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The U.S. Payments Deficit and the Strong Dollar: Policy Options

Richard N. Cooper

In 1984 the United States ran a current account deficit of $102 billion, seven times larger than the "alarming" deficit of 1978. The United States had to borrow from foreigners an equivalent amount, net of any American investment abroad.

This large deficit can be attributed in part to the fact that the U.S. economy was recovering earlier and more vigorously from the 1982 recession than were other countries, especially those in Europe, and in part to the fact that one of its most important regional markets, Latin America, was still in a period of slump and retrenchment from the debt crisis that started in 1982 and continues. But there is fairly general agreement with Federal Reserve Governor Henry Wallich's recent statement that these and other miscellaneous factors can only account for about one-third of the deficit, and that the exceptionally strong dollar is responsible for about two-thirds.

The U.S. dollar, on a U.S.-trade weighted basis and after correcting for inflation differentials, has appreciated about 40 percent since 1980, a year which already saw substantial appreciation from the low year of 1978. The dollar in mid-1985 is considerably stronger (on a trade-weighted basis) than it was in 1970, before the Smithsonian agreement that devalued the dollar in December 1971.

Is this a problem? U.S. employment has risen, U.S. inflation rates have dropped, and economic recovery continues, albeit at a moderate pace. If the course of economic events is going well, why should the government alter the course of economic policy? If there are no problems, there is no need for solutions.

There are two difficulties with this insouciance. The first is that the strong dollar is hurting badly those sectors of the economy that are most exposed to foreign competition, whether at home or abroad. Much of the manufacturing sector is feeling very strong competition, which has depressed manufacturing output even while the economy is growing. Manufacturing output has remained virtually unchanged since the spring of 1984, for instance, despite

rapid (12 percent) growth in the defense industries and a continued growth in demand for manufactured goods, which was satisfied mainly by a ten to 15 percent growth in imports of manufactured goods. Mining output declined. Marketing receipts to farmers continued to stagnate (but net farm income was up sharply from 1983 thanks to government support) as agricultural exports remained below levels reached in 1980 and 1981.

Stagnation in these industries even while the economy is doing reasonably well evokes strong pressures for protection against imports or, as in the case of farmers, pressures for aggressive export promotion and retaliation against those who are or seem to be restricting agricultural imports from the United States. Protectionist pressure in the United States are now stronger than they have been since 1970-71, which ultimately led to the Nixon-Connally import surcharge and a depreciation of the dollar. The sentiments attract broad congressional support not only on the basis of constituency politics, but also because of a feeling that America's future technological bases and its national security are threatened by a decline of such manufacturing activities as steel, machine tools, heavy equipment, and so on. So a consequence of a continued strong dollar may be introduction of many specific import restrictions and possibly even, through emulation abroad, a breakdown in the liberal international trading system, as happened after U.S. adoption of the Hawley-Smoot tariff in 1930.

A second difficulty with current circumstances is that the United States is rapidly building up external debts — at an annual rate that exceeds the *total* external debts of such large debtors as Brazil and Mexico. On Commerce Department figures (which are however subject to large margins of error) the United States in 1985 will become a net external debtor for the first time since 1914. The build-up of external debt imposes a burden on future generations. If the counterpart of the debt were being productively invested in the United States, that would be no problem; future Americans and foreign lenders would both be better off. But as will be made clear below, exceptional external borrowing has not been accompanied by exceptional domestic investment; on the contrary, investment has followed a fairly typical cyclical path. Even if the external debt itself is not repaid, it will have to be serviced out of future income that has not been augmented. Sooner or later a worsening of the U.S. terms of trade will be required to generate the necessary improvement in net exports. So future generations will not be able to enjoy all of their contemporary production. Moreover, given that social security payments are fully indexed to the consumer price index, the burden of this worsening terms of trade, as of servicing the debt directly, will fall mainly on wage-earners, just when they are also being asked to support a growing population of the aged.

So for both these reasons—a threat to the liberal trading system and an unwarranted additional burden being transferred to future generations—the

present configuration of the U.S. economy with its large external trade deficit in goods and services cannot be considered satisfactory. This is so even without mentioning the anomoly, from a global point of view, of a capital-rich nation such as the United States being the world's largest borrower.

Why is the dollar so strong? There is wide agreement that the main explanation is a torrent of foreign investment in the United States, along with some decline in U.S. investment abroad; with flexible exchange rates this flow of funds pushes up the value of the dollar. Three broad, non-competing explanations in turn are given for the inflow of foreign funds. The first focuses on the United States as a political safe haven relative to other leading countries. This explanation might support an outflow from newly socialist France in 1981, or from a Germany stricken with Polish jitters at about the same time. But it hardly can explain a flow of funds from Britain, with its most pro-business government in memory, or from staid, politically conservative Japan.

A second explanation focuses on the "dollar" as a financial asset, and suggests that it has been subject to a psychological "bubble," whereby expectations of a further rise feed on themselves as funds flow in and make the expectations correct. I believe there have been periods when this factor has operated, especially in late 1984 and early 1985, but it cannot begin to explain the sustained rise since 1981 (Frankel, 1985.)

