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APPROACHES TO MANAGING EXTERNAL EQUILIBRIA:  
WHERE WE ARE, WHERE WE MIGHT BE HEADED,  
AND HOW WE MIGHT GET THERE

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## Abstract

This paper examines the issue of the U.S. external deficit in a global context. First, the paper considers certain aspects of the current economic situation that have contributed to the U.S. deficit and the progress that has been made to date in laying the basis for its narrowing. Second, the paper raises some questions about the international economic implications of a substantial reduction in the U.S. fiscal deficit, about the need for additional impetus to bring about further adjustment in the U.S. current account deficit, and about the preparedness of other industrial countries to absorb the elimination of the U.S. external deficit. Finally, the paper sketches a few scenarios for the U.S. external adjustment process and comments briefly on them as alternatives.

Approaches to Managing External Equilibria:  
Where We Are, Where We Might Be Headed,  
and How We Might Get There

Edwin M. Truman<sup>1</sup>

The major international economic problem thus centers on the balance of payments of the United States with the rest of the world. Triffin (1987)

While not all economists around the world would agree with Robert Triffin's statement that the external deficit of the United States is the central international economic problem today, a remarkably large majority would agree with him -- remarkable by the normal standard of agreement among economists. The consensus breaks down, however, when it comes to the question of why the U.S. external deficit is so important.

I believe that the U.S. external deficit is a common problem -- a problem worth not only the priority attention of the United States but also the cooperative attention of the major industrial countries. In this connection, the Group of Seven in their statement released after their meeting in West Berlin on September 24, 1988, reached several conclusions:

Current trends and prospects in those countries with the largest imbalances are consistent with and supportive of balance of payments adjustment requirements. . . . Where external and budget deficits are still large the strengthening of the fiscal position will be essential. Where external

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1. An earlier version of this paper was presented at the Jubilee Robert Triffin, "Evolution of the International and Regional Monetary Systems," Brussels, Belgium, December 8-9, 1988. The paper has benefited from comments and suggestions by Ralph C. Bryant, William L. Helkie, Peter Hooper, David H. Howard, Karen H. Johnson, Jaime R. Marquez, and Ellen Meade; however, the views expressed are my own and should not be interpreted as reflecting those of the Board of Governors or other members of its staff.

fiscal position will be essential. Where external surpluses remain large, strong domestic demand growth is required.<sup>2</sup>

Despite expressions of official confidence contained in international communiques, the more-or-less well-informed public has substantial doubts about the ability of national authorities individually or collectively to orchestrate the adjustment of the U.S. external deficit in a smooth and constructive manner. I believe that these doubts derive from the perceived size of the task and from implicit or explicit concerns about the working of the process of international policy coordination. These concerns do not focus on the benign or malign intent of the authorities, rather they involve uncertainties about the feasibility of the process. They were summarized by Ralph Bryant, another former student of Robert Triffin:

There is great uncertainty about how policy actions and nonpolicy shocks originating in one nation influence economic developments in others. . . . Even when analysts agree about the sign of effects, moreover, little consensus exists about their empirical magnitude. . . . Individual governments do not even have at their disposal an agreed analytical framework for evaluating the effects of external forces on their domestic economies. . . . Insufficient public awareness of the extent of economic interdependence, which in turn contributes to a lack of political will by government officials, is also an important obstacle [to a convergence in analytical views].<sup>3</sup>

In this paper, I provide my own perspective on where we are with respect to managing today's external equilibria, where we might be headed, and how we might get there. First, I lay out three basic facts, as I understand them, about the current

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2. International Monetary Fund (1988a), p. 329.  
3. Bryant (1987), pp. 9-10.

situation -- where we are. Second, I raise three questions about where we might be headed -- questions on which there is limited consensus among economists and, for that or some other reason, limited consensus among policy makers. Third, I discuss three scenarios about where we might be headed. Having demonstrated my capacity to be a three-handed economist, I offer a few summary comments in conclusion.

### THREE FACTS

1. The 1980s have been a period of sustained growth and price stability for industrial countries and newly industrializing economies.

Viewed against the background of the 1970s, the 1980s have been a qualified "success." The success has been unexpected, and policies have been, some would say regrettably, uncoordinated.

