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Heinz-Jürgen Scheid*

Current Account Balances and International Economic Policy Coordination

The existing balances on the current accounts of the major industrialised countries have given rise to demands, addressed particularly to German economic policy-makers, which amount to a revitalisation of the "locomotive theory". However, were the world economy once more to be "reflated" in accordance with the "locomotive theory", there would be a danger that the improvements in stability which have been attained would be sacrificed without actually solving the pressing international economic problems.

The balances on the major industrial countries' current accounts – which at least in nominal terms remain stubbornly high – continue to be the point around which international economic policy discussions revolve. Although increasing attention has also been given in recent times to the South-East Asian NIC's which have their own considerable foreign trade surpluses, interest is primarily concentrated upon the United States, Japan and the Federal Republic of Germany. The magnitudes which have by now been attained both by the American current account deficits and by the Japanese and German surpluses are seen as posing one of the chief dangers to the further development of the world economy.¹

There can be no mistaking the fact that the substantial devaluation in the US dollar since March 1985, especially against the yen and the deutschmark, has already been demonstrating the desired effect upon trade flows for some time.² The exchange rate-induced improvement in US suppliers' price competitiveness led to a real growth in American exports of more than 14% in 1987. Some industries are said to be experiencing a veritable export boom.³ In Japan, import demand has been picking up strongly, and the country's real net exports are clearly declining. Thanks to the flexible response which has been made in adjusting to the new situation, Japan's economic prospects are still favourable despite the strong revaluation of the yen.

In the Federal Republic of Germany, too, external economic adjustment has come a remarkably long way. While West German exports rose by only 0.4% in real

terms during 1987, the real increase in imports was 4.5%. The real trade surplus, still DM 85 billion in 1985, had almost halved to DM 47.6 billion in 1987.⁴

After a considerable delay, this evident reversal in trade flows is now gradually beginning to work its way into the nominal current account balances. Until recently, the pronounced shifts in the terms of trade resulting from the fall in both the dollar exchange rate and the price of oil had been concealing the adjustment progress made in real terms.

Nevertheless, it would be presumptuous to expect that the price effects, which are now on the wane, could eliminate the underlying problem. According to calculations by the OECD and the IMF, which are largely in agreement on this, the balances on current account in the three major industrial countries will decline only slowly even in the medium term.⁵ Consequently, the magnitudes involved can be expected to remain, for the

¹ Cf., e.g., OECD: Economic Outlook, No. 43, Paris, December 1987, p. VII ff., or also IMF: World Economic Outlook, Washington D.C., October 1987, p. 2 ff. On the most recent developments, see also O.-E. Kuntze and M. Wegner: Weltwirtschaft 1988: Abgeschwächtes Wachstum bei fortbestehenden Risiken, in: Wirtschaftskonjunktur, Monatsberichte des Ifo-Instituts für Wirtschaftsforschung, No. 1, 1988, p. A 1 ff.

² Cf., inter alia, J. Beyfuß: Wechselkurse und Außenhandelsströme, in: iw-trends, No. 1, 1988.

³ Cf., e.g., S. Nasar: America's Competitive Revival, in: Fortune, 4th January, 1988, p. 36 ff.

⁴ Figures provided in the delimitation of the national accounting system. Source: Federal Statistical Office (Statistisches Bundesamt).

⁵ It should be noted that the IMF projections were published before the turbulence on stock markets and foreign exchange markets set in. However, the scenarios presented by the OECD in December 1987 also show that, because of the associated recessionary risks, any further rapid devaluation of the dollar would hardly accelerate the process of external economic adjustment. Cf. IMF: World Economic Outlook, op. cit., p. 19 ff., and OECD: Economic Outlook, op. cit., p. 159 ff.

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foreseeable future, above the levels regarded as bearable and desirable for the world economy.

However sceptically one may regard such medium-term model calculations and the assumptions they make on complex inter-relationships in the world economy, there is one aspect which the OECD's and IMF's scenarios do demonstrate very clearly. The process of external economic adjustment takes rather longer than many had hoped after the drastic exchange rate movements of the past three years.

