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American Economic Relations with the Federal Republic of Germany and with Japan

by Martin Bronfenbrenner, Durham/North Carolina *, Brighton/UK **

Disagreement on appropriate policies to reduce the American balance of payments deficit has been a major source of friction between the US, on the one hand, and the Federal Republic of Germany and Japan, on the other. Against this background Professor Bronfenbrenner presents a theoretical analysis of how deficit countries may proceed to solve their problems, passing on to point out, in terms of this general analysis, what the US is doing and what Germany and Japan would like it to do.

It is well known that the United States has developed over the past 15 years increasingly general negative or "unfavourable" balances of both trade and payments with the rest of the world, while Federal Germany and Japan have both developed positive or "favourable" ones. It is less well known that the negative US bilateral balance with Japan is the largest any country has had with any other in the history of international trade. It has become easy but it remains fallacious for America to interpret the entire American trade deficit to its relations with OPEC and Japan.

Deficit and surplus countries are often less than friendly to each other, particularly when, as in the US-Japanese case, three exacerbating features are involved: (1) the surplus country is highly protectionist, either in terms of tariff duties or in terms of non-tariff protection; (2) a large bilateral balance, inadequately absorbed by triangular trade, is an important feature of both the surplus and the deficit country's over-all surplus and deficit positions; (3) the bilateral imbalance arose suddenly and unexpectedly. This is why the US-Japanese economic relationship is more strained than the US-German one, threatening in fact to develop into something close to a cold economic war.

When a country expands aggregate domestic demand, as by deficit financing and monetary ease, this will tend (other things equal) to reduce its trade surplus or increase its trade deficit, and induce downward pressure on the world valuation of its currency at the same time that it raises domestic income and employment. The US Govern-

ment believes its own relatively expansive policies in the recovery from the "oil shock" recession (1974-75) have in this way weakened its international economic position, and also raised its domestic inflation rate, while permitting the rest of the world to increase employment through exports to the US.

This view is called the "locomotive theory"; it makes the US the "locomotive" of the world economy, or at least of the Western bloc. American proponents of this theory go on to believe that both Germany and Japan, in particular, should share the locomotive role more fully than they have done in the past, and accept the inflationary risks involved. The Germans, and to a lesser extent the Japanese, see their domestic policies as more successful than the American ones in mitigating the inflationary consequences of the oil shock. They therefore see no reason for abandoning these policies as a favor to the US, which should have been less "soft on inflation" throughout the recent past.

This disagreement, locomotive theory versus sound finance, has been the main source of friction between the US and the Federal Republic of Germany. The Japanese, in addition, are accused by American critics of expanding their exports (and reducing their imports) as substitutes for domestic expansion in keeping up their growth and employment rates, and of using a wide variety of "unfairly-competitive" devices for this purpose — quotas and other forms of non-tariff pro-

* Duke University.

** Institute of Development Studies at the University of Sussex.

tection against imports, "exchange dumping"¹ for exports being the most important. In the following, a general analysis is presented of how deficit countries like the US may proceed to solve their problems. In terms of this general analysis it is then pointed out what the US *is* doing and what Germany would *like* the US to do.

Theoretical Framework

A country in balance of payments deficit may react in one or more of five patterns:

- (1) Depreciate its currency, or permit it to float downward (elasticity approach).
- (2) Manipulate its level of domestic aggregate demand (absorption approach).
- (3) Reduce its domestic inflation rate by monetary policy (monetary approach).
- (4) Increase its levels of protection to import-competing industries and of subsidy to export industries (protectionist approach).
- (5) Draw down its international reserves and await assistance from abroad (passive approach).

In the present situation, the US is attempting to combine (1) and (5), and threatening (4). Federal Germany believes the US should concentrate upon (2-3).

The theoretical background of all these policies can be presented as a simple 4-quadrant geometrical model of payments equilibrium (Figure 1). The model has three parts, corresponding to three of these quadrants, which can be combined to give the fourth.