The decade started off with a few sour notes. In 1980, the dollar hit a new low in terms of the currencies of most major industrial countries. The United States went through a near disastrous experiment with credit controls followed by a sharp recession. Aided by the second oil-price shock, inflation rates in many industrial countries reached new highs; on average consumer prices for the OECD countries as a group increased only slightly less in 1980 (13 percent) than they did in 1974.<sup>4</sup> Although the U.S. current account recorded a surplus in 1980, the deficits of Germany and Japan were regarded as not only

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4. OECD (1988a).

unsustainable but dangerous. All of this was followed by slow growth in 1981 and the U.S. recession in 1982.<sup>5</sup>

All the returns are not in, but when they are, the decade of the 1980s, at least for the industrial countries, is likely to be viewed as one featuring the kind of sustained non-inflationary growth of which the authors of communiqués are fond. Using the IMF's latest published forecasts, for the industrial countries real GNP is expected to increase at an average annual rate of 2.6 percent for the decade as a whole compared with 3.3 percent for the decade of the 1970s. Excluding 1980, 1981, and 1982, which might be viewed as belonging more to the previous period, growth is expected to average 3.4 percent. Meanwhile, consumer price inflation for the decade as a whole is expected to average 5.5 percent annually (3.7 percent for 1983-89), compared with an annual average of 7.9 percent in the 1970s.<sup>6</sup>

Like many facts, this one requires qualification. First, many developing countries, the heavily indebted middle-income countries and those in Africa in particular, have not enjoyed a decade of growth and stability by any standard. Second, unemployment rates in Europe rose in the early 1980s to highs that were essentially unprecedented in the postwar era and have generally remained at those highs with the important

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5. Excluding the United States, OECD members on average experienced positive growth in 1982, but the rate of increase in real GNP/GDP was the lowest since 1975, and the growth of real private consumption was less than 1 percent, compared with 1.5 percent in 1975. OECD (1988a).

6. International Monetary Fund (1988b).

exception of the United Kingdom.<sup>7</sup> Third, the wide swings in exchange rates are thought by some to have exacerbated risks and fragilities in financial markets. Fourth, of course, unprecedented external imbalances have emerged for the United States, Japan and Germany. This qualification is sufficiently important to be listed as part of a second fact.

2. The unprecedented U.S. external deficit that emerged in the first half of the 1980s was in large part the result of the interaction of fiscal and monetary policies in the United States and other industrial countries.

Analysis reported by Peter Hooper and Catherine Mann, involving a wide range of macroeconomic models, concludes that about two-thirds of the increase of the U.S. current account deficit during the 1980s and about two-thirds of the appreciation of the dollar between 1980 and 1985 can be explained by the combined effects of changes in policies in the major industrial countries: the shift toward fiscal ease in the United States, the shift toward fiscal restraint in Germany, Japan, the United Kingdom and France, and the shift toward restraint in U.S. monetary policy.<sup>8</sup>

What I believe is significant about the Hooper-Mann results is not the precise estimates of how much of the dollar's rise and how much of the U.S. current account deficit are

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7. If I were a European policy maker I would worry about the potential "hard landing" associated with this situation a lot more than I would worry about the U.S. external deficit.  
8. Hooper and Mann (1988) suggest that the remaining one third of dollar's rise and one third of the increase in the U.S. current account deficit can be attributed to an exchange-market bubble, the international debt crisis, and to exogenous (confidence) factors that may have raised U.S. growth relative to foreign growth.

attributable to each factor. What is significant is that at least three major forces were jointly responsible. According to their analysis, for every dollar "contributed" to the U.S. current account deficit by the U.S. fiscal expansion over the 1980-85 period, forty cents was contributed at the same time by fiscal contraction in the other major industrial countries on average.<sup>9</sup> Meanwhile, U.S. monetary restraint, according to the models, contributed little on balance to the actual deterioration of the U.S. external deficit, but did contribute significantly to the higher dollar and the lower U.S. rate of inflation, and did reduce U.S. growth and, thereby, affected the mix of influences on the U.S. current account deficit.

The deterioration of the U.S. external position over the early part of this period coincided with a reversal of the external deficits of Germany and Japan that prevailed in 1980, and, as noted above, were regarded as unsustainable. The deterioration also coincided with an improvement in the combined current account deficit of the heavily indebted developing countries between 1981-82 and 1984-85. Industrial countries other than the United States "contributed" little or negatively to the latter phenomenon.

Today it is widely believed that the U.S. external deficit is unsustainable and that, combined with its putative twin, the U.S. budget deficit, the world economy is headed for a "hard landing." This view, however, has been somewhat clouded

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9. In fact, the fiscal contractions in Germany, Japan, the United Kingdom and France were partly offset by fiscal expansions in Canada and Italy.

since it was first advanced more than three years ago when the U.S. current account deficit was just passing \$125 billion on the way up.<sup>10</sup> In the fourth quarter of 1987, the U.S. current account deficit peaked at \$178 billion (at an annual rate and adjusted for \$45 billion in capital gains), and the hard landing had not yet occurred.