Unconvinced Market Participants

Against this background, the top priority in the major industrial countries' efforts to coordinate economic and exchange rate policies is to achieve a more rapid yet orderly reduction in the high current account balances. The approach adopted is basically a correct one in that it strives to eliminate the domestic causes of the external deficits and surpluses. To this end, all parties to the Louvre Agreement of 22nd February 1987 entered into concrete economic policy obligations,⁶ which indeed were also essentially fulfilled.⁷ The objective of exchange rate stabilization was only intended as a supportive element in the overall strategy,⁸ designed to facilitate progress with internal adjustment and to avoid the recessionary risks accompanying any further rapid decline in the dollar exchange rate.

Hence the underlying reason for the severe turbulences on the foreign exchange markets in the latter part of 1987 was not so much associated with the concept of coordination *per se* as with the difficulty in implementing it. Between March and October 1987, the central banks created a certain amount of breathing space as far as exchange rates were concerned with the aid of a coordinated interest rate and intervention policy. However, this was not utilized effectively enough to make adjustments in the real economies of the deficit and surplus countries. What was lacking above all was any perspective capable of convincing the financial markets that the structurally high American federal budget deficits would be lastingly reduced. Evidently the

fact that the shortfall in the US budget in the 1987 fiscal year was lower than the previous year's by over \$ 70 billion was not enough for participants in the market. However, as long as low domestic savings in the USA continue to stand face-to-face with a high demand for finance from consumers, the corporate sector and the federal budget, the USA will continue to have recourse to foreign savings by importing large amounts of capital. If American net capital imports in the USA remain high, the current account deficit cannot disappear.

The financial markets' stability therefore remains in jeopardy. New tensions in the pattern of exchange rates cannot be ruled out, and protectionist tendencies are receiving further impetus. From this point of view, the fact that the present level of current account balances is generally described as a disequilibrium would appear both understandable and justifiable. Nevertheless, it would hardly be possible or make sense in economic terms to define any particular constellation of deficits and surpluses, or indeed their total elimination, as a desirable equilibrium situation.⁹

Latent Danger

However right it is to try and add greater momentum to external economic adjustments by using international coordination as a lever, it is also important to recognize the more or less latent danger of wrongly interpreting current account balances. The discussion surrounding closer international coordination of economic and exchange rate policies has evidently also led to a renaissance of the idea of macroeconomic finetuning.¹⁰ At least in part, existing current account imbalances are being taken as a cause for making economic policy demands. In this regard, the Federal Republic of Germany in particular is criticized for allegedly persisting with too restrictive a course in its monetary and fiscal policy despite its high export surpluses and subdued growth prospects.¹¹ In view of the low rate of inflation, the criticism continues, there is sufficient scope for expansionary policies.¹² The stimulation of the German domestic economy in this way, it is said, would be doubly helpful. On the one hand, it would bring hope

⁶ Statement of the Ministers of Finance and Central Bank Governors of Canada, France, Germany, Japan, the United Kingdom and the United States, Paris, 22nd February, 1987.

⁷ The US federal deficit fell by \$ 70 billion during the 1987 fiscal year, though this was partly due to extraordinary factors. Japan took measures to stimulate the domestic economy, and the German Federal government topped up existing tax reduction plans by over DM 5 billion effective from 1st January, 1988.

⁸ The aim "... to foster stability of exchange rates around current levels" is only officially stated in the closing sentence of the communiqué which runs over several pages.

⁹ For a critical account of the false interpretation of current account imbalances, see H. Willgerodt: *Dollarschwäche: Lehren und Irrlehren*, in: *Frankfurter Allgemeine Zeitung*, 16th January, 1988, p. 13.

¹⁰ For a critical treatment of this cf. J. Scheide and S. Sinn: *Internationale Koordination der Wirtschaftspolitik: Pro und Contra*, Kieler Diskussionsbeiträge, No. 135, November 1987, esp. p. 23 ff.