1. The country's balance of trade B , in real terms, is related inversely to its real national income Y , for any given set of relative prices and protectionist devices. It is drawn (quadrant I) as a straight line b , but the linearity is a matter only of convenience. The downward slope of b implies the existence of a single income level \bar{Y} such that, for Y less than \bar{Y} , B is positive and trade is in surplus. And vice versa, for Y greater than \bar{Y} .

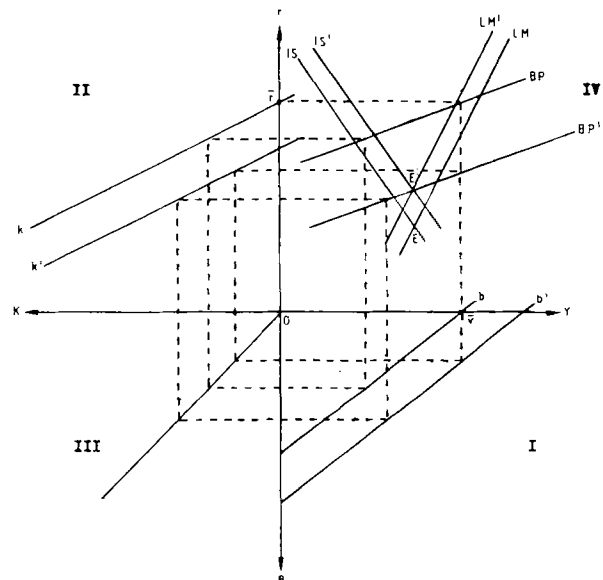
2. The country's net real capital outflow K includes both the transactions of residents and foreigners, both new investments and changes in the ownership of existing capital across international boundaries. It is taken as an inverse function k of the

country's real interest rate r , and again drawn linear for convenience (quadrant II). The downward slope of the k function implies the existence of a single domestic real interest rate \bar{r} such that there is a net outflow of capital when r is less than \bar{r} , and a net inflow when r exceeds \bar{r} . Again we are supposing exchange rates, relative prices, and protective devices given; we also suppose the interest rates of other countries to be given as well.

3. The definition of balance of payments equilibrium (quadrant III) is that a positive trade balance B be offset by a positive capital outflow K and vice versa. A rise in B raises the balance of payments, but a rise in K reduces it; capital exports and commodity imports affect published balances in the same ways.

4. Quadrant IV shows a locus of (Y, r) points, for which the balance of payments is in equilibrium with neither gain nor loss of international reserves. This function, also linear, we label BP . Its upward slope implies that a rise in income must be offset by a rise in domestic interest rates to avoid disequilibrating the balance of payments.

Figure 1
Balance of Payments Function



Problems arise, however, because no point on BP may be consistent with *domestic* equilibrium. Lord Keynes' system of macroeconomics, as modified and elucidated by Sir John Hicks, includes two other primarily domestic relationships involving (Y, r) loci of real income and real interest. These are called respectively IS (or commodity equilibrium) and LM (or monetary equilibrium) functions. The IS function involves equality between planned real saving S and planned real

¹ This is not the place to attempt a rigorous general definition of "exchange dumping". The charge against the oligopolistic *shosha* (Japanese trading companies) is approximately as follows. Following the weakening of the American trade and payments balances, the dollar gradually fell from Y 360 to Y 200 and below. The *shosha*, however, protected Japanese export markets by pricing Japanese exports in dollars below the current yen-dollar rate. They lost money on this operation, but recouped their losses while protecting Japanese producers against import competition on the Japanese home market. They did this by pricing dollar imports into Japan above the current dollar-yen rate.

investment I^2 . It is drawn sloping downwards in Figure 2. A simple form of the supporting argument is that an increase in Y raises S , but for a corresponding increase in I there must be a fall in r . The LM function involves equality between the demand for and the supply of the society's real money stock. It is drawn sloping upward in Figure 2. A simple form of the supporting argument is that an increase in Y raises the demand

