

Kamppeter, Werner

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Intereconomics

Suggested Citation: Kamppeter, Werner (1988) : The double deficit of the USA and disequilibria in the world economy, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 23, Iss. 4, pp. 189-196,
<https://doi.org/10.1007/BF02925109>

This Version is available at:

<https://hdl.handle.net/10419/140142>

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Werner Kamppeter*

The Double Deficit of the USA and Disequilibria in the World Economy

The disequilibria in the world economy, of which the massive trade and current account deficits of the USA are but one manifestation, have reached dangerous proportions. The following article presents a number of scenarios to show how they may develop in future.

For years the savings ratio of households in the USA has been far lower than that in the other industrial countries, but between 1982 and 1986 it fell from 6.8 to 4.7%, with the net savings ratio even declining from 5.1 to 1.6%. By way of comparison, the savings ratios of German and Japanese households stood at 12.1 and 17.4% respectively in 1986.

Saving by private households meets the credit demand of the rest of the economy, in other words the corporate sector and the state. Borrowing by US companies has increased rapidly during the eighties, albeit primarily to finance corporate take-overs and financial speculation, but the state's demand for credit has escalated (Figure 1); in 1986 new government indebtedness came to \$ 214 billion, equivalent to around 5% of the country's GNP.

The opposing trends in saving and credit demand were bound to lead to a savings gap. Since insufficient saving signifies excessive consumption, a shortfall in supply was also an inevitable consequence. Both gaps were closed not by the effects of inflation but by the external sector (Figure 2), with the trade deficit making good the shortfall in supply and the current account deficit closing the savings gap.

The underlying problem is therefore not the US budget deficit in itself – in relation to GNP it has been

below the OECD average in recent years – but the combination of a budget deficit with inadequate saving; only then does the budget deficit become a double deficit. This decline in the "savings cover ratio" in the USA also explains why US foreign debt has increased faster than the budget deficit and continued to grow in 1987 despite a reduction in the budget deficit.

Since the savings and supply gaps in the United States were made good by the external sector, other countries had to have corresponding savings and supply surpluses. Surplus countries had to export more than they imported and invest surplus dollars abroad. Since 1982 it has been mainly Japan and the Federal Republic of Germany (and, to a lesser extent, Taiwan and some Latin American countries) that have recorded substantial trade and current account surpluses and made corresponding transfers of savings. In 1986/87 Japan and Germany lent around 4% of their national income abroad, whereas the USA borrowed the equivalent of 3.5% of GNP (Figure 3).

If one enquires how these two countries were able to generate savings surpluses of this magnitude in such a short time, the following picture emerges (Figures 4 and 5). In Germany saving by households has been consistently high, but since 1982 the proportion used by the corporate sector and the state has steadily decreased. Between 1980 and 1986 the credit demand of German companies declined from DM 93 to 30 billion at *current* prices and that of the state from DM 62 to 24 billion. The proportion taken up by borrowers from abroad increased accordingly to DM 73.5 billion in 1986, 58% of net saving.

* Research Institute of the Friedrich Ebert Foundation, Bonn, West Germany. Revised version of a paper presented at the symposium on "The Double Deficit of the USA: Should Germany take Action?" held by the Foundation on 29th September 1987. The author wishes to express particular thanks to his colleague Alfred Pfaller for his encouragement and comments.

Table 1
Germany and Japan: Exports to the USA
as a Percentage of Total Exports¹

	Germany	Japan
1980	6.1	24.3
1982	6.6	26.2
1986	10.7	38.5

¹ Merchandise trade (excluding services).

Sources: Deutsche Bundesbank, Bank of Japan.

A similar trend can be observed in Japan, though with the differences that new borrowing by the state was reduced even more sharply between 1983 and 1987 and that corporate credit demand was consistently higher than that from abroad. Nevertheless, Japan has become the largest capital exporter and creditor nation in the world.

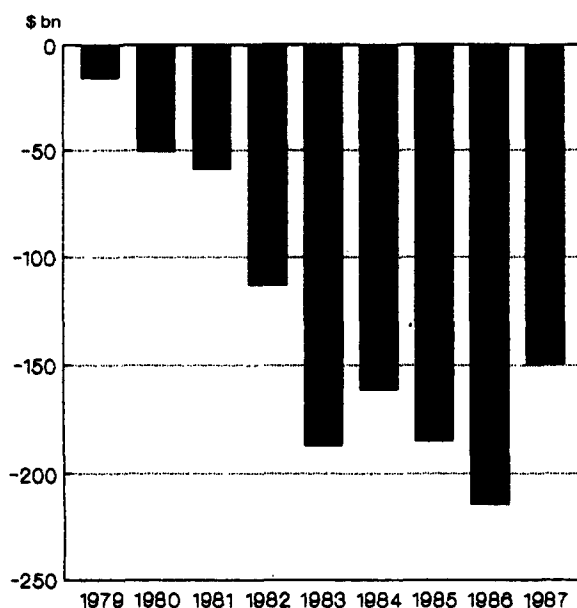
Hence in Germany and Japan the declining absorption of domestic saving by enterprises and the state since 1982 led to savings surpluses, with whose help the US savings gap was closed, either directly or via third countries. The shortfall in US supply was filled in a similar way directly and via third countries.

