Wanted: Policy Consistency

By Masaru Yoshitomi

If we are to correct the massive imbalance in the current account, we need domestic demand policy consistent with exchange rate changes. Thus, I would like to concentrate on the issue of consistency and the related macroeconomic policy issues.

In seeking specific policies to rectify the current account imbalance, it is counterproductive to depict the problem as rooted in peculiarly Japanese social and cultural factors (the "Japan problem" syndrome) or to try to affix blame on this country or that. Instead, we should attempt to examine the problem with the shared science of economics and to identify those things that Japan should do and those other things that the United States should do–and this analysis should be the basis for macroeconomic policy coordination.

In looking at the relationship between exchange rates and domestic demand policy, it is elementary international economics that a surplus-running country that sees its currency appreciate needs to stimulate domestic demand in order to reduce the external surplus and achieve domestic balance (maintaining employment while stemming inflation). By contrast, a deficit-running country that sees its currency depreciating must curtail domestic demand.

For example, even though the yen's appreciation may erode Japan's international competitiveness, the surplus-reducing impact of appreciation tends to be offset if the appreciation-induced recession depresses Japanese prices–and the way to avoid this is to stimulate domestic demand, which also has the subsidiary benefit of mitigating the appreciation-induced recession. At the same time, if the dollar's depreciation is to lessen the U.S. deficit, it is imperative that import prices go up–yet if domestic producers take advantage of higher import prices to raise their own prices, imports will not be any less price competitive and will continue to expand. Domestic demand must thus be depressed to deter such follow-the-leader price hikes by domestic producers. And it is especially imperative in a country such as the United States–where the actual unemployment rate (6.0% in June 1987) is close to the natural unemployment rate–that domestic demand be curtailed and that labor and capital be shifted to producing for exports.

The dollar's overvaluation has been substantially corrected since the September 1985 Plaza Accord. Thus the logic of international economics mandates that policy since 1986 should have been to stimulate demand in Japan and to depress it in the United States. Yet the trend was to curtail the structural budget deficit in Japan and to simply hold the line in the United States with no budgetary improvement. In terms of fiscal policy, neither Japan nor the United States did what it should have in 1986.

What of monetary policy? Japan persisted in reducing its official discount rate, which may be assumed to have stimulated domestic demand. Buoyed by the low interest rates, housing investment has risen 15% on an annually adjusted basis since July–September 1986. In the United States, M_2 (currency and demand deposits plus time deposits) continued to increase at greater than 9%, thus serving to stimulate domestic demand. And of course, the collapse in international oil prices in 1986 stimulated domestic demand in both countries.

As a result, Japan's net exports showed negative growth (GNP growth being only 2.5% despite 4% domestic demand growth) and the trade surplus shrank in volume terms. Yet in the United States, net imports continued to increase (GNP growth of 2.5% and domestic demand growth of 3.5%) because the dollar's depreciation was not accompanied by fiscal and monetary policies to curtail domestic demand.

In fiscal 1987 (October 1986 through September 1987), however, U.S. fiscal policy finally turned to reducing the deficit, and it is likely that the deficit will be cut by $35 billion (0.8% of GNP). At the same time, M_2 growth has been less than 4% (annually adjusted) for the last three months as monetary policy has gradually tightened up. Helped by these macroeconomic policies, there is a good chance domestic demand growth will be held to 1.5% to 2.0%, and U.S. net exports in 1987–88 are expected to boost GNP by 0.5% to 1.0%. In Japan, the expansionary ¥6 trillion demand-stimulative policy package and other factors will help domestic demand stay as strong as in 1986 while exports remain sluggish.

As a result, trade figures announced after mid-1987 have indicated that the current account imbalance is shrinking even in dollar-denominated terms. This is one reason why the yen has stopped its sharp climb.

This process of rectifying the current account imbalance has two major implications for international macroeconomic policy coordination. First is the fact that rectifying massive current account imbalances is a long process taking more than several years. During this period, steady reductions will have to be made in the U.S. fiscal deficit. While curtailing U.S. domestic demand will most likely plunge the world economy into a growth recession, the alternative is persistent current account imbalances and a collapse in the value of the dollar, the collapse of the dollar in turn provoking higher dollar interest rates, accelerated inflation in the United States, recession induced by tight-money policies, exacerbation of the developing countries' debt problems and a major financial crash worldwide. Growth recession resulting from a return to sound fiscal policies in the United States is clearly the preferable alternative.

The other implication is that the expansion in Japanese domestic demand must be sustainable over the medium term, which means that the policies to stimulate this expansion must also be sustainable in the medium term. It is impossible to achieve these medium-term policy targets with short-term stimulation, and Japan needs to formulate medium-term fiscal policies suited to these new needs. ●

Masaru Yoshitomi is director general of the Economic Research Institute of the Economic Planning Agency. He served as economist at the International Monetary Fund 1970–74 and chief of the General Economic Department of the Organization of Economic Cooperation and Development 1984–87. He has authored various books and articles on the international economy.