Is the U.S. Serious about Its Balance of Payments?

By Shiro Miyamoto

More than a year has passed since the famous G-5 meeting of central bankers and treasury secretaries from France, Japan, Britain, the United States and West Germany, and the yen's sharp appreciation has made it a decidedly deflationary year for the Japanese economy. Yet at the same time, Japan's dollar-denominated trade surplus with the United States has shown no signs of abating, and a new round of acrimonious trade friction seems inevitable.

Nor, for the United States, are there any indications that the dollar's depreciation is resulting in export expansion. It is therefore necessary to look both at Japanese trade in the wake of yen appreciation and at the United States' import dependence and export competitiveness to find where the real problems lie.

Recession spreads to employment

The recessionary impact of the yen's appreciation has become more pronounced in recent months. Japanese exports are continuing down in yen-denominated terms (all figures customs-clearance basis) and the backwash is rapidly spreading from export-oriented industries to the rest of the Japanese economy.

In the year from September 1985 through August 1986, the yen appreciated a whopping 57% against the dollar (IMF calculations). As a result, Japanese yen-denominated export value has slipped steadily since the third quarter of 1985. In the second quarter of 1986, yen-denominated exports were only ¥9.12 trillion—down 17% from the figure for second-quarter 1985. Likewise, the current profits of some 8,160 Japanese companies in steel, electrical equipment, general-use machinery and other industries were 8% less in first-quarter 1986 than they were in the preceding quarter. Japanese GNP for the same quarter was down 0.5%, the first minus figure in 11 years.

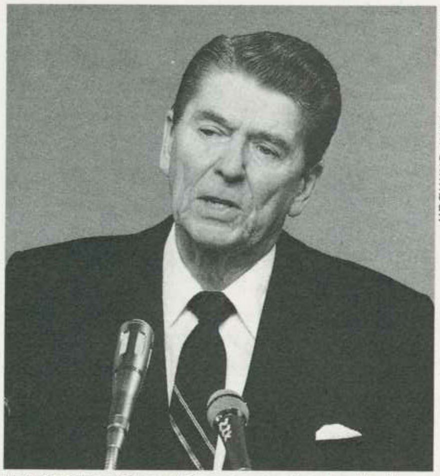

Photo: The Asahi Shimbun

U.S. President Ronald Reagan remains troubled by the lack of strong indications of export expansion despite the dollar's sharp depreciation.

Export volume also slipped for five straight months starting in March 1986, clearly as a result of the yen's appreciation. Mining and manufacturing growth over the previous month has been nil or negative every month since April, unemployment was a record 2.9% in July, and the big companies are scaling back their plans to hire new graduates next spring as the currency-induced recession spreads to employment.

Such is not, of course, to imply that currency realignment has been without redeeming value for the Japanese economy. Theoretically, the Japanese economic outlook should gradually turn brighter as cheaper imports become available and the benefits of lower resource costs and lower interest rates make themselves felt.

With the double advantages of yen appreciation and lower crude prices, Japan's import bill for the seven months January–July 1986 was only ¥13,499.9 billion—29% less than in the same period of 1985. Because import volume has recently been enjoying double-digit growth, there has clearly been a sharp decline in costs. Yet there is a considerable lag between the benefits to the importers and the benefits to the economy as a whole. As things now stand, the more likely scenario is that the deflationary impact of the yen's appreciation will couple with expanded imports to depress demand for domestic production and hence to exacerbate the deflation in the economy as a whole.

The burgeoning dollar-denominated trade surplus

While Japan's yen-denominated export value has been steadily declining, the dollar-denominated figure for the seven months January–July 1986 was up a sharp 21% to $117.6 billion.

The first culprit here is the J curve. As the yen appreciates, the dollar-denominated value of exports necessarily increases even if export volume does not. Second, yen-inspired higher prices do not have an immediate impact on export volume for OEM (original equipment manufacturing) products, automobiles, VCR equipment or other exports which are non-price competitive. In addition, there is considerable volume that was contracted before the yen's appreciation and is only now clearing customs.

By region, exports were up 25% to the United States and 60% to the EC, yet down 9% to the Middle East and 23% to a China seeking to hold down imports.