3. Considerable progress has been made in correcting the twin deficits.

The U.S. federal budget deficit peaked at \$220 billion (5.3 percent of GNP) in FY1986. In FY1987, it declined to \$150 billion (3.4 percent of GNP), and in FY1988 it was essentially unchanged, while declining slightly as a percentage of GNP. Under the influence of the revised Gramm-Rudman-Hollings legislation, the budget is projected to decline a bit further this year both in nominal terms and as a percent of GNP.

From one perspective, the perspective of those who feel that the budget deficit was dangerous and unjustifiable to begin with, such progress is regarded as too little and too late. From another perspective, recent and immediately prospective progress are seen as too limited. I believe that the important point is that it is generally agreed that the federal budget deficit must

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10. This view has been associated, in particular, with the analyses of Stephen Marris. (Marris (1985) and (1987).) An early version appeared in print in December 1985. The U.S. current account deficit in the third quarter of 1985 was \$110 billion an annual rate, \$126 billion when \$16 billion in capital gains, induced largely by the dollar's depreciation, are excluded. It should be noted that the dollar continued to decline in 1986 and 1987, as Marris said it would, but the economic and financial consequences to date have not been as dire as he predicted.

be reduced further.<sup>11</sup> Considerable disagreement does exist about how such a reduction is to be brought about, which is contributing to the skepticism by some about whether it will occur.

On the external side, progress, at least in nominal terms, has come later than on the fiscal side. It is useful to put that progress in perspective. In real terms (1982 dollars), the U.S. external deficit as recorded in the U.S. national income and product accounts reached a peak in the third quarter of 1986, and has declined by almost 40 percent over the past two years. However, the improvement in real terms has been partly offset by a deterioration in the terms of trade associated with the dollar's depreciation. It is the improvement in nominal terms -- the current account balance -- that is relevant to the international balance of saving and investment and to the U.S. dependence on capital inflows.<sup>12</sup>

As noted above, the U.S. current account deficit (adjusted for the influence of capital gains) peaked in the fourth quarter of last year. Since then, it has declined about one third, and the trade deficit, which also peaked at \$165 billion (at an annual rate) in the fourth quarter of 1987, has

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11. There is a minority view. Chairman Greenspan addressed this minority view in his testimony before the National Economic Commission, "there is a significant counterview, fortunately to date a minority opinion, that in fact deficits do not matter much, or in any event that there is no urgency in coming to grips with them." Greenspan (1988).

12. For certain analytical purposes, these figures should be scaled by nominal GNP, which would imply somewhat greater progress.

also narrowed by about one third.<sup>13</sup> The improvement in the U.S. trade balance associated with the dollar's depreciation since early 1985 has been larger than is suggested by these figures; it has been estimated that, if the dollar had remained at its peak and everything else had remained the same, the U.S. trade deficit would have been at least \$20 billion larger in late 1987 and \$70 billion larger in late 1988.<sup>14</sup>

Some observers attribute all of the improvement in the U.S. trade balance to the decline of the dollar from its peak in early 1985 and, partly as a consequence, call for a continuation of the dollar's depreciation in order to ensure that the progress continues. Such an interpretation and inference is misleading and potentially dangerous. It is misleading because it fails to recognize the considerable relative improvement over the 1980s in U.S. unit labor costs. Hooper (1988a) has estimated that between 1980 and the first half of 1988 U.S. compensation per hour in manufacturing increased by 45 percent compared with an increase of almost 75 percent on average in current dollars in ten foreign

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13. In fact, the start of the underlying improvement in the U.S. trade balance can be dated in early 1987. U.S. trade data for 1986 and 1987 were distorted by the decline in oil prices in 1986 and their recovery in 1987. Excluding oil imports, the U.S. trade deficit peaked in the first quarter of 1987, and has since declined by 40 percent. For those who want to focus on the balance excluding U.S. agricultural exports as well (which rose by \$16 billion, at an annual rate, between the first quarter of 1987 and the third quarter of this year), the decline in the deficit has been 23 percent.

14. See Meade (1988).

industrial countries.<sup>15</sup> Over the same period, U.S. output per hour in manufacturing increased at essentially the same rate as output per hour increased on average in other industrial countries.<sup>16</sup> As a result, U.S. unit labor costs in manufacturing increased much less than in the other countries. With the dollar's foreign exchange value essentially unchanged on average over the period, it follows that wage and productivity trends have tended to favor the restoration of equilibrium to the U.S. external accounts.