¹¹ See, e.g., Morgan Guaranty Trust Company of New York: *World Financial Markets*, September/October 1987, p. 9 f., or M. Meyer, R. Thomas and D. Seward: *The Reluctant Germans*, in: *Newsweek*, 9th November, 1987, p. 13. On the most recent discussion, see, e.g., S. Greenhouse: *A New Plan to Spur European Growth - Greater Economic Cooperation*, in: *International Herald Tribune*, European ed., 23rd February, 1988.

¹² Even the OECD comes to the conclusion that "Additional macroeconomic policy action is necessary ..." (*Economic Outlook*, No. 43, op cit., p. XI).

of reducing the high rates of unemployment. Beyond that an increase in West German import demand would also have a stimulating effect on the world economic cycle and hence ease the task of reducing the American current account deficit. Only then, the argument goes, would the Federal Republic of Germany be making the contribution it owes to the stabilization of the world economy.

An immediate objection to such a line of argument is that the facts of the case make it rather difficult at present to speak of an unduly restrictive course in West Germany's monetary or fiscal policy. In both of the past two years, the money supply target which had been established beforehand was exceeded to no small degree, while the official discount rate is now at the lowest level in the history of the Federal Republic, and public-sector deficits are again rising strongly in the current year, primarily because of substantial shortfalls on the revenue side.

It would seem that a question of greater economic importance is whether or to what extent it makes theoretical sense to consider the international interrelationships between economic cycles solely from

the point of view of changes in current account balances. Any such perspective oriented to residual balances is based on a Keynesian mode of thinking. These ideas are basically in line with the "locomotive theory", with which attempts to apply it in practice were made following the Bonn world economic summit meeting in 1978. At that time, too, the proposal was that countries with relatively low inflation rates and with current account surpluses – Japan and West Germany – should begin by stimulating their domestic economies with the aid of job-creation programmes so that they would then, in a second step, take the remainder of the world economy "in tow" by way of increased imports of goods. However, the results gave little ground for encouragement. In as far as the policy was actually pursued at the time, it did not achieve the desired objectives. Instead, it tended to induce currency devaluation and accelerated inflation.¹³

¹³ Cf., e.g., K. J. Keller: Die Lokomotivtheorie – Grundlagen und Probleme, in: Zeitschrift für Wirtschaftspolitik, Vol. 29, 1980, p. 255 ff., or H. M. Kaufmann: International Stagflation and the "Locomotive Hypothesis", in: Kredit und Kapital, Vol. 15, 1982, p. 227 ff. On the re-emerging discussion, see, e.g., W. M. Corden: On transmission and coordination under flexible exchange rates, in: W. H. Buiter and R. C. Marston (eds.): International economic policy coordination, Cambridge 1985, p. 8 ff.

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(Ed.)

REGULIERUNG IN DER BUNDESREPUBLIK DEUTSCHLAND

Die Ausnahmereiche des Gesetzes gegen
Wettbewerbsbeschränkungen

REGULATION IN THE FEDERAL REPUBLIC OF GERMANY

The Exceptions in the Law against Restraints to Competition

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Revival of the "Locomotive Theory"

In the form in which it now appears to have been revived, the "locomotive theory" centres around controlling macroeconomic aggregates at an international level on a coordinated basis, and with the aid of discretionary demand policy. A fiscal impulse which stimulates the domestic economy reduces the surplus (or increases the deficit) in the balance of trade and the current account, meaning that demand effects are also transferred into the international economy. In a greatly simplified form, the chain of cause and effect functions as follows: The expansion of demand by the state raises the (nominal) national income in the "locomotive country". Then, in a proportion determined by the marginal propensity to import, the income-dependent demand for foreign products increases. This has a negative effect on the "locomotive country's" current account, whereas other countries build up equivalent export surpluses. The improved current accounts in the foreign countries induce multiplier and accelerator effects which raise (nominal) national income there by an amount which is several times that of the original demand impetus. The increased national income abroad in turn leads to higher import demand there, and this is again of benefit to the "locomotive country".