A third factor is interest rates and other yields in the United States, relative to those abroad. Dollar interest rates have been consistently higher than those on comparable DM, yen, and Swiss franc securities (but not those denominated in British pounds or French francs) since 1980. For example, in 1984 the yield on three-month Euro-dollar deposits was 10.9 percent, whereas Euro-yen deposits yielded 6.3 percent and Euro-DM deposits yielded 5.7 percent. Substantial yield differentials in favor of the dollar existed on long-term securities and on equities as well, although most of the foreign funds have gone toward the purchase of fixed interest securities rather than equity.

If the main factor behind the strong dollar and the U.S. trade deficit is high yields on dollar securities, then attention must turn to why those yields have been so high, both relative to some key foreign yields and relative to past U.S. history. Two explanations, both of which undoubtedly have some merit for long-term bonds, concern expectations about higher inflation and uncertainty about future inflation rates. High inflation would raise interest rates, and a higher expected inflation in the future would help explain why long-term rates are higher than short-term rates. Moreover, uncertainty about future inflation, and possible future movements in bond prices, would tend to raise bond yields relative to historical levels. But these two yield-raising factors would hardly recommend U.S. fixed interest securities to foreigners, unless on average they have a more favorable view with respect

to future U.S. inflation, and uncertainty about future inflation, than American investors do.

A third factor that could help explain high U.S. interest rates in the last several years is the tax legislation of 1981 as partially corrected in 1982, which made investment much more attractive because of enlarged investment tax credits and more rapid depreciation of assets for tax purposes. An investment boom would have put upward pressure on interest rates. In fact, investment slumped severely in 1982-83, but picked up strongly in 1984. Table 1 shows that profits after taxes per unit of output of all U.S. non-financial corporations rose by 88 percent between 1978 and 1984, both boom years, even though profits before taxes (per unit of output) rose only 43 percent, as did the largest component of costs, compensation of employees. Looked at another way, profits after taxes rose from 5.6 to 7.6 percent of (value-added) sales during this period, even though profits before taxes declined slightly. If U.S. non-financial corporations have a capital-output ratio of about two, the tax changes in the early 1980s raised the after-tax rate of return to total installed capital in the non-financial corporate sector by about one percentage point between these two boom years.

Despite the higher after-tax rate of return, for the economy as a whole gross domestic investment, at 17.4 percent of GNP, was no stronger in 1984 than it has been in other boom years such as 1979 or 1973, and was modestly lower than the 17.9 percent it reached in 1978. The best one can say is that the favorable tax provisions offset the negative impact of high interest rate on overall investment, and that interest rates might have been lower if investment had been lower. But the point to note here is that 1984 did not see

TABLE 1

Output, Costs, and Projects
U.S. Nonfinancial Corporate Business

	1978	1984	Percent change, 1978-84
Value-added (GDP basis, $bn)	1276	2153	69
Value-added in billion of 1972 dollars	846	977	15
Cost plus profits per unit of output	100.0	100.0	46
Compensation (%)	66.2	64.7	43
Profits (%)	11.1	10.9	43
Profits after tax (%)	5.6	7.6	88

Note: Data here are calculated with adjustments for inventory valuation and capital consumption, i.e. they are calculated as in the GNP accounts rather than in accordance with the tax laws.

Source: *Economic Indicators.*

unusual amounts of investment for a year of vigorous economic activity.

What was unusual for a year of vigorous economic activity was the size of the budget deficit. Budget deficits typically rise in recession, such as 1982; but they typically decline during recovery. The U.S. federal budget deficit, in contrast, has stayed just under $200 billion during 2-½ years of recovery. Legislated tax reductions have offset part of the normal recovery of revenue, and increases in defense spending have more than offset the reductions in non-defense spending. Moreover, a Presidential-Congressional impass has prevented serious steps to reduce the budget deficit in the future, thus offering the prospect of continuing large deficits with the resultant upward pressure on long-term interest rates. At 3.4 percent of GNP in 1984, the government deficit (federal, state and local) absorbed that much private U.S. savings, which did not leave enough left over to finance domestic investment, despite the fact that at 18.4 percent of GNP private (including corporate) savings was exceptionally high during 1984. As a result of the discrepancy, savings had to be imported from abroad, i.e., the United States became a net importer of goods and services. The heavy demands of the federal government, added to those of private investors, pushed up U.S. interest rates. Without the inflow of foreign capital, they would have gone even higher.

A final factor, in my judgment, bears considerable responsibility for high U.S. interest rates. That is the extraordinarily tight monetary policy the United States has had during the past six years. There is considerable controversy over exactly how monetary "tightness" or "ease" should be measured. I start from the theoretical observation that the real short-term rate of interest on an asset free of default risk should be close to zero in a period of deep recession, with high unemployment and excess capacity. Time preference under such circumstances should drop to zero; there is no reason to defer expenditures to the future, since there is no limitation on current production. And so it has been in previous recessions, or even negative (Table 2). But during 1982 the real short-term rate of interest on Treasury bills was over four percent even after monetary policy eased in mid-year and interest rates on low-risk assets fell sharply (to eight percent on Treasury bills) following the Mexican debt crisis. Corporate demands for external funds dropped sharply in 1982, by more than the increase in government borrowing requirements. Such high interest rates during a deep recession can only be explained by tight monetary policy, and could have been avoided if monetary expansion had been greater.[1]