The view that the U.S. external deficit should be solved by further depreciation of the dollar is potentially dangerous because depreciation can only be effective if it results in fundamental improvement in competitiveness and if real resources can be transferred to the external sector. Many observers are concerned that the U.S. economy is operating close to capacity and that further reductions in the U.S. external deficit will not be feasible without further reductions in the U.S. fiscal deficit. In fact, the issue is not one of feasibility; as the Latin American countries have demonstrated, a country can achieve substantial external adjustment with minimal fiscal adjustment,

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15. Not the other G-10 countries; data were available for Denmark and Norway but not for Sweden and Switzerland. In terms of the other G-10 currencies, the dollar in the first half of 1988 averaged 3 percent above its average for 1980 according to the index used by the staff of the Federal Reserve Board. See also Hooper and Larin (1988).

16. It is tempting to argue that the relative performance of U.S. manufacturing productivity during the 1980s was induced, rather than hindered, by the wide swing of the dollar over the period. However, the dramatic change in trend in relative growth rates of labor productivity in manufacturing appears to have begun in early 1970s. See Hooper and Larin (1988).

but in Latin America the overall process has been associated with rising inflation, high real interest rates, and slow growth.

### THREE QUESTIONS

1. What are the international implications of a further reduction in the U.S. federal budget deficit?

Even if one assumes, as I do, that the U.S. federal budget deficit will be substantially reduced, if not eliminated, during the first half of the 1990s, the economic and financial implications of such a reduction are hardly agreed; the economics profession does not have a certain answer or set of answers to offer the policy maker.

In part, this uncertainty arises because of a lack of knowledge about what other policy adjustments might be made at the time the reduction in the U.S. budget deficit occurs. However, even when it comes to experiments with large macroeconomic models in which other policies are assumed to be either unchanged or change in a specified manner, the implications of a U.S. fiscal contraction are ambiguous, at least with respect to the behavior of the foreign exchange value of the dollar.

In a joint paper, Ralph Bryant, John Helliwall, and Peter Hooper (BHH) argue that enough systematic experiments have been conducted with such models to enable one, with caution, to treat them as a set of independent observations on the same

phenomenon.<sup>17</sup> Reporting on 20 simulations conducted with various versions of 14 models, they examine the implications of a U.S. fiscal contraction, defined as a reduction of real U.S. government purchases of goods and services equal to one percent of baseline real GNP (somewhat more than would be called for in FY1990 by the Gramm-Rudman-Hollings legislation) that is sustained over six years. They find that such a fiscal contraction produces, in the first year, one case in which the dollar appreciates by more than 1 percent, 9 cases in which the dollar depreciates by more than 1 percent, with the remaining results showing little change, which I define as appreciation (3 cases) or depreciation (7 cases) by less than 1 percent.<sup>18</sup> After four years, the dollar would appreciate by more than 1 percent in 3 of the reported simulations, would change little in 5 cases, and would depreciate by more than 1 percent in 12 cases.<sup>19</sup> After six years, the results are about the same: 3, 4 and 13, respectively.<sup>20</sup>

From one perspective, the results are more disparate than is suggested by the tabulations just presented because the models are not independent estimates based on a common theoretical structure; they differ in structure, particularly with respect to their treatment of expectations. For models in

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17. Bryant, Helliwell and Hooper (1988).

18. A smaller sub-sample of 12 observations, with 8 of the full sample of 20 deleted, is equally divided between "no change" and depreciation. In all the experiments, it is assumed that U.S. monetary policy, indexed by M1 or M2, is unchanged from the baseline.

19. The smaller sample is divided 1, 3 and 8, respectively.

20. For the smaller sample, 2, 1 and 9, respectively.

which expectations are not adaptive but forward-looking and model-consistent, a depreciation of the dollar is projected to be immediate, substantial and sustained. However, in order to rely upon those results, one must also accept the particular assumption about the formation of expectations as well as the rest of the structure of the model.<sup>21</sup>

Of course, the macroeconometric models rely heavily on the experience of the 1980s in deriving their results. The 1980s have been described as a "new world" with increased international mobility of capital as national financial markets have been liberalized. Thus, the OECD (1988b) observes:

The experience of the United States in 1981-85 illustrates the kind of situation that can arise in this new world. That fiscal expansion (coupled with monetary restraint) would go together with currency appreciation was a well established text-book result (associated with Mundell and Fleming), but one whose practical relevance was widely doubted and which, when it occurred, was highly disconcerting to policy makers outside the United States. [emphasis in the original]