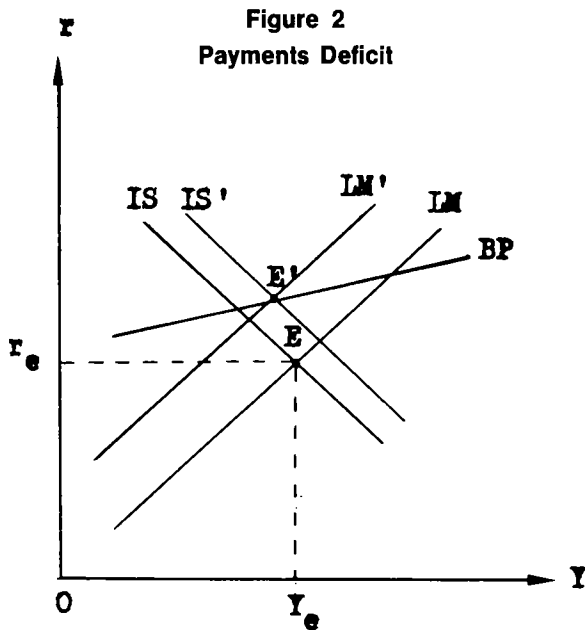


Figure 2
Payments Deficit

for liquid assets L , of which the most important is real money. The increase in demand must be balanced by an increased supply of M by its holders and creators (the banking system) which requires in turn an increase in r .

Indicate by the point E in Figure 2 the intersection of the IS and LM functions. This is a condition of domestic equilibrium, since the demands and supplies are equal for both the flow of goods and the stock of money. (It need not, however, involve full employment.) Let the co-ordinates of E on these diagrams be (Y_e, r_e) , with the subscript e signifying equilibrium³. If E also lies on BP — a case not shown diagrammatically — the equilibrium position of the economy is determined both domestically and internationally at (Y_e, r_e) , but there is no reason for this to be the case immediately.

We are interested particularly in cases like Figure 2, where E lies below and to the right of BP , be-

² Saving actually includes tax payments. Investment includes government purchases of goods and services, and also net expenditures by foreigners for goods and services (the trade balance B). In what follows, however, we shall treat I and the IS function as independent of B .

³ This discussion assumes that no supply restrictions can prevent Y_e being produced, or in other words that the full employment position Y_f (not shown) does not lie to the left of Y_e .

cause this represents a country with a payments deficit. A move to BP from E requires a rise in the interest rate to reduce capital outflow (or induce capital inflow), a fall in the income level to reduce imports, or usually both at once. To reach point E' for example, money might be tightened but public expenditure increased or taxes reduced. (Such operations are often called "fine-tuning".)

Currency Depreciation

We can now attempt to fit into our apparatus the five remedies assembled in the last section.

The first and perhaps the most nearly orthodox of these, at the present time, is to depreciate one's "overvalued" currency — the negative balance of payments is itself evidence of overvaluation — or to permit it to float downwards in the foreign exchange markets.

On our diagrams, this leaves (IS, LM) unchanged except for the reaction (which we ignore) of any change in the trade balance B upon the commodity-equilibrium function IS . The initial intended effect is on b (shift to b' on Figure 3). If this occurs, BP will move to BP' on Figure 4, via the projective geometry of Figure 1.

Four points should be stressed especially in connection with this neo-orthodox approach, which the US sometimes appears to follow quite deliberately⁴ and at other times appears to have had forced upon it.

(a) Depreciation lowers at least temporarily the relative foreign prices of the depreciating country's exports, and raises at least temporarily the relative domestic prices of one's imports. (The word "relative" means in the first case "relative to the prices of foreign-produced export-competing goods".) Whether it also raises the depreciating country's supply of foreign exchange and lowers its demand for foreign exchange depends upon the price elasticities of world demand for its exports and of its own demand for imports. The more elastic (responsive to price changes) is either of these demands, the more effective is depreciation in remedying a trade deficit. If the elasticities are sufficiently low, depreciation may actually increase the deficit instead of eliminating it⁵. In the American case, it has appeared that the

⁴ The Bretton Woods system of international finance (1945-71) based world currencies on gold and US dollars. This meant that the US could only depreciate its currency by raising its gold price. It also meant that its trading partners could nullify this American action by raising their own gold prices in the same proportion. Escape from this constraint was one of the principal aims of the so-called "Nixon shock" (August, 1971) which marked the demise of the Bretton Woods system.