Accordingly, growth in Japan, Germany, Taiwan, South Korea and a number of other countries was export-led. The USA acted as the locomotive of the world economy. In view of the lucrative business to be done in the USA, the proportion of German and Japanese exports going to the US market increased dramatically (Table 1).

Hence the national disequilibria in consumption, saving, debt and investment were complementary and cancelled each other out internationally, but only at the price of growing US foreign indebtedness and massive trade and current account deficits. Both were bound to undermine confidence in the US economy. The reduction of national imbalances has therefore itself become a dangerous structural problem for the world economy. However, it is clearly not just a question of correcting the American disequilibria but equally one of eliminating the complementary disequilibria of surplus countries.

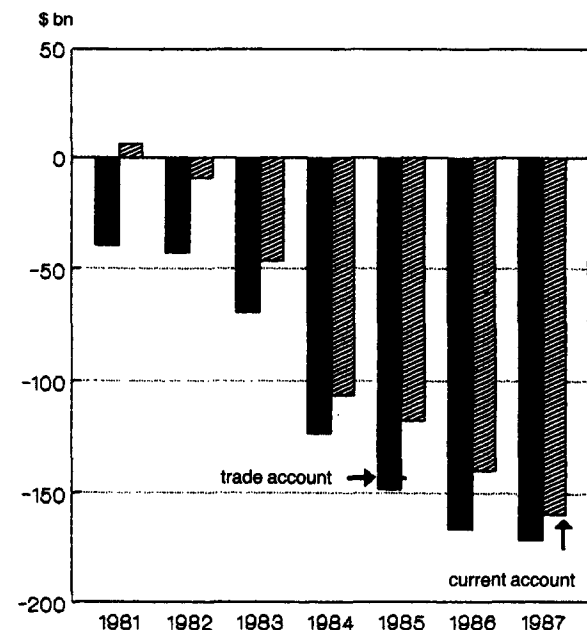
The remainder of this article uses scenarios to illustrate four possible ways in which the current disequilibria in the world economy may develop. The fifth scenario presents a proposal for rectifying the defect that has underlain the developments of recent years.

Figure 1
The US Federal Budget Deficit



Source: Executive Office of the President: Special Analyses, Budget of the United States Government.

Figure 2
The US Trade and Current Account Deficits



Source: OECD Economic Outlook, December 1987.

Hard-landing Scenario

In the eighties the high yields offered on US securities made them extremely attractive to foreign investors. The steady appreciation of the US dollar and the boom on Wall Street held out the prospect of capital gains as well. The appreciation of the dollar was fuelled partly by the demand for dollars from foreign investors, but its momentum was also sustained by repeated waves of speculation on a revaluation which up to 1985 always proved to be justified. Until the beginning of that year the exchange rate therefore diverged increasingly from the equilibrium exchange rate (calculated on the basis of inflation differentials; cf. Figure 6).

Since then the dollar has lost more than half its value. As expectations of depreciation grew firmer, it became more difficult to finance the US savings gap, for interest rate differentials were no longer sufficiently large to offset the expected capital losses. Private investors therefore began to withdraw their capital. To prevent an even sharper fall in the exchange rate the central banks had to buy dollars, sometimes on a large scale (an estimated \$ 80 billion in the first quarter of 1987).

Despite the "orderly" depreciation of the dollar so far, it is legitimate to question whether the central banks would be able to counter a massive flight from the dollar accentuated by speculative transactions. Since the

dollar is still the most important currency by a long chalk, they would probably be unable to absorb a deluge of dollars into the market.

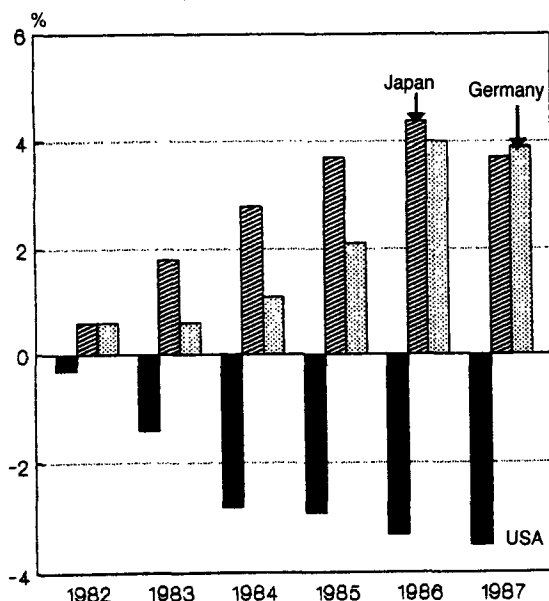
Such an