In fact, the text-book result does not require monetary restraint (indexed by the level or growth rate of the monetary aggregates), and the empirical result, perhaps, also should have

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21. In fairness, one must also accept the assumption that expectations are adaptive if one relies upon the results of the other models. However, the balance of conventional wisdom may still be on that side. Note that one possible inference from models with forward-looking and model-consistent expectations is that the dollar declined following the U.S. election because "the market" expected the U.S. budget deficit to be cut, which would be contrary to what the newspapers told us that the market was saying at the time about the budget deficit.

been well known.<sup>22</sup> Nevertheless, most, but not all, large macroeconomic models now model exchange rates by relying on real interest-parity equations which almost automatically produce the result that a fiscal contraction will depreciate the home country's currency.

The collective wisdom of the economics profession, at least as represented in large macroeconomic models, is closer to a unanimous view about the implications of a reduction in the U.S. budget deficit for the U.S. current account deficit. In general, the correlation is positive, under the dominant influence of income effects. However, the relationship is not dollar for dollar. For their sub-sample of results from 12 simulations, BHH find that a \$100 billion reduction in U.S. government spending would produce, on average after three years, a reduction in the U.S. fiscal deficit of \$85 billion and a reduction in the current account deficit of \$35 billion (plus or minus a standard deviation of \$15 billion).

Some would argue that some of the contractionary effect on U.S. economic activity of tighter fiscal policy should be offset by an easier monetary policy. This would tend to depreciate the dollar and increase the net impact of the initial fiscal contraction on the overall budget deficit, but the net

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22. The first version of the Federal Reserve Board staff's Multi-Country Model (MCM) contained this empirical result. It was analyzed extensively in Stevens et al. (1984), and the MCM's results were available to the professional community in the late 1970s. The current version of the MCM has the same property.

additional impact on the current account might be negligible.<sup>23</sup> Thus, the statistical "bang per buck" as measured by reduction in the U.S. current account deficit per dollar of reduction in the fiscal deficit would decrease.

The implications of a reduction in the U.S. budget deficit for other countries are generally thought to be mildly deflationary -- lower growth and lower inflation -- at least in the initial effects. In this connection, the policy authorities in other countries would be presented with several issues. First, would they be confident that the U.S. fiscal contraction would take place? On this question, views differ. Second, assuming the answer to the first question is positive, would the policy authorities welcome the associated deflationary effects on their own economies? This is an interesting question only if one assumes, which I would argue is reasonable, that policies are not always optimal or that results are not always as expected and the costs of ex post correction are large. Only after reaching a view on these first two issues, would the policy authorities be expected to consider what, if anything, to do with their own policies to deal with any unwanted deflationary effects from a U.S. fiscal contraction.

2. How much further impetus toward adjustment of the U.S. external accounts is necessary or desirable?

The U.S. current account deficit in the third quarter of 1988 was about \$125 billion (an annual rate), about \$115

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23. This is the average result in the BHH sample. In general, the effects on the current account of the lower dollar are offset by the effects of higher income (and demand for imports).

billion after adjustment for the negative influence of net capital losses associated with the dollar's appreciation in the third quarter. The trade deficit was \$114 billion, at an annual rate. How much further should the deficit decline if the objective is a U.S. external position which is no longer worrisome?

Once again, the economics profession does not have a consensus answer to this question, in part because of its normative aspects. Some observers invoke broad economic or political principles and argue that the United States should not import capital from the rest of the world; the United States should export capital to the developing countries where the marginal social productivity of that capital must be higher than in the United States.

Other observers take a narrower view of the matter and argue that the issue is one of "sustainability". How large a deficit, if any, is compatible with "normal" capital flows? The problem, of course, is that "normal capital flows" are notoriously difficult to specify.<sup>24</sup> The OECD's examination of eleven episodes in which countries changed their macroeconomic policies concluded, "the current account as such seems to have been regarded as the crucial unsustainable element in rather few

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24. Frenkel and Goldstein (1988) comment, "Given the instability of perceived investment opportunities across countries and over time, it is hard to say if, for example, the United States should be regarded as a net capital exporter or a net capital importer, and if the latter, whether normal inflows are \$10 billion or \$100 billion." Until a few years ago, most economists would have said that normal capital inflows were closer to the former.

of the episodes considered, though its indicator role in pointing to fundamental problems was relevant in most of them."<sup>25</sup>