⁵ The famous Marshall-Lerner condition for a depreciation to reduce the trade deficit is that the sum of these elasticities be at least unity. (The algebraic derivation ignores possible supply limitations of either country's exports.)

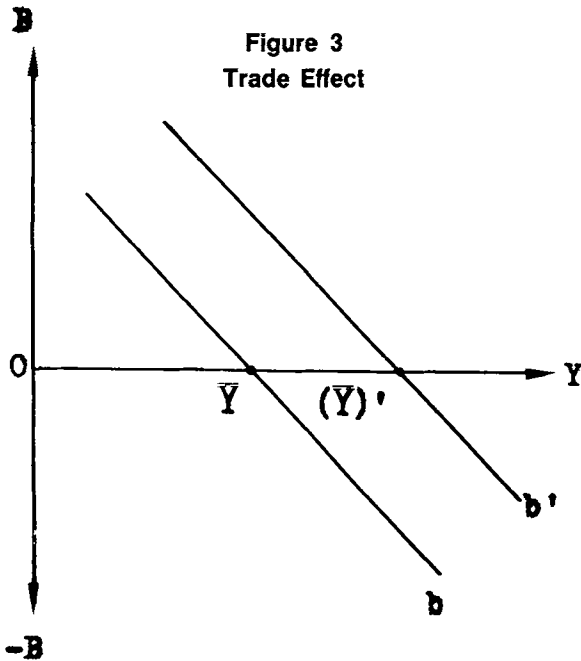


Figure 3
Trade Effect

relevant elasticities have been quite low in the short run but higher in the long run; the diagrammatic result is the famous Brookings Institution "J-curve" which to me resembles a soup ladle rather than the letter J. According to this empirical relation, between 15 and 18 months are required for an American depreciation to operate in reducing the American trade deficit. (Over this period, the US dollar will presumably continue to float down, setting up new J-curves at every step!)

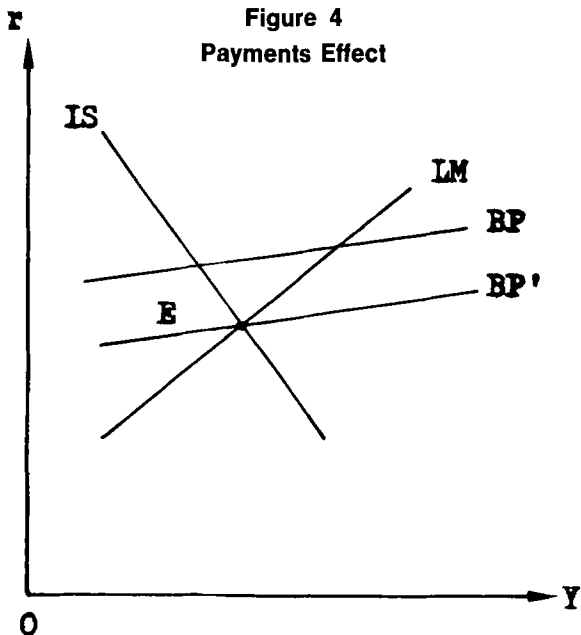


Figure 4
Payments Effect

(b) Depreciation or floating is not expected to affect the depreciating country's capital outflow K . But depreciation imposes exchange losses on foreigners who have invested in the depreciating country's assets, and provides capital gains to depreciating-country citizens who have invested in foreign assets. It is likely, as a result, to lower "confidence" in the depreciating country's economy, particularly insofar as it arouses anticipations of further depreciations to follow. In such cases, benefits on the trade side are offset, and may even be more than offset, by some combination of increased capital exports (capital flight) and decreased capital imports. This may be occurring in the contemporary US case, to judge by newspaper accounts of OPEC countries' reluctance to hold their mounting reserves in dollar assets.