Seen from this perspective, macroeconomic policy gains an international dimension. The idea is that international coordination of monetary and fiscal policy should make it possible to combat a worldwide demand shortfall in the same way as a "demand gap" on the domestic market. Thus, a coordinated policy of expansion would be beneficial to all the countries involved.¹⁴

However, the foreign-trade-induced transmission of economic cycles according to a Keynesian pattern amounts to a "zero-sum game". For each gain in national income and employment in the surplus countries, there is an equivalent loss of demand in the deficit countries. Hence a shortfall on the current account would be harmful to domestic economic activity.

¹⁴ Attempts are also being made to establish that coordination of macroeconomic policies is beneficial for all participants by applying games theory. Cf., e.g., W. H. Buiter and R. C. Marston (eds.): *International Economic Policy Coordination*, op. cit., particularly the contributions by Miller/Salmon, Currie/Levine and Oudiz/Sachs; see also A. Steinherr: *Konvergenz und Koordinierung der makroökonomischen Politiken*, in: Commission of the European Communities: *Europäische Wirtschaft*, No. 20, 1984, p. 71 ff. For a critical approach see R. Vaubel: *International Collusion or Competition for Macroeconomic Policy Coordination? A Restatement*, in: *Recherches Economiques de Louvain*, Vol. 51, 1985, p. 223 ff.; J. Scheide and S. Sinn: *Internationale Koordination*, op. cit.; M. Feldstein: *The End of Policy Coordination*, in: *Wall Street Journal*, 10th November, 1987.

A proportion of effective demand would not be directed towards domestically produced items, but would "seep away" to suppliers from abroad. The connection here does also seem to be confirmed by the conventions of national accounting, for declining or "negative" net exports have the effect in pure accounting terms of reducing the national product. Certainly, on the one hand, it is true that income-dependent changes in import demand during the periods which follow serve as a corrective to the stimulatory effect of a current account surplus or the deflationary effect of a deficit. Yet, on the other, there is an unmistakable proximity here to mercantilist ideas. A country will be encouraged in its economic policy to try and use balance of payments surpluses on visible trade and on the current account to gain an employment advantage at the expense of its trading partners.

This obviously leads us to lose sight of the dynamic effects of a growing international division of labour. The surpluses and deficits on the trade and current accounts provide no indication of whether the volume of world trade lying behind these figures is shrinking or expanding.¹⁵ Hence external economic surpluses and deficits do not, by themselves, allow any reliable statement to be made about the prosperity of the world economy. Only the protectionists claim that higher imports would cause damage to the domestic economy. The one question which therefore needs to be seriously examined is under what conditions the foreign-trade-induced transmission of an economic impetus as propounded by the "locomotive theory" actually works at all and whether, apart from that, it is possible to treat the present situation of the world economy as a "Keynesian" one.

Preconditions for Successful Application

One important precondition directly comes to light to which multiplier and accelerator analysis using theoretical models is bound. Such analysis works on the implicit assumption of fixed exchange rates.¹⁶ It is only in such an exchange-rate regime that the so-called money-supply mechanism can come into effect, meaning that changes in current account balances also transmit monetary purchasing power from one economy to another.¹⁷ A country's money supply is then subject to the "dictates of the balance of payments", thus varying

¹⁵ Cf. also H. Willgerodt: *Dollarschwäche: Lehren und Irrlehren*, op. cit.

¹⁶ Cf. H. M. Kaufmann: *Internationale Stagflation*, op. cit., p. 231.

¹⁷ Cf. J. Roth: *Der internationale Konjunkturzusammenhang bei flexiblen Wechselkursen*, Kieler Studien No. 135, Tübingen 1975, p. 16 ff.

in line with the foreign trade and foreign exchange position at any time. A current account surplus raises the domestic money supply and, with a certain time-lag, also the nominal national product. Now let us assume, under these conditions, that public-sector demand is increased abroad, leading to income and price increases there. This then improves the home country's export opportunities, and there is a positive effect on the home country's balance of trade and current account.