[1] **In principle interest rates should be calculated on an after tax basis both to borrowers and lenders, which is a complicated and uncertain exercise for any particular interest rate. Suffice it to say that few holders of Treasury bills were in a marginal tax bracket of 50 percent, which is what would have been required to lower real after-tax Treasury bill rates to zero in late 1982, and even higher tax rates earlier in the year.**

TABLE 2

Nominal and Real Short-Term Interest Rates

	3-month Treasury bill rate	Dec.-Dec. Change in Consumer Price Index	Real short-term interest rate
		(percent, annual rates)	
1958	1.8	1.8	0.0
1960	2.9	1.5	1.4
1970	6.5	5.5	0.9
1975	5.8	7.0	-1.1
1981	14.0	8.9	4.7
1982	10.7	3.9	6.5
1983	8.6	3.8	4.6
1984	9.6	4.0	5.4
1985*	8.0	3.7	4.1

* First five *months.*

Source: Economic Report of the President: Economic Indicators.

The Fed was understandably reluctant to engage in greater expansion for fear sf rekindling inflationary expectations, even in a deep recession. But the presence of that dilemma does not gainsay the role of tight money in maintaining high short-term U.S. interest rates. The determinants of long-term interest rates are much more complicated, since unlike short-term rates they reflect not only non-observable expectations about inflation rates some years in the future, but as noted above they also reflect uncertainty about bond prices which presumably get reflected as a risk premium in current long-term interest rates. Moreover, long-term rates also presumably reflect expectations about future long-term borrowing (e.g. future budget deficits) relative to the size of the economy. But long-term rates must also reflect current short-term interest rates as well, since (given the uncertainties described) a premium presumably has to be paid in normal times—and especially in times of economic slack--to encourage lenders to lend at long rather than at short-term. So, in general, the higher are short-term rates, the higher long-term rates will be. So once again more responsibility for high interest rates belongs to the Fed than it or others have been willing to acknowledge.

Making a judgment about monetary policy in 1985 is more difficult than for 1982, a year of deep recession. But the American economy still has considerable slack (capacity utilization rates are only 81 percent in manufacturing, and according to OECD estimates the U.S. economy is still operating about five percent below its GNP potential). Real short-term interest rates remained above four percent in the first half of the year despite lower-than-capacity growth, compared with a putative riskless real long-term rate of

interest of around three percent throughout the nineteenth century. Has the rate of time preference, and the real rate of return to capital, increased markedly in recent years? We do not know the answer to that question, except inferentially. As noted above, the 1981-82 tax changes perhaps raised the average after-tax rate of return to capital in the corporate sector by about one percentage point, consequential but not huge. I would judge that monetary policy has been tight since 1982 as well as during 1982.

There has been reason for tight money: to squeeze inflation out of the American economy. Judgments will differ about whether the Fed has applied just the right dose, both in timing and in magnitude. But one lesson of the experience of the early 1980s is that the *modus operandi* of monetary policy in a regime of flexible exchange rates and high international mobility of capital differs substantially from the way it used to affect the economy. Now tight monetary policy appreciates the dollar and squeezes the entire tradable goods sector of the economy--exports as well as import-competing goods, from products as well as manufactured goods--in working its deflationary impact. The strong dollar and the large trade deficit are a direct consequence of an anti-inflation policy that has relied exclusively on monetary measures.

Before we turn to policy options, a final analytical observation needs to be made. When it comes to the determination of exchange rates, all explanations must be put in *relative* terms. Conditions and expectations abroad also influence exchange rates. The main point to note here is that while the United States has engaged in fiscal expansion and tight money since 1981, putting upward pressure on U.S. interest rates, the other major countries—Japan, West Germany, Britain, and, since 1983, France—have engaged in fiscal contraction, thus putting downward pressure on their interest rates.

According to OECD calculations, the structural budget deficit—that is, the deficit corrected for cyclical variation—of the United States shifted in the expansionary direction by 0.9 percent of GNP between 1980 and 1983. During the same period, the structural budget deficit of Japan shifted in the contractionary direction by 1.9 percent of Japanese GNP, Britain's fiscal thrust contracted by 2.7 percent of GNP, and West Germany's fiscal thrust contracted by 3.0 percent of GNP, as each of these countries moved to reduce budget deficits that they considered unacceptably large. Taken together, the six economic summit countries other than the United States contracted by 1.3 percent of GNP (Table 3). While the United States was expanding fiscally, other leading countries were contracting fiscally, and the combination induced capital flows from those countries to the United States and strengthened the dollar. Of course, fiscal expansion can sometimes lead to capital outflow, as it did from France in 1981, but that fiscal expansion was accompanied by expansionary monetary policy and nationalization of banks and other f i s as well.

TABLE 3
Structural Budget Positions
(in percent of GNP)

	1979	1980	1981	1982	1983
United States	1.2	0.7	1.6	0.3	-0.2
Japan	-4.3	-4.1	-3.5	-2.8	-2.2
West Germany	-2.3	-2.5	-2.4	-0.9	0.5
France	-0.8	0.8	-0.2	-0.6	-0.7
United Kingdom	-3.2	-1.1	1.8	3.3	1.6
Major seven, exc. USA	-3.5	-2.9	-2.7	-2.0	-1.6
OECD Europe	-2.9	-2.2	-2.4	-2.1	-1.7

Note: The structural budget position is that which would prevail if the economy were operating at its potential output, **defined** in terms of peak to peak trend in output.