(c) The US is often accused in Germany, in Japan, and in many European strong-currency countries, of maliciously permitting the dollar to slide downwards. This slide is supposed to distress these surplus countries' export industries, and also their import-competing domestic industries. These distressed industries are then expected to pressure their governments into stimulating their economies, raising inflation rates, and letting the resulting increase in demand for American goods raise the dollar and balance American trade. I should be surprised if this "conspiracy" theory were correct, because of the prospective effect of the weak dollar upon the American price of energy, and also because of the capital-movement effect just considered. (American industry is concerned with possible capital shortages delaying recovery from the 1974-76 recession as well as lowering its longer-term growth rate.)

(d) During the 1930s, depreciation in Country A was followed by competitive depreciation in Countries B and C. It was the resulting breakdown of world trade and payments that the Bretton Woods system was planned to prevent. It is by no means certain that a regime of "dirty floating",⁶ in particular, can prevent the lapse into competitive depreciation which nobody desires.

Domestic Absorption

Consider the ultra-simple equation, $Y = A + B$. Here it means that real national income Y is the sum of domestic absorption A and the trade balance B . (Domestic absorption is defined as the sum of domestic consumption, private investment, and public expenditure for goods and services.)

⁶ A "dirty" float is a market in foreign exchange which is manipulated by large purchases and sales, ostensibly to prevent "disorder", by Treasuries, Central Banks, and other monetary authorities of individual countries.

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BALANCE OF PAYMENTS

The implication of this equation is clear. If B is sufficiently negative to make the entire payments balance negative, or insufficiently positive to balance a capital outflow, the deficit country should manipulate its domestic demand for goods and supply of money – on our diagrams, its (IS, LM) functions – so as to reduce A , increase Y , or both, while holding the exchange rate at its initial par value.

Diagrammatically (Figure 5) the fine-tuned move from E to E' represents a contraction of A , while that from E to E'' represents an expansion of Y . The first move is contractive, the second expansive. In most cases, however, the expansive move to E'' is physically impossible because of crucial shortages or "bottlenecks" – skilled labor or plant capacity under full employment, or energy under OPEC restrictions. In practice, therefore, the only move is the contractive one to E' , which involves recession conditions and increased unemployment. This explains the unpopularity of this approach, in, for example, labor circles.

There have been no intentional changes in the functions we have labelled (b , k , BP). In practice, there may be a fall in k (capital-outflow function) if the deficit country can remedy its position without resorting to depreciation. The rubric for this outcome is a resurgence of confidence in the country's currency and its ability to "hold the line". On the other hand, a deliberate recession can set off the sorts of social discontent, culminating in riot and revolution, which operate in precisely the opposite direction. On our diagram (Figure 1) only the first (favourable) outcome is illustrated. The shift from k to k' represents increased confidence and a capital inflow. An upward shift to k'' (not shown) would represent the opposite reaction⁷.

International Monetarism

Our third school of international macroeconomic thought can be motivated most easily as a reaction against the elasticity approach (currency depreciation) in countries with inflation rates already higher than the inflation rates of their trading partners and fearful of accelerated inflation following devaluation. It is, however, a positive doctrine of its own as well.

This positive doctrine is that much demand *both* for foreign goods of all kinds – particularly durables – *and* for investment assets located overseas, should be interpreted as a flight from domestic liquid assets in the presence or anticipation of domestic inflation. (The capital-asset case

⁷ A shift from k to k' produces the same result on the BP function as illustrated on Figure 4. A shift to k'' would move BP in the opposite direction (upwards).

is clearer than the durable-goods one, but consider the entrepreneur or consumer intent on beating the next round of price increases!) If this is correct, a reduced inflation will reduce a payments deficit from both the trader and the capital side. The "trade" reduction is from reduced imports, the "capital" reduction from reduced outflows.

The attack on the elasticity approach springs from the argument that "the world is one market". By this is meant that the relative prices of any country's exports and of that country's imports are basically determined uniformly on world markets (apart from transport costs and protective duties). If this is true, exchange-rate changes can affect the ratio only temporarily, unless they succeed in changing the composition of the import and export "market-baskets" or "bills of goods".