The issue of sustainability is complicated as well because it may be a moving target. The large deficits recorded in the U.S. current account during the 1980s have weakened the U.S. net external asset position. Although the precise levels of external assets and liabilities are not known for a variety of reasons, it is clear that the cumulated U.S. current account deficit of close to \$700 billion for the 1983-88 period has eroded markedly that position. The consensus forecast implies that the position will continue to deteriorate for at least the next few years. In such circumstances, the paths of the trade and current accounts can diverge significantly owing to the fact that a primary difference between the two balances is interest payments on the progressively larger net external debt. It is at this point that questions concerning the sustainability of the external situation become increasingly complex. For example, use of one conventional indicator of the burden of a country's international indebtedness--the ratio of net debt to GNP--can lead to the conclusion that external stability, that is, sustainability of a country's external situation, is consistent with an ongoing, and perhaps sizable, current account deficit, as long as the trade balance is near zero; net nominal debt would be expanding at about the same rate as nominal GNP. In such an interpretation, a target of eliminating the U.S. current account deficit could be considered excessive.

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25. OECD (1988b), p. 12.

Even if one could construct a firm target for the U.S. current account position, such a target would not provide much guidance on the issue of how much, if any, further impetus is needed to bring about the necessary further adjustment. Although the economics profession generally agrees about the signs of effects of income (demand) and prices (relative) on international flows of goods and services, there is less consensus about the long-run magnitudes of these effects, and much less consensus on their timing.<sup>26</sup>

It is by now commonplace for international economists to observe that "conventional" models of the U.S. external account predict that, absent further depreciation of the dollar, the U.S. current account deficit will begin to widen in 1989 or 1990. However, the conventional models may be wrong. One reason may be that they neglect, or capture incompletely, so-called supply-side effects. Such effects may arise from the interaction of the past depreciation of the dollar, growth in U.S. productivity, and continued moderation in wage increases. These supply-side effects may lead to an expansion of the U.S. capital stock at a faster rate than in other industrial countries. This would tend over time to expand the productive capacity of U.S. industry at a given set of relative prices and increase its ability to produce more for export and to compete more effectively against imports.

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26. Bryant, Holtham and Hooper (1988, pp.110-115) present information, drawn from six models, on the differential partial-equilibrium, long-run effects on the U.S. current account of changes in real GNP and exchange rates. Some estimates differ by a factor of two or three.

Peter Hooper has pulled together some preliminary evidence that supports this hypothesis.<sup>27</sup>

Thus, it is possible that such supply-side effects on top of the unknown amount of "conventional" adjustment that remains in the pipeline as the result of changes in price competitiveness that have already occurred may be sufficient to continue to narrow the U.S. external deficit for a considerable period ahead. Moreover, the eventual adjustment may be sufficient to satisfy the financial markets even if it does not satisfy those who believe the United States should be a net exporter of capital.

3. What are the implications of further adjustment of the U.S. external accounts for other countries?

I sometimes wonder if the policy authorities in other industrial economies would welcome further substantial adjustment in the U.S. current account deficit. A cynic might argue that they would not, as long as the reduction in the deficit were not accompanied by protectionism or accelerating inflation, because they would not have U.S. policy makers to kick around anymore.

A somewhat more complex argument might consider why the authorities of other countries might want the U.S. current account deficit to shrink dramatically. One answer is that they agree with those economists who are concerned with the global allocation of savings. Another is that they are genuinely concerned about the implications for growth and the stability of financial markets of a so-called hard landing for the dollar. A

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27. Hooper (1988b).

third, suggested earlier, is that they would welcome the contractionary effects on their economies associated with a narrowing of the deficit, just as they quietly welcomed the expansionary effects of the emergence of the deficit in the mid-1980s.

From my perspective, an important question is the one recently presented by Fred Bergsten in his strategy for the new U.S. administration in the 1990s: What would be the implications for current account positions and policies of other countries if the U.S. current account deficit shrank from \$155 billion in 1987 to \$5 billion by 1992?<sup>28</sup> The first \$25 billion has already occurred, and some would argue that the remainder of the process is well under way. Indeed, Bergsten is relatively optimistic about the ease with which the U.S. external adjustment might be brought about. He is less convincing about the ease with which it would be absorbed in the rest of the world. Five countries are expected by Bergsten to accept \$110 billion of the adjustment: Japan, Germany, Belgium, the Netherlands and Switzerland. The policy makers in these countries, and in the other countries whose current account positions are assumed to be unchanged, do not even have the assistance of a crude device analogous to the Gramm-Rudman-Hollings legislation to help to guide the adjustment process.