Source: P. **Muller** and R.W.R. Price, "Structural Budget Deficits and Fiscal Stance," **OECD** Working Paper No. 15, July 1984, Annex 1.

Possible policy actions

Often remedies follow **from** analysis of a problem's causes. But sometimes the remedies that are suggested from this **analysis** are not feasible, and in any case many other remedies are often put forward. It helps to illuminate the problem to analyze to what extent these suggested remedies would in fact work. In the case of the strong dollar and the large U.S. trade deficit, a number of proposals have been put forward. Some of them involve actions by the United States; some involve actions by other countries. In particular, it has been observed that the United States has a large bilateral trade deficit (equal to about one third of its total trade deficit) with Japan and therefore that a substantial part of any solution to U.S. problems could be undertaken by Japan, by liberalizing its **market** to imports, by imposing a **tax** on its exports, or by limiting outflows of capital with a view to strengthening the external value of the yen. More generally, it has been suggested that Japan, alone or in combination with other leading countries, should reverse its present course of fiscal contraction and provide some fiscal stimulus to domestic demand.

With respect to U.S. actions, proposals range from selective import surcharges (aimed at Japanese goods) through a general import surcharge to disincentives to capital inflow (**e.g.** through a tax on interest payments to foreigners). In addition, it has been suggested that the United States should reduce its large budget deficit, should engage in monetary expansion, and should intervene in the foreign exchange market with a view'to depreciating the external value of the dollar.

Actions by other countries

We will first take up the proposals for actions by other countries, and then return to possible actions by the United States. Since so many of the suggestions focus on Japan, it is useful to sketch briefly the nature and origin of the Japanese external surplus on goods and services, or, what comes to the same thing, the nature and origin of Japanese net investment abroad. Japan is a country with an exceptionally high savings rate, with gross private saving (by households and corporations) amounting to about 26 percent of GNP. Until the early 1970s Japan also had a high rate of domestic investment, but that dropped markedly as Japan's growth rate slowed after the first oil shock, and now amounts to about 21 percent of GNP—still high by international standards, but low by historical Japanese standards and in particular low in comparison with Japanese savings rates (Table 4). Where is the excess savings to go? One possibility, in no one's interest, is to dissipate it through a major recession which brings income closer into line with consumption. A second possibility is for the government sector to absorb it through budget deficits as it did in the late 1970s. A third possibility is to invest it abroad. Over the past six years Japan, through fiscal contraction, gradually shifted the absorption of excess Japanese savings from the government sector to the external sector, so that by 1984 each absorbed just over 2-1/2 percentage points of the excess savings, i.e. Japan invested abroad (net) nearly three percent of its GNP.

This relationship, X-M = S-I + (T-G), holds for any country and for any period of time, where X-M is net exports of goods and services (= net foreign investment if foreign aid grants and other unilateral transfers are included in "services"), S = gross private saving, I = gross domestic investment, and T-G is the government budget surplus. Net foreign investment is the difference between private saving and the calls on private saving

TABLE 4

Relation Between Japanese Trade Balance and National Savings and Investment

	1970	1973	1979	1984
		(percent of GNP)		
Net exports	1.0	0.0	-0.9	2.6
−				
Gross private savings	33.1	32.0	28.6	26.1
+				
Government budget surplus	1.8	0.6	-4.8	-2.6
−				
Gross domestic investment	33.9	32.6	24.8	20.9

arising from domestic investment or the need to finance a budget deficit. It must be asked of any proposal for altering the trade balance, X-M, how it will alter the savings-investment balance in the economy. This framework places changes in the overall trade balance directly into a macro-economic context, where it belongs.

The framework is useful in evaluating proposals such as those made above. American officials and journalists have called on Japan to liberalize its import market with a view to reducing its large trade surplus and with it the large U.S. trade deficit, for instance. With respect to this proposal, there is first of all the question of how Japan might liberalize imports as a matter of policy, since apart from agriculture the policy-controlled restrictions on imports are few. Rather, the obstacles to foreign exporters seem to be deeply ingrained habits of thought, in middle-level Japanese bureaucrats both in government and in large firms, something that cannot be altered by simple ministerial decree. But suppose, as a thought experiment, that all the real and fancied obstacles to importing into Japan were swept away. Would that reduce the Japanese current account surplus, running at just under three percent of GNP? To do so, according to the above identity, it would have to reduce Japanese savings or increase Japanese investment. We can assume that, apart from induced changes in GNP, the budget deficit would increase slightly, due to loss of tariff revenues; but average tariffs into Japan are 6.8 percent, and account for only 2.5 percent of government revenue and under 0.7 percent of GNP. How would liberalization alter savings and investment? By increasing competitive pressures within the Japanese economy, it might lead to lower corporate savings, and other things being equal that, like the reduction in governmeht revenue, would reduce the trade surplus. But lower profitability and lower corporate cash flow might also reduce corporate investment, and that would work in the opposite direction.