The higher import prices come about early as per the elasticity approach, but (according to the monetarists) percolate through the economy as costs of production for other industries and as sources of wage demands by labor. Export prices eventually rise *pari passu* with import prices, and the country returns to essentially the same payments deficit that it suffered before the depreciation. Another depreciation produces another round of similar effects, "and so proceeds ad infinitum" in real terms. All that has changed is the price level, which has been raised, and possibly also the inflation rate, which may have been accelerated.

Our geometry is in real terms, and the applicable diagram (for the positive argument) is again Figure 4. The favourable changes (from a reduced inflation rate) have come this time from both trade and capital aspects, not from trade alone as in the analysis which led to Figure 4. We have there-

fore used Figure 1, to illustrate the theme. (On all quadrants, the primed functions represent changes brought on by tighter money and disinflation.) Also, contrary to our previous practice, we indicate the effects of the trade balances upon IS along with those of disinflationary monetary policy upon LM.

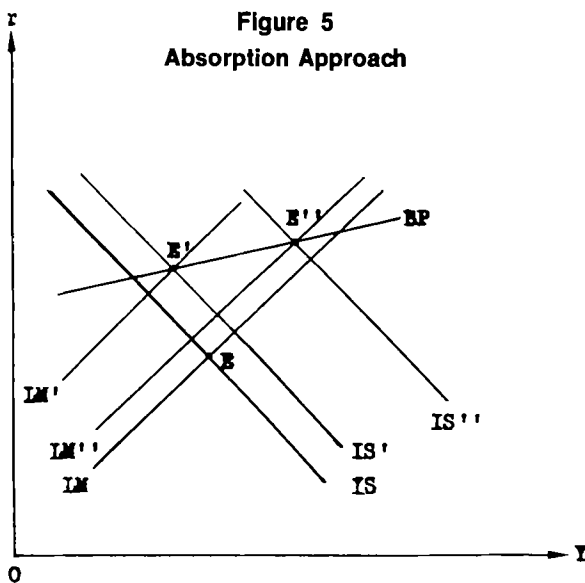
Such is the medicine currently prescribed for the US by the Federal German and the Japanese governments, as well as by the majority of Western European countries, many of which never ingested it themselves in earlier periods of "dollar shortage", and (one may suspect) might not be able to stomach it if their balances of payments turned negative. An equivalent discipline was of course imposed more or less automatically by the pre-1914 gold standard, but its imposition is more painful when opponents can blame flesh-and-blood central bankers and financial technocrats rather than disembodied market forces for its more unpleasant rigors.

Protectionism

A fourth and penultimate method to combat a payments deficit is an obvious one for the public press, including financial journalism. It is protection for import-competing domestic industries. Under the same head of protectionism many writers include controls over capital outflows and technological information ("export of jobs"), as well as subsidies to export industries; I shall follow their example. Protection may be direct and overt, as by tariffs and quotas on foreign imports. Covert forms, such as Japanese "administrative guidance" to potential domestic customers, American arm-twisting to secure "voluntary" export restrictions by Asian trading partners, and nearly everyone's discriminatory administration of safety, health, and environmental regulations against the competitive foreign product, are apparently gaining in both frequency and importance.

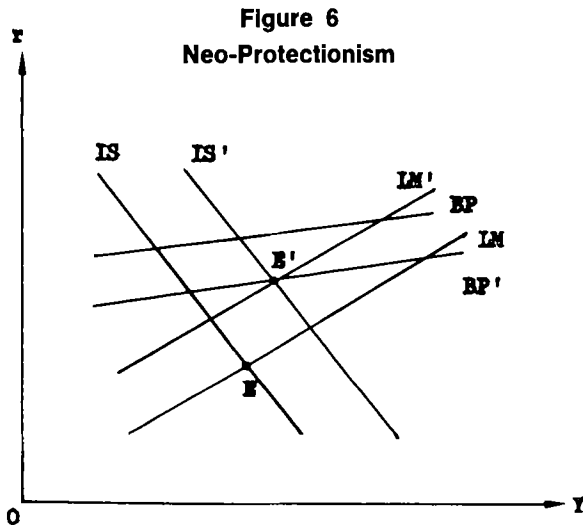
Increased protection, primarily through the instrument of import quotas, is currently threatened by the US in an oblique manner as a remedy for its payments deficit. Important segments of organized American labor and agriculture have been pressing for increased protection with mounting vehemence since the oil shock raised their production costs and American corporations began moving offshore to produce for the American market by American methods. The American government has been professing inability to resist such pressures in the future unless its trading partners increase their purchases of American exports. Whether the American negotiators are exaggerating their domestic weakness as a form of international threat, as they are occasionally accused of doing, is anyone's guess.