Imports in the January–July 1986 period were down 0.1% from the same period of 1985, slipping to $75.3 billion. Much of this decline is accounted for by the steep 34% drop in oil imports as crude oil prices plummeted, although there were also declines in other commodity imports. At the same time, imports of manufactures have been up in double digits every month since March, and the $29.9 billion total for the January–July 1986 period

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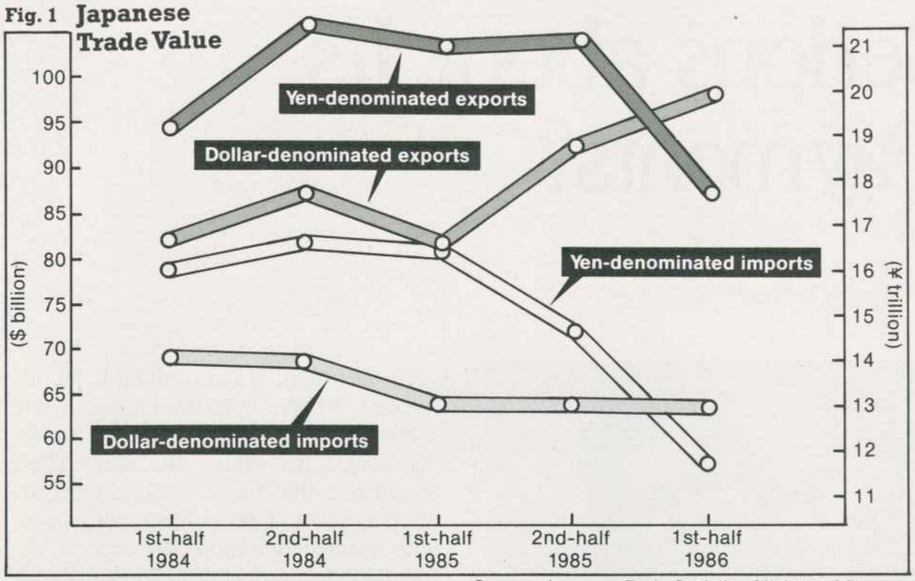
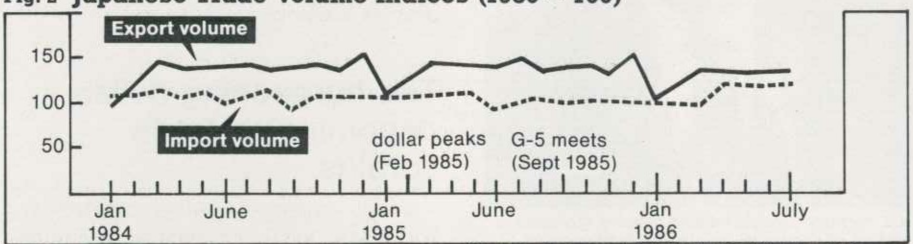
Fig. 1 Japanese Trade Value



Source: *Japanese Trade Statistics*, Ministry of Finance

Fig. 2 Japanese Trade Volume Indices (1980 = 100)



Source: *Japanese Trade Statistics*, Ministry of Finance

was 29% greater than the total for January–June 1985. Imports from the EC showed especially strong growth, increasing 47% with the emphasis on pharmaceuticals, automobiles and the like; and imports of manufactures from the Asian NICs (newly industrializing countries) were also up 21%. Imports of manufactures from the United States were up 26% for a January–July total of $10.7 billion, but machinery imports were down 4.6% and the total would have been down 2.4% had it not been for the sharp jump in imports of non-monetary gold in the May–July period.

As a result, Japan's dollar-denominated trade surplus for the period January–July 1986 was $42.3 billion—nearly double the figure for the same period of 1985—and some people are predicting that the total for the year may top $80 billion unless something is done to stem the tide.

Why the U.S. trade deficit persists despite the dollar's depreciation

On July 14, 1986, the *Wall Street Journal* ran a story asking why U.S. exports have increased only modestly over the last 16 months even though the dollar has depreciated more than a third against the Japanese yen and the German mark.

In theory, the dollar's depreciation should stimulate U.S. exports, depress imports and generally have a stimulative effect on U.S. industry and employment. Yet things have not turned out that way. According to U.S. Commerce Department figures, the U.S. trade deficit for the months January–July 1986 was $102 billion, up 26% from the same period of 1985. Within this, the deficit with Japan was up 22% to $34.2 billion.

A number of reasons have been advanced to explain the U.S. trade deficit's intransigence.