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28. Bergsten (1988).

### THREE ILLUSTRATIVE SCENARIOS

Assume that the U.S. federal budget deficit will be substantially reduced, if not eliminated, during the first half of the 1990s. To be concrete, assume that the deficit is reduced by \$150 billion by 1994. As a "baseline," assume that in the absence of further policy action, including the posited action on the U.S. fiscal deficit, the U.S. current account deficit would stabilize at \$125 billion and that dollar exchange rates on average in terms of other major currencies would stabilize around end-1988 levels.

In the face of the assumed U.S. fiscal contraction, other macroeconomic policies could change, including U.S. monetary policy and monetary and fiscal policies in other industrial countries. Three illustrative scenarios are outlined below along with their possible implications for the "baseline" conditions.<sup>29</sup>

Scenario 1. If U.S. monetary policy did not change (indexed by the level of M2 in the baseline) and, as a result of the U.S. fiscal action, the dollar depreciated by about 5 percent, possibly sooner rather than later depending on one's view of the expectations process, the level of U.S. economic activity might be expected to be roughly 2 percent lower than it

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29. The reader is cautioned, one might say additionally cautioned, not to take the figures in the three scenarios literally. They are intended to be illustrative only, though they are roughly consistent with the average results reported in Bryant, Helliwell, and Hooper (1988).

otherwise would be after 5 or 6 years;<sup>30</sup> at the same time, the level of U.S. consumer prices might be about 4 percent lower than otherwise; the U.S. current account deficit might narrow by, perhaps, \$60 billion to a level of \$65 billion; and the level of economic activity in other industrial economies might average about 1 percent lower after 5 or 6 years than it would otherwise, while the level of consumer prices might average 2 to 2-1/2 percent lower, with unchanged economic policies in these other countries.<sup>31</sup>

Is this an attractive scenario? The answer depends critically on whether one believes that there is an excessive amount of pressure on capacity in the U.S. economy today and, thus, in the baseline situation.

Would the U.S. external adjustment be adequate? It might well be adequate if the baseline assumptions are reliable. However, some would argue that the baseline assumption about the dollar is not credible. If one thought that, contrary to the assumption, the dollar would be under downward pressure under the baseline conditions and accepted this scenario's presumption of further downward pressure, then additional external adjustment might result, depending in part on whether other adjustments were made to policies and on what they were.

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30. In most models, the shortfall in the level of economic activity is initially greater than this amount and is eventually eliminated, e.g., after a dozen years or more, as an unchanged monetary policy produces lower interest rates and eventually "crowds in" additional demand.

31. Unchanged monetary policy, as for the United States, is indexed by the baseline level of the appropriate monetary aggregate.

Can a convincing case be made that the U.S. fiscal adjustment should be supplemented by monetary or fiscal expansion in other industrial countries? The assumption that monetary policies are indexed by the level of money and the assumption that such policies are unchanged in other countries imply that short-term interest rates would be expected to decline in those countries. Short-term interest rates might be expected to decline by, say, 100 to 150 basis points, while short-term interest rates declined by about twice as much in the United States. Some might doubt that even this degree of "policy adjustment" in other countries would be realistic.

Which countries might be prepared to take the lead in adjusting their policies? The answer would depend (a) on how satisfied the authorities were with the baseline conditions, (b) on how confident they were in the expected implications of the scenario, and (c) on whether they believed authorities in other countries would take complementary actions. It is likely, however, that some other industrial countries would be forced to alter their policies because of the size of the U.S. external adjustment even if it might be limited to \$60 billion. Thus, policy actions in other countries would be inevitable. The issues are what they might be and whether they would assist or impede the overall process of macroeconomic adjustment.

Scenario 2. If U.S. monetary policy tightened to offset the tendency for the dollar to depreciate,<sup>32</sup> the task of U.S. fiscal adjustment would be exacerbated because higher U.S. interest rates would add to the budget deficit at the same time other measures were trying to reduce it; the level of U.S. economic activity would be roughly 3 percent lower than it might be otherwise after 5 or 6 years, and the level of U.S. consumer prices might be 5 to 6 percent lower; the U.S. current account might be expected to narrow by roughly the same amount as in scenario 1 (\$60 billion); and the decline in the level of economic activity and consumer prices in other industrial countries would probably average only slightly less than in scenario 1 after 5 or 6 years, with unchanged policies in those countries.