All in all, complete trade liberalization might lead to a modest reduction in the trade deficit—it would be nothing, like the $10 billion of increased exports that many American groups contend they could sell to Japan under these circumstances when allowance is made for the additional exports from other countries. The main effect would be to change the composition of Japan's imports (toward agricultural products, not manufacturers) and a further depreciation of the yen to keep Japan's net foreign investment in line with its savings-investment balance. Japanese exports would become even more competitive and, paradoxically, some manufactured products whose importation is now inhibited by Japanese practices would actually find greater difficulty gaining access to the Japanese market after total liberalization than before. Of course, if the liberalization depressed Japanese GNP, the trade surplus might actually increase as investment fell by more than the fall in private savings minus the rise in the government deficit.

Moreover, a modest reduction in the Japanese trade surplus would not

necessarily lead to a reduction in the U.S. trade deficit; that would depend on the response in Japan's other trading partners as well as in the United States. Liberalization concentrating on agricultural products would probably benefit the United States disproportionately, but even then the final outcome would depend on the impact on the U.S. savings-investment balance, a topic taken up below.

Another proposal, that Japan impose an export tax, is even less likely to have the desired effect. An export tax would (other things being equal) reduce the Japanese government deficit. It would also undoubtedly reduce corporate savings as Japanese firms cut their prices somewhat to remain competitive abroad. By reducing profitability, it would cut domestic investment in Japan, and that plus the reduction in the budget would probably lead to a reduction in income which would cut investment further. Thus a tax on exports would very likely lead to an increase rather than a reduction in the trade surplus, partly through yen depreciation, partly through economic stagnation.

These results serve to illustrate the point that when one is dealing with the entire trade sector, rather than particular commodities such as citrus or lumber, it is unsafe to assume that other things will remain equal. By the savings-investment identity, something else has to change if the trade balance is to change, and that will typically affect the entire economy. Alternatively, if the savings-investment balance does not change, the overall trade position will not change either, even though the composition and even the level of both exports and imports may (in general, will) be affected by actions that operate on trade.

This observation is not meant to suggest that such import liberalization as the Japanese can take would not be desirable. On the contrary, protectionist pressures are fed by specific actual or perceived grievances about the difficulty of exporting to Japan, and actions to mitigate these grievances and open the market will be helpful in managing U.S. protectionist pressures through a difficult period. But we should not measure their success by the reduction in the U.S. trade deficit, for that is likely to be negligible.

A third suggestion sometimes made is that Japan should introduce a tax on capital outflow, analogous to the Interest Equalization Tax (IET) used by the United States in the 1960s, or otherwise restrict the outflow of capital through administrative guidance (Bergsten). Heavy flows of investment abroad by Japan's financial institutions, especially to the United States, have depressed the market value of the yen, and that in turn has contributed to Japan's trade surplus. If the purchase of foreign securities can be restrained, the argument runs, the yen will appreciate and Japanese goods will become less competitive on world markets.

Once again, the proposal must be assessed in terms of its likely impact on the overall balance between savings and investment in Japan. So long as

Japanese savings remain exceptionally high, where will they go? An IET would raise government revenue, thus reducing the government's need to borrow and depriving Japanese financial investors of a source of domestic securities. Market interest rates would therefore fall in Japan. While market interest rates do not play the significant role in Japan that they do in the United States, the decline in interest rates might well stimulate some domestic investment, and the induced rise in income would stimulate more investment, on both counts reducing the trade surplus. Of course, any fall in domestic interest rates would, by itself, enlarge rather than reduce the tendency of institutional investors to buy foreign (especially U.S.) securities. It would also reduce government interest payments on that portion of old and new government debt that is sensitive to market rates, thus reducing further the government deficit and the interest income of bondholders.'

Furthermore, appreciation of the yen might reduce corporate savings, but also would discourage investment to the extent it was being undertaken on the basis of current competitiveness in international markets. All in all, restrictions on capital outflows from Japan would help modestly to reduce the Japanese trade surplus, but it would run strongly against both the domestic and the foreign (especially U.S.) pressures for capital market liberalization over the past decade, and thus would represent a major reversal of structural policy.[3]

A fourth suggestion is that Japan should stimulate domestic demand through greater fiscal stimulus--either by an increase in government expenditure or by a tax cut. From 1979-1984, Japan contracted fiscally by three percent of GNP so that the "structural" budget deficit now stands at just over one percent. This contraction has contributed, as noted above, to the emergence of a large trade surplus. Fiscal expansion would mark a reversal of the "administrative reform" to which the Nakasone administration, like its Suzuki predecessor, is committed. Fiscal expansion could be made more palatable, however, by concentrating the effort on housing, in which there is underinvestment compared with other countries of comparable per capita income. For instance, Japan could make mortgage interest payments tax deductible and take steps to improve the granting and the marketability of mortgages in Japan, perhaps by creating a secondary mortgage market in the fashion of Fannie Mae. These moves would reduce the Ameri-

[2] Net financial liabilities of the Japanese government are about 27 percent of GNP, close to the ratio of the United States and notably higher than that of France and Germany, but lower than the roughly 50 percent ratio of the United Kingdom. Muller and Price, Table A311.

[3] For a history of recent U.S. efforts to persuade Japan to liberalize its financial markets, see Frankel 1984. The impact of this proposal may be discovered soon, since Japanese pension funds and life insurance companies have virtually reached the current limit of 10 percent of their portfolios that can be invested in foreign securities. The practical issues are whether that guideline should be revised upward, or tightened to include foreign-currency denominated securities issued by Japanese firms, now excluded from the restriction.

can "competitive advantage" in producing fixed interest securities and would help reduce gross household savings in Japan by encouraging greater spending on houses and their contents.