First, the recent currency realignment has largely been among the world's three major currencies—the dollar vis-à-vis the yen and the mark. While the yen and the mark have appreciated sharply against the dollar, the Canadian dollar, the Korean won and the other Asian NIC currencies, being linked to the dollar, have appreciated very little since the September 1985 G-5 meeting. The decline in more expensive imports from Japan will have very little net effect on the U.S. trade deficit if there is a compensating increase in imports from these dollar-linked countries. In fact, U.S. imports from Korea, Taiwan and other Asian NICs were up about 20% in January–July 1986. Fully two-thirds of the U.S. trade deficit is incurred in its trade with countries other than Japan.

Second, U.S. exports are concentrated primarily in products suffering from sluggish world demand and global supply gluts. Typical here are agricultural products, crude oil and other commodities, and it is unreasonable to expect currency realignment to produce a sharp increase in demand for these products.

Third, the Latin American countries, the main customers for U.S. exports, are making a major effort to hold down their imports, and Japanese and West European domestic demand is not expanding as fast as the U.S. would like.

Fourth, there are a number of important products such as compact disk players and VCR equipment that are not manufactured in the United States, plus a number of other products such as textiles, steel and automobiles that are already subject to an array of export quotas. Currency realignment is unlikely to have much additional impact on trade volume here.

Inelastic imports and declining exports

Yet while all of these factors contribute to the problem, the U.S. economy's addiction to imports and the American managerial mindset, including the transnational behavior of U.S. companies, are even more important.

In the early 1980s, the U.S. trade pattern was basically one of sluggish export growth and chronic import expansion. Even though 1985's exports fell short of 1980's, imports were up 40%. As a result, the trade deficit grew worse every year, and by 1985 the U.S. trade deficit was $145 billion. During this same period, imports consistently accounted for about 9% of U.S. GNP, indicating that imports had acquired considerable inelasticity and are now an integral part of the economic structure. By contrast, exports fell from 8% in 1980 to 5% in 1985. This combination suggests that the key to rectifying the U.S. trade imbalance lies less in suppressing imports than in revving up exports.

In looking at U.S. exports' international competitiveness, it needs to be recognized that the interests of the state do not necessarily coincide with those of individual companies. The Report of the President's Commission on Industrial Competitiveness issued in January 1985 defines competitiveness as "the degree to which a nation can, under free and fair market conditions, produce goods and services that meet the test of international markets while simultaneously maintaining or expanding the real incomes of its citizens." In striking contrast to this definition, which links competitiveness directly to export competitiveness, the U.S. National Association of Manufacturers defines competitiveness as the maximization of profits and makes no reference to exports per se.

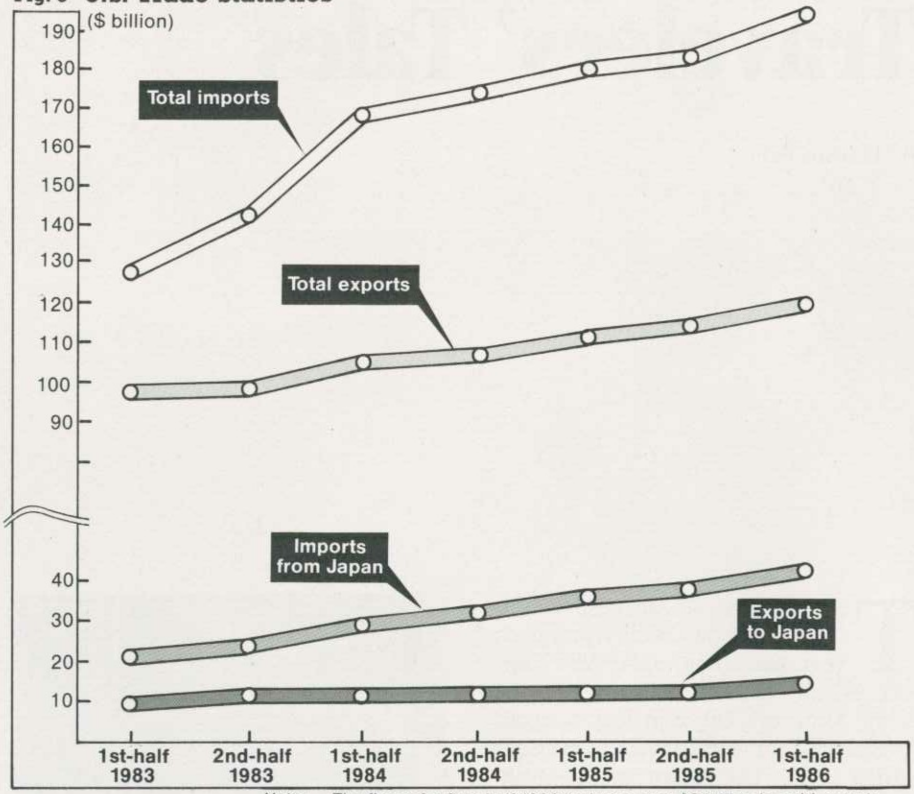
As a result, major disparities have developed in recent years between export-linked competitiveness for the nation as a whole and profit-linked competitiveness for individual companies. How else are we to explain the seeming dichotomy between a U.S. government that tries to whip up export expansion and nags other countries to stimulate domestic demand and to open their markets more and individual U.S. companies that are racking up record profits through aggressive outsourcing. In a very real way, balance of trade statistics are no longer as significant as they used to be in today's highly interdependent and intertwined international economy.