Current account surpluses generate increases in the country's foreign exchange reserves, which provide greater scope for money and credit creation, allowing domestic total monetary demand to rise, which leads to multiplier and accelerator effects. In the medium term, prices and wages increase, and the trend in the current account is again reversed. The prerequisite for the chain of events described by the "locomotive theory", then, is that there are flows of foreign exchange with the aid of which purchasing power is transmitted from one economy to another and the monetary base is expanded in the surplus country.¹⁸

Under a system of flexible exchange rates, however, this derivation does not apply. A current account surplus no longer has the effect of raising liquidity, because the central bank in the country concerned is not obliged to accept an increase in domestic money supply for the sake of defending fixed parities. In contrast to the situation when rates are fixed, there is no foreign exchange problem, an overall balance of payments equilibrium exists at all times. This is not true, on the other hand, of the individual accounts in the balance of payments. With floating exchange rates, whatever surpluses or deficits occur on trade and services are mirrored by an equivalent amount in the capital account. A current account surplus means that, on balance, capital is exported. Hence the expansionary impetus provided by additional exports of goods is automatically linked with capital outflows tending to put upward pressure on interest rates which can then also result in a slackening of the domestic economic cycle. Under these circumstances trade and capital flows can be expected to generate mutually opposing effects upon economic activity.¹⁹

As a counter to this argument, one could point out that developments since the Louvre Agreement have shown certain parallels to a system of fixed exchange rates. In

the first half of 1987, at least, the US current account deficit was financed for the most part by support purchasing of dollars by non-American central banks. In a similar process to what was seen in the final phase of the Bretton Woods system, the burden of adjustment was shifted from the deficit country to the surplus countries. At the cost of a pronounced expansion in their own money supplies, the central banks outside the USA removed an estimated \$ 100 billion from the market during 1987,²⁰ in order to stabilize the American currency and ensure an adequate flow of capital to the United States.

In that sense the monetary condition for economic impulses to be transmitted internationally as suggested by the "locomotive theory" could actually be said to have been fulfilled. At least in part, the US current account deficit is being funded by money creation in the surplus countries, and the induced money-supply effects in those countries ought to trigger an expansionary process along Keynesian lines. Yet in reality things have not developed in that way. Admittedly, the fact that money supply targets were exceeded, in West Germany for example, has not so far led to inflation being rekindled; indeed current risks to price stability are seen as rather slight because of the revaluation of the deutschmark and the low price of oil. Equally, however, the marked expansion of the money supply has not so far been followed by a boost to economic activity as could have been expected in the presence of a deflationary gap in Federal Germany.

A Keynesian Situation?

Consequently, the question arises as to whether Keynesian demand management represents a suitable policy device at the present time. In the light of recent theoretical development demand management on a Keynesian pattern is no longer regarded as a generally valid instrument for controlling the economic cycle, but only as a possible (marginal) case in the event of "Keynesian underemployment"; that is, it would only be appropriate from a policy viewpoint to use this approach if there were a worldwide deficiency of demand.²¹

Given a cyclical underemployment, a current account surplus could lead to additional export demand flowing

¹⁸ Cf. H. Willgerodt: Kapitalbilanz und Devisenströme, in: F. Greiß and F. W. Meyer (eds.): Wirtschaft, Gesellschaft und Kultur, Festgabe für Alfred Müller-Armack, Berlin 1961, p. 459 ff.; or H. Willgerodt: Handelsschranken im Dienste der Währungspolitik, Düsseldorf/Munich 1962, p. 33 f.

¹⁹ Cf. even such early work as G. Haberler: Prosperität und Depression, 2nd ed., Tübingen/Zurich 1955, p. 427 ff.

²⁰ See, e.g., P. Stephens: Lessons of harsh economic reality, in: Financial Times, 22nd February, 1988; or L. Gieske: Perspektiven der weltwirtschaftlichen Entwicklung, reproduced in: Deutsche Bundesbank: Auszüge aus Presseartikeln, No. 3, 1988.

²¹ Cf. H. M. Kaufmann: Internationale Stagflation. . . , op. cit., pp. 232, 236 ff.

into the home country and stimulating income and employment there. In this way a domestic deflationary gap could be plugged. In a case such as this, it is possible to boost domestic economic activity even without the money-supply effects due to market operations in support of the dollar, via the indirect route of the (private) export of capital. The deflationary effect of saving in national accounting terms is reduced because the "export valve" is opened. The consumption forgone in favour of the transfer of capital increases the demand for exported goods, and overall expenditure in money terms increases in the home country. Other things being equal, the growing net exports then increase national income and employment in the capital exporting country.