A larger budget deficit, augmented by greater household borrowing, would put upward pressure on interest rates, capital outflow would decline, and the yen would appreciate. National savings would decline, and that would reduce the trade surplus, unless the combination of higher interest rates and stronger yen stifled domestic investment. But since the higher rates would be induced by greater domestic spending, the main impact (as in the United States in recent years) would be a shift of investment from the export sector to greater orientation toward the domestic market.

The impact on the United States, to be discussed below, of fiscal stimulus in Japan would be strengthened if such stimulus were also undertaken in Germany and the United Kingdom; and if these countries did so, France could also be less restrictive. As noted above (Table 3), Britain and Germany now maintain structurally tight fiscal policies in the face of high domestic unemployment. Both could relax somewhat in the interests of better internal and external balance. A concerted move by all these countries would also have the advantage of minimizing movements in the exchange rate among their currencies, while helping all to appreciate against the dollar.

One sometimes hears the argument, especially in Germany and to a lesser extent in other European countries, that fiscal expansion would be inflationary despite the high unemployment because of structural rigidities in the economy, which is heavily keyed to export rather than domestic demand. I entertain considerable skepticism about this argument in its extreme forms. But to the extent it has some merit, one form of government expenditure that would not be inflationary is foreign aid, especially if it is untied. Many developing countries are financially strapped at present, and would welcome well-placed funds that could be spent in any of the industrialized countries.

But all of these suggestions rely on actions by other countries, possibly under U.S. prodding. Belated U.S. suggestions at the 1985 Bonn Economic Summit that other countries should engage in fiscal expansion apparently were coolly received, in marked contrast with the concerted program of action agreed at the 1978 Bonn summit.

Actions by the United States

Analogous actions to those suggested for Japan have also been made for the United States, with reverse sign: a surcharge on imports, a tax on capital mflows, and a reduction in the budget deficit. Again, the investment-savings framework will be helpful in analyzing them.

An import surcharge could be selective (on Japanese goods) or general. Both have been proposed, and either could be imposed legislatively or by Presidential action under the Trade Act of 1974. What would be the impact of an import surcharge? It would of course raise some revenue, and thereby work toward reducing the budget deficit. It would raise U.S. prices to the extent that foreign suppliers did not absorb the surcharge fully, and that would permit U.S. firms in competition with imports to raise their margins and/or their volume of sales, thus increasing corporate profits. On both counts there would be some reduction in the trade deficit, unless the surcharge stimulated an offsetting boom in investment. But these two effects in all likelihood would only represent a fraction of the tendency of America consumers to turn away from the taxed imports, leaving a larger incipient improvement in the trade balance than can be supported by the associated increase in tax revenues and corporate profits; in that case the dollar might appreciate to restore the savings-investment balance, so export-oriented firms and farmers will be made *worse off* by the surcharge.[4] Moreover, in a world ridden by external debt and by budget deficits that are almost universally considered too large, a move by the United States to impose a surcharge on imports is likely to be widely emulated, and that could vitiate what gains the United States garnered and leave the world as a whole worse off.

The selective surcharge would run less risk of widespread emulation (except perhaps against Japan), but would generate much less in the way of additional savings and more in the way of yen depreciation against the dollar. The net effect is likely to depress Japanese income and investment, and that would leave both Japan and the rest of the world worse off.

If yield-oriented capital inflow accounts for the strength of the dollar, then one way to weaken the dollar might be to impose a tax on interest and dividend payments to non-resident holders of U.S. securities. To the extent such a measure could be successfully levied, it would reduce the budget deficit by the amount of the revenue. It would also, however, lead to higher domestic interest rates in the United States as the competition for funds within the country drives them up. Higher domestic interest rates (not in principle available to foreign investors, because of the tax) would reduce domestic investment to some extent, a manifestation of the "crowding out" that was extensively predicted before observers realized how globally mobile capital is these days. Lower investment might lead to lower income

[4] What happens depends on the extent to which foreign exporters cut their prices, on the degree of price substitutability between imports and domestic goods, and on the mark-up over incremental costs at which domestic producers can supply the additional goods. The generalization in the text is more likely the more foreigners cut their prices and the higher the substitutability for domestic goods so long as the surcharge exceeds the mark-up, but it will be less likely the higher is the mark-up on domestic goods.

and output. A weaker dollar would permit higher domestic prices, hence corporate savings. On both counts the trade deficit would be reduced. On the other hand, the government deficit would increase by the higher interest payments that would have to be made to the public, and this factor might swamp the revenues raised from the tax itself.

Moreover, there is considerable question how effective a tax of this kind could be, given the multifaceted channels by which capital flows in today's world. Would intra-corporate interest payments be taxed? If so, it would be an administratively complicated tax indeed; if not, corporations could borrow from their subsidiaries abroad, and, via arbitrage, the U.S. market would remain linked to the world market on a tax free basis. Moreover, the purpose of the tax would be to weaken the dollar. Yet the tax would not apply to dollar securities issued outside the United States, and so long as they remained attractive to investors around the world some upward pressure on the dollar would remain.