This might be viewed as the extended-EMS scenario. It might appear to some to be more attractive than scenario 1 because it would be designed to maintain exchange rates unchanged. It would also bring about more disinflation in the United States than scenario 1, which might be welcomed by some who might not be particularly interested in the stability of exchange rates.

It would probably not be welcomed among the heavily indebted developing countries since dollar interest rates would eventually decline by about as much as in scenario 1, but they

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32. Note that this involves a slowing of nominal money growth relative to the baseline; because of the decline in the price level relative to the baseline, an unchanged monetary policy involves a larger supply of money in real terms. Hence, the lower short-term interest rates in scenario 1.

would initially rise, and there would be less growth in the United States and, therefore, in the industrial countries on average.

If it were felt that additional U.S. external adjustment would be necessary beyond the \$60 billion "produced" by scenario 2, it would be difficult to see how it could be accomplished without tolerating some depreciation of the dollar or without the adoption of policies in other countries that would be aimed explicitly at narrowing the U.S. external deficit.<sup>33</sup>

Scenario 3. If with the assumed course of U.S. fiscal policy and unchanged U.S. monetary policy, the dollar did not depreciate but, instead, appreciated by, say, 5 percent because of increased confidence in the U.S. economic policies and, therefore, increased attractiveness of investing in the U.S. economy,<sup>34</sup> the level of U.S. economic activity and the level of consumer prices might be somewhat lower than in scenario 1 after 5 or 6 years; U.S. interest rates might be lower, which would help the process of fiscal adjustment, but that process would be adversely affected by lower U.S. growth; the impact on the U.S. current account might be somewhat smaller, say, \$10 billion less, than in scenario 1 because the effects of the stronger dollar would not be fully offset by those of weaker U.S. economic

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33. As in scenario 1, changes in some countries' policies probably could be forced by the size of the adjustment in the U.S. current account position. The issue is whether these policies aid or impede the process of global adjustment.

34. Note that what is called for in this scenario is not only an immediate appreciation of the dollar in response to U.S. fiscal action, but a response that is sustained for an extended period relative to the assumed baseline.

activity; the depressing effect on the level of economic activity and consumer prices in other industrial countries might be somewhat smaller compared with scenario 1.

This scenario, if it were regarded as realistic, which some would argue it is not, suffers somewhat in comparison with the other two scenarios by producing less U.S. external adjustment. That might or might not be important in the larger scheme of things. If U.S. external adjustment were not important, this scenario would take some of the "adjustment burden" off of other countries because the negative effects on their growth would be smaller and the amount of U.S. external adjustment to be accommodated would be reduced.

#### CONCLUDING COMMENTS

In this paper I have illustrated some of the complexities involved in managing external equilibria in today's interdependent world of many quantitatively important and sovereign policy authorities.

In the tradition of Robert Triffin, I started with three "facts" about the current situation. Those facts were qualified on my part, and I suspect would not be universally accepted as facts by all other observers.

I next posed three questions about the economic implications of U.S. fiscal adjustment, the needed and desired extent of U.S. external adjustment, and about the implications of such adjustment for other industrial countries. In asking questions, I wanted to indicate that neither I nor the economics

profession has definitive answers and, thus, to suggest that a large dose of humility is appropriate in these matters.

I sketched three "illustrative scenarios" that were predicated on two assumptions: the U.S. federal budget deficit would be gradually eliminated, and the dollar's average foreign exchange value would be unaffected if the fiscal deficit were not eliminated. These scenarios may not have been particularly illuminating because (a) the assumptions are not convincing, (b) the choice among them depends on factors that are not explicitly taken into account (the exchange rate regime, an assessment of the current economic situation, etc.), (c) they tend to raise additional issues rather than to supply answers, or (d) some or all of the above.

I believe that much of this complexity is an unavoidable, if frustrating, aspect of today's international economic environment. Such complexity is not likely to be dealt with effectively by resort to simplified formulas that take the form of if "x", then "y" -- if a country has an external deficit, then it should contract aggregate demand, or if its currency is depreciating, then it should tighten its monetary policy, etc. One reason that such "rules" are not useful is that they assume that the given situation arises in isolation or when everything else is in equilibrium.

To deal with our economic problems we, first, must try to reach an understanding about the initial conditions--what they are and what are their implications. On this basis, policy choices can be made, but policy makers must recognize that these

choices, including a choice of unchanged policies, involve uncertainties. For this reason, the ongoing process of international economic policy cooperation should be complemented by efforts to reach greater consensus on analytical frameworks and empirical magnitudes. Only by groping and learning in this way can we hope to build an international monetary system that efficiently serves the needs of all its members.

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