U.S. industrial management policy changed perceptibly in the 1960s and 1970s. Until then, most U.S. companies manufactured important parts and undertook key processes either inhouse or at affiliates. This vertically integrated production system was gradually transformed, however, by the switch to a service economy and the growing importance of imports, and U.S. companies turned to a policy of aggressive outsourcing. Adopting a horizontal division of labor, U.S. companies sought to profit from diversification into new industries and overseas manufacturing alliances.

This trend was further accelerated by a number of factors in the 1980s. First were the high domestic interest rates. According to the Commission on Industrial Competitiveness cited above, the yield on investing in commercial paper has been better than that on investing in manufacturing facilities since 1980. It is unreasonable to expect companies to invest in new production facilities or to make the effort to restore export productivity when the pay-off on financial investment is better than that on manufacturing investment.

Second was the dollar's exchange strength during this period. Coupled with the outsourcing strategies of U.S. companies, the strong dollar, by making overseas production costs all that much lower, was a major stimulus to overseas production. And once supplier relationships have been built up with overseas subsidiaries or affiliates, it is very difficult to change course even though the underlying conditions may change.

Fig. 3 U.S. Trade Statistics



Note: The figure for first-half 1986 includes over $2 billion in gold exports.
Source: *FT990 (Highlights of U.S. Export and Import Trade)* and *Commerce News*, United States Department of Commerce

A fresh U.S. trade policy

A number of ways have been suggested to reduce the U.S. trade deficit. Some people argue that the U.S. should cut its growth rate and thus stem the influx of imports, others say that the fiscal deficit is at root of the problem and that the first step is to get the budget deficit under control, still others advocate currency realignment to promote exports and deter imports, and there are others who would enact protectionist legislation to directly curtail imports. Nor does this exhaust the list by any means. Yet if we accept the need to preserve and strengthen free trade and to respond to the international economy's increasing interdependence, the most important policy is clearly that of making U.S. companies more productive and hence enhancing U.S. export competitiveness.

While the Report of the President's Commission on Industrial Competitiveness admits that there is no surefire remedy for flagging export competitiveness, it recommends that the U.S. do at least the following four things if it wants to be internationally competitive.

1) Trade should be given the highest national priority and American commercial policy agencies redirected to achieving enhanced industrial competitiveness.

2) The costs of investment capital should be lowered for U.S. industry.

3) A greater effort should be made to develop and commercialize new technologies.

4) There should be more emphasis on vocational training to enhance U.S. productivity.

Yet even if all of these recommendations were implemented, there would still probably not be any quick rebound in U.S. export competitiveness. According to estimates by the U.S. Government Accounting Office (GAO), the top 250 U.S. exporters alone account for 85% of all U.S. exports, and there are another 11,000 companies that have the ability to export but just are not interested. This was also noted by the *Wall Street Journal* article mentioned earlier, which pointed out that many U.S. companies have responded to the dollar's depreciation by holding their export prices constant, or even raising them, to up the profit margin on exports. This is not the behavior of companies intent on expanding export volume.

Because the United States is the leader of the free world, it is hoped that more U.S. companies will make the serious efforts required to enhance U.S. export competitiveness and to reduce the U.S. trade deficit. The United States needs a trade policy that will do this, both for its own sake and for the world's sake. ●