In practice there are institutional rigidities and arbitrage is incomplete, so a plausibly comprehensive tax on interest payments with coverage for the obvious loopholes would probably lead to some weakening of the dollar and some improvement in the trade balance.

The main obvious impact of these tax measures would be through the revenues they generate for the government. That suggests, as did the analysis at the outset of the paper, that a major measure to weaken the dollar and reduce the trade deficit would be to reduce the budget deficit. Reducing the budget deficit, it is argued, will lead to lower interest rates and less foreign investment in the United States. That in turn would weaken the dollar and improve the trade balance (e.g., Feldstein.)

The simple starting point for this recommendation is the savings-investment figures mentioned earlier, and shown again in Table 5; U.S. private saving was exceptionally high in 1984, and domestic investment was normal for a boom year. The budget deficit, however, at 3.4 percent of GNP, was exceptionally large for a boom year, and absorbed not only the modest excess of private savings over domestic investment, but drew in substantial foreign saving as well.

Moreover, the budget problem is a problem of the federal budget; state and municipal governments taken together by 1984 were running a substantial surplus of $51 billion.

Virtually everyone now agrees on the need for a reduction in the federal budget deficit. Yet little happens because of political impass over how the reduction should be split between non-defense spending, defense spending, and a tax increase, with President Reagan insisting that the main burden must fall on nori-defense spending and House Democrats insisting that there will be no more squeeze of non-defense spending (which if social security and interest payments are excluded declined in real terms between fiscal

TABLE 5

Relation Between U.S. Trade Balance and National Savings and Investment

	1966	1973	1979	1983	1984*
			(percent of GNP)		
Net exports	0.4	0.5	-0.1	-0.1	-2.6
=					
Gross private savings	17.0	17.2	16.8	17.3	18.4
t					
Government budget surplus**	-0.2	0.6	0.6	-4.1	-3.4
—					
Gross domestic investment	16.6	17.3	17.5	14.3	17.4

*-preliminary
**-Federal, state, and local

Note: Columns may not show equality due to rounding errors and small statistical discrepencies.

Source: Calculated from Council of Economic Advisers, *Economic Report*, 1985.

year 1981 and 1985) without a squeeze on defensespending, which rose $96 billion (61 percent) between 1981 and 1985, by an amount almost equal to the deterioration in the external balance. Many Senators and Representatives argue that a tax increase is also needed to close the gap–realistically speaking, it cannot be done through expenditure reductions alone.[5]

A cut in government spending or a rise in taxes operates directly on the savirlgs-investment balance by reducing the budget deficit. But at a time when the economy is hesitant, a sharp reduction in the budget deficit would certainly send the economy into recession, thereby leading to a reduction in interest rates and an improvement in the trade deficit for undesirable-and non-sustainable—reasons. It would hurt the United States and rest of the world as well. The solution usually and appropriately mentioned to deal with this problem is to pass soon legislation that reduces *future* budget deficits. Given the annual determination of expenditures, gradual reduction in the prospective budget deficit can mainly be achieved by a phased tax increase and/or by a phased elimination of entire programs, or by scaling back multi-year military procurement.

But a program cutting back on the prospectivebudget deficit will not nec-

[5] Non-defense spending for all programs other than social security and interest payments are estimated at $318 billion in fiscal year 1985, against a budget deficit of $222 billion. Thus 70 percent of all these government programs—law enforcement, foreign affairs, highways and airports, health programs (other than medicare), space, energy, agricultural support, etc.—would have to be eliminated to eliminate the deficit.

essarily lead to a reduction in interest rates, a weakening of the dollar, and a beginning toward reducing the trade deficit. Short-term interest rates are mainly influenced by the actual budget deficit, not much by future deficits; and it is uncertain how soon or how much long-term interest rates would fall following a persuasive reduction in budget deficits starting in FY 1987. Little might happen at once. Indeed, positive action on the budget deficit might lead to a strengthening of the dollar in the short run, as foreign confidence in the U.S. ability to manage its affairs increases and market dynamics rather than changes in fundamental economic factors dominate determination of the exchange rate.

If a sharp cut in the actual budget will generate a recession and a persuasive cut in prospective deficits cannot be certain of effect, what is to be done? The key to a soft landing is to substitute net external demand for budgetary thrust, and, given the response lags, that requires that the exchange rate be brought down more rapidly than the actual budget deficit. Therefore, what is needed is action on the prospective budget deficit combined with an easing of monetary policy.

How does monetary expansion help in the savings-investment framework? First, it lowers short-term interest rates, thereby lowering business costs; net interest payments amounted to 4.1 percent of non-financial corporate business value-added costs in 1984. A decline in average interest rates from 12 to nine percent would reduce costs by one percentage point. Second, it would weaken the dollar and thereby fatten profit margins through some combination of higher sales and higher markups. On both counts, pressure on the manufacturing and agricultural sectors would be relieved. Whether the trade deficit would be reduced is more problematic; it depends on whether lower short-term interest rates and higher profit margins would stimulate investment in excess of the increased corporate and farm savings. If not, the trade balance would improve; if so, it would deteriorate further, though due to higher economic activity rather than to currency appreciation.[6]

Is the United States living beyond its means? In some sense, yes: it is drawing substantial net resources from the rest of the world. But U.S. unemployment is still 7.3 percent and capacity utilization rates are only 81 percent in manufacturing (and 80 percent in materials) even while large volumes of manufactures and materials are being imported from abroad.[7] This configuration suggests a lack of competitiveness rather than a high pressure of demand pulling resources into a fully utilized economy. If U.S. competi-

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[6] There would also be a modest direct effect of lower short-term interest rates on the trade balance, since foreigners are net holders of short-term interest-bearing claims on the United States. That effect would relieve somewhat downward pressure on the dollar.

