Of course, balanced trade accounts for the United States would not mean an end to Japanese direct foreign investment. On the contrary, the lower the dollar the larger the incentive for Japanese firms to use the United States as a workshop with cheap labor.

Japan with ***balanced trade?*** There is a second scenario where Japan spends rather than lends, with trade balanced and net foreign assets steady rather than rising. This would take a drop in the high Japanese saving rate. In time, it will happen. Demographic trends make for a much more rapid aging in Japan than in other OECD countries and the aging will involve more spending, less saving.

Table 7
Changing Age Structure in OECD Countries
(Percent of Population Age ***65*** and Over)

	Japan	United States	Germany	OECD
1980	9.1	11.3	15.5	12.2
2000	15.2	12.2	17.1	13.9
2020	20.9	16.2	21.7	17.9

Source: OECD

But, as the table shows, the demographic factors will take three decades to come fully into operation. That is far too distant to be of comfort today. The reality of the moment is too large and concentrated surpluses, too much visibility of Japanese capital. Japan will have to look for almost bottomless opportunities of investment for the next three decades. The United States will not be the major borrower for long, nor will Europe. Asia and Latin America are plausible for direct investment although it is difficult to see a scale of tens of billions of dollars. After all, all of Latin America has a deficit on goods and services of less than **$20** billion!

Japan go home. Another scenario is outright disturbing and unattractive. This scenario is one where Japan's success and increasing visibility leads to a political backlash worldwide which, in turn, drives Japan into a retreat, consolidating her position in Asia.

It is no secret that there is a worldwide resentment against Japan. Among the reasons is the perception of a very closed Japanese society, apparent lack of a genuine and sincere interest in progress of the world economy, and the sheer envy for Japan's success. Japan has done little or nothing to dampen this growing problem: promises of development capital for Latin America have not come off and cooperation in the Brady Plan, for example, has shrunk to little. Japan suffers the ambiguity of having been a free rider too long, inexperienced and shy, yet tempted to play a big-time role. Japan is an outsider in the western world and just as she herself cannot make up her mind to play the game full out, the major industrialized countries and their electorates cannot get accustomed to treating Japan other than as a very distant, very rich relative who shows up at a family gathering mostly unwelcome and uninvited. The rich uncle from America was naive and jovial; the rich Japanese relative does not fit in.

There is resentment and there is insecurity and fear in America because the United States is no longer #1. All this will find its way into commercial policy and the regulation of direct foreign investment before long. Debtor countries in Europe and Latin America have endlessly paraded the signs saying "Yankee Go Home;" how long will it take before we see "Japan Go Home" in the streets of industrialized countries? There is a genuine ambivalence about foreign direct investment—it does create jobs and is far better than the alternative of imports, but it does bring in a foreign landlord. Foreign direct investment fosters productive change, but it evokes from those who must change and adapt, a reaction of hostility all the more irrational, the easier the focus on the "foreign" takeover.

World politics will, in the end, set the pattern for trade and payments flows. The United States is, of course, #1, but no longer strong or determined enough to provide the leadership for the world economy. Japan is clearly far too small to assume the top position and it certainly is entirely unacceptable that Japan dominate the industrialized countries' world. Germany and Britain have traded places and France, de facto, has slipped below Italy, but there is no room at the top for Japan. Neither the United States nor the emerging European bloc

would accept Japan at the top. The clear implication is a tri-polar world.

Japan will be driven to develop her own trade and finance zone in Asia. Japan is a high saving country, in part for demographic reasons, and the investment opportunities in Japan are falling short of saving potential. Capital export, therefore, is inevitable. In the past, the chief concentration of Japanese assets was in securities and direct investment in the United States. This will not stop, but a deteriorating climate will make Japan focus increasingly on alternative markets. It is difficult to avoid the conclusion that Japan's energies will increasingly focus on developing the Asian region rather than trying to own and operate Wall Street.

The way Japan, *Inc.* operates also facilitates the formation of an Asian co-prosperity zone: government and business work hand-in-glove and business moves jointly. They move together as a group, because they are so keenly aware of vulnerability on their own. The decision will be made by consensus, and the rest is routine.

The Asian co-prosperity scheme is the most likely option for Japan. But also, Japan might look to Russia as a new and major market. One is drawn to the conclusion that Japan will look for a much more substantial, extraordinary market for Japanese money, technology, and capital goods.

The link between money and politics is almost inevitable. At stake is not whether Japan gets a seat on the United Nations Security Council or the position of managing director at the International Monetary Fund. Japan's massive saving rates of the next three decades (and the lack of economic motivation in the United States) will force a change in world politics. It is likely to go beyond trade and finance zones; because Japan is involved and Japan is different, it cannot be business as usual. The post-World War II status quo will go.

Just as apparent as the Japanese co-prosperity is the development of an inward-looking Europe. The very idea of Europe 1992 has turned the area from Euro-sclerosis to Euro-phoria. Where a few years ago policymakers did not know how to cope with the prospect of dismal growth, today's growth is of the best kind—generated by animal spirits.

An important part of the new Europe is a strong commitment to negligible inflation. The convergence to German inflation has been substantially achieved and is credited with the return to growth. It is very unlikely that this success would be easily jettisoned. Fixed

exchange rates are now the rule as is apparent from the heroic Spanish entry into the Emns, without devaluation at a conspicuously overvalued exchange rate. European exchange rate arrangements were invented to fight more effectively the lack of symmetry in the international adjustment process. In the end, they have become a formidable detriment to U.S. policy interests.

At the present time, significant risk premia continue to prevail for softer currency countries. Given the commitment to fixed rates, and less than full credibility, these countries experience high real interest rates and hence high growth rates of their internal debts. Increasingly, these countries will strive to make their currency commitments harder. Thus Europe is moving effectively toward a single currency. The intra-European removal of all and any restraints on capital flows and the freedom to provide financial services across borders complements the fixed rates in creating a single financial bloc.

For the dollar, the intra-European trade integration and the financial integration cannot be seen as other than as bad news. The trade integration is already provoking defense investment by U.S. firms inside Europe with adverse consequences for U.S. located production. Financial integration abroad undermines the dollar as a world currency. The combination certainly reinforces the dollar decline that is already required by the current imbalance.

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