Figure 5
Absorption Approach



Protection operates like devaluation (Figures 3–4) upon the protectionist country's balance of payments with the additional features of attracting foreign investment in "tariff factories" and discouraging or limiting the outflow of domestic capital.

A more macroeconomic and finely tuned variety of protectionism – which is also, however paradoxically, a less-protectionistic variety – has arisen at the English Cambridge, and will presumably cross the Atlantic in the near future if it has not already done so. The stress of this variant is on the commodity-equilibrium (IS) effects of the trade balance B and of shifts therein. (These our diagrams have generally ignored, as has our verbal analysis.) This shift from IS to IS' (Figure 6) is a consequence of the shift from BP to BP' in the same figure, which is itself a more direct consequence of the rise in B . The shift in IS is expected to increase aggregate domestic demand, income, and employment in the deficit country, even though a tighter monetary policy may be simultaneously disinflating the economy as by the leftward shift of LM to LM' (also on Figure 6).



The mechanism suggested particularly by Mr. Wyn Godley to capture all these benefits is an over-all surcharge on imports, even those complementary with domestic production. The size of this surcharge should be calibrated to offset the marginal propensity to import, so that the total import volume should remain unchanged as income rises and expansion should not be threatened by payments constraints. Since imports are to be maintained, not reduced, the policy should not greatly injure the deficit country's trading partners as a group; some individual partners will suffer if the deficit country's demand for their particular exports is highly price-elastic, which usually means that these exports compete with home production

in the deficit country. Some deficit-country's domestic and export industries would also be injured insofar as they rely on imported raw materials or imported components.

A note on petroleum may be in place here, since so many European attacks on the US permissiveness toward its payments deficit concentrate on this commodity. That is to say, they concentrate on American reluctance either to reduce imports of OPEC oil directly or to increase domestic production by paying OPEC prices for domestic oil. Analytically speaking, its inclusion within the above protectionist framework is not difficult. A tariff or quota on imported petroleum, or a price stimulus to domestic production, operates like any protective instrumentality, even though it may not be protective in precisely the usual sense of the term.

Turning to more substantive aspects of the energy crisis, I believe the European and Japanese critics are understandably insensitive to certain specifics of the American position. They seem to be assuming implicitly – although they usually know better – that in America, as in Germany or Japan, efficient public transport systems of adequate size are, or could soon be, in place in all large and medium-sized cities, that only the peak of the aristocracy live more than, say, 5 km from their work or from a major train, bus, or tram station. These conditions have not held since 1945, and this is why the adjustment called for by America's critics is quantitatively different from the adjustment required for their own conservation-type adjustments to OPEC in 1973-74, at least in the short term.

Muddling Through

Our fifth and last policy alternative is really no policy at all, or sometimes a "policy" of leaving it to surplus countries among one's trading partners to change their own policies so as to eliminate one's own deficit.

Of course, the primary reason for a monetary authority, be it a Treasury or a Central Bank, to hold dead-weight reserves of gold, convertible currencies, or foreign balances, is precisely the provision of time to diagnose payments deficits as they occur, and also time to permit random, seasonal, or similar short-term payments deficits to right themselves with no need for policy adjustments. The US in particular, held some \$ 25 bn in gold as of 1950, evaluated at \$ 35 per ounce, and so could largely ignore its deficits for nearly 20 years. Meanwhile its gold stock fell to \$ 10 bn, but subsequent gold price rises (not recognized in the US accounts) would raise this to perhaps \$ 55 or even \$ 60 bn at current prices.