However, it is crucial as a prerequisite that the typical characteristics of a Keynesian situation really do exist in the capital exporting country. This means part of the productive capacity being unutilized because saving is too high and consumption and/or investment too low. Entrepreneurs are short of profitable investment opportunities at home, a situation which changes little in the event of interest rates coming down.²² The export of capital would then offer the opportunity to invest the surplus savings abroad. This generates an additional demand effect on the goods market since, on balance, more goods are exported. The increased demand from abroad absorbs domestic goods which would otherwise not have been either produced or sold.

The effects of a current account surplus on economic activity would then correspond to those of an expansionary fiscal policy at home. Yet this poses the question of whether it is really at all necessary to use the roundabout route of inducing a stimulus to the economy from outside if Keynesian unemployment prevails. If a country really does face slack demand in the economy as a whole, which might be threatening to intensify cumulatively, it has enough options available for taking domestic expansionary measures. Use can be made, in such situations, of the monetary and fiscal policy instruments in accordance with the Keynesian approach.

The Experience of the 1970's

In contrast to the above, the experiences of the 1970's have shown that the limits to global demand management need to be closely drawn.²³ Obviously, the

assumption of a price sensitive supply of goods is not borne out in the real world. As a rule, when expansionary policies are pursued inflationary consequences prove impossible to avoid. Hopes that employment programmes would bring the goal of full employment closer to realization have not been fulfilled in the past. A stable inverse relationship between inflation and unemployment, as presumed by the Phillips-curve theory, does not actually exist. The economic policy failures of the 1970's thus provided the motivation for a deep-seated change of paradigm, and to a fresh interpretation of the economic situation which had come about in the light of stagflation theory.²⁴ The new approach at the beginning of the 1980's persuaded most industrialised countries to direct their economic policies towards combating inflation in order to create the conditions for an enduring economic upswing. It became apparent during this process that – contrary also to the assumptions made by supply-side economics – it was impossible to regain stability without suffering severe setbacks in employment.²⁵ Especially in those areas where all manner of rigidities existed, it became inevitable that employees would be made redundant.

Were the world economy once more to be "reflated" in accordance with the "locomotive theory", the danger would be that the improvements in stability which have been attained would be sacrificed without actually solving the pressing problems in the world economy, for these – it is generally agreed – are not cyclical but primarily structural in nature.²⁶ The Bank for International Settlements was already sounding a warning note in its 1986 annual report:

"In the long run, monetary policy influences mainly the overall rate of inflation. To lose sight of this relationship could jeopardise the hard-won gains in the fight against inflation. That danger is perhaps greatest when the immediate prospects for overall price developments are as favourable as they are at the moment as a result of a decline in energy prices and, in most countries other than the United States, appreciating exchange rates."²⁷

²³ Cf., e.g., K. Schiller: *Die Grenzen der Wirtschaftspolitik* (neu betrachtet), in: *Jahrbücher für Nationalökonomie und Statistik*, Vol. 201, No. 1, 1986, p. 1 ff.

²⁴ Cf., e.g., G. Haberler: *The Problem of Stagflation. Reflections on the Microfoundation of Macroeconomic Theory Policy*, Washington, D.C., 1985.

²⁵ Cf. Bank for International Settlements: *53rd Annual Report*, Basle 1983.

²⁶ Cf. K. Schiller: *Die Grenzen der Wirtschaftspolitik* (neu betrachtet), op. cit.

²⁷ Bank for International Settlements, *56th Annual Report*, Basle 1986, p. 116.

²² On the Keynesian investment trap, see O. Landmann: *Keynes in der heutigen Wirtschaftstheorie*, in: G. Bombach, H.-J. Ramser, M. Timmermann and W. Wittmann (eds.): *Der Keynesianismus*, Vol. 1, Berlin/Heidelberg/New York 1981, p. 142 ff.