[7] OECD estimates suggest that the U.S. economy was operating 4 to 5 percent below capacity in 1984.

tiveness could be improved, domestic output would rise and satisfy some of the demand that is now being satisfied by imports. The higher output would generate the additional savings that would, absent an investment boom, permit a decline in net foreign investment in the United States. Thus to the extent that a monetary-policy induced depreciation of the dollar stimulated output, incomes and savings, it would reduce the trade deficit as well.

Of course, the Federal Reserve may understandably hesitate over adopting a policy of greater monetary expansion. It has been successfully engaged in fighting inflationary expectations. Moreover, the policy suggested would actually result in some domestic price increases following depreciation of the dollar. However, price increases from a depreciation of the dollar are inevitable sooner or later, and they are less likely to revive inflationary expectations in the context of a policy that is deliberate, fully explained, and taken in a broader context of economic slowdown and desired fiscal contraction.

The risk of revived inflationary expectations could be reduced further if the Federal Reserve undertook monetary expansion by buying foreign rather than domestic securities, at least beyond its normal monetary targets. Such an action would have three desirable effects. First, it would make the symbolically useful point that the Fed is not simply monetizing the federal deficit. Second, it would signal that the Fed is concerned about the exchange rate of the dollar in terms of other major currencies, and will take it into account in framing monetary policy.[8] Third, the process of selling dollars for yen or German marks would put direct downward pressure on the dollar relative to these currencies. Such a move would be officially welcome by those countries which have occasionally urged the United States to closer cooperation in exchange rate management. Appreciation of their currencies would reduce their trade surpluses, and would provide encouragement to greater fiscal stimulus to take up the slack.

Of course, purchasing foreign securities would put less downward pressure on Treasury bill rates than would purchases of Treasury bills, but the increased bank reserves that would result from Fed purchases of foreign exchange would result in a lowering of short-term interest rates as banks expand their investments and loans.

What is suggested here is that the Federal Reserve should engage in unsterilized exchange market intervention. There is little doubt that such action can influence the exchange rate. It is sometimes suggested that the Fed should intervene in the foreign exchange market to influence the exchange rate *without* altering the path of monetary magnitudes, i.e. that it

[8] Ronald McKinnon (1984) argues that the Fed should go much further and actually key monetary policy to the yen and DM exchange rates, in conjunction with a collaborative effort with the Gennan Bundesbank and Bank of Japan to control the growth of the joint U.S.-Japanese-German money supply.

should engage in sterilized intervention, offsetting the monetary effects of foreign exchange purchases by sales of domestic securities. It has lately become fashionable to assert, citing Fed staff studies, that sterilized intervention does not in fact influence the exchange rate beyond some very short run. Yet the Fed studies I have seen suggest a much more agnostic position than this contention claims, and I consider sterilized intervention useful in certain contexts.[9] However, in present U.S. circumstances, where the dollar is held strong by deficit-driven capital inflows, sterilized intervention would not be helpful beyond a signal of the Fed's interest in the exchange rate (which however itself might be important in shaping exchange market expectations), because it would tend to widen rather than narrow the interest rate differentials that are in large part driving the capital flows. Moreover, it would be premature, before a sustainable budget is reestablished, to adopt a system of target zones for exchange rates.

Concluding observation

In many ways, the problem that the United States faces is similar to that of a developing country in need of a stabilization-cum-devaluation package of policy measures. There are of course some important differences, revolving around the fact that the United States has a floating currency and large capital inflows that are directly responsible for keeping the currency strong. But there are also some important similarities, revolving around a large budget deficit and a currency that (on the arguments given above) is unsustainably strong. So let us pursue the analogy further.

The artful task of stabilization policy is to reduce the budget deficit and improve the trade balance without driving the country into an economic slump. This balancing act is accomplished by cutting the budget deficit and simultaneously devaluing the currency, so that increased (net) export demand can replace the cutback in government demand (or in household demand, if a tax increase is involved.) Even then, for a country with a large trade deficit, the impact of the devaluation may itself be contractionary at first because the public must pay more in home currency for imports before they have a chance to adjust their pattern of expenditures (or before domestic businesses have an opportunity to produce replacements for the imports).[10] The stimulus to exports will be expansionary but not initially by an amount that will offset the contractionary effect of higher expenditures on imports.

This timing factor from currency depreciation suggests another reason

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[9] See the summary in Henderson and Sampson, 1983.

[10] This factor will be less important for the United States to the extent that foreign exporters cut their prices in order to maintain their position in the U.S. market. But that practice has its limits.

why the fiscal contraction should be gradual, and the currency depreciation should be brought about as rapidly as possible, if necessary with policy encouragement. In other words, if the passage of a budget package does not at once lead to an anticipatory decline in interest rates and the dollar (as I suspect it will not), the monetary authorities would be well advised to push interest rates and the dollar exchange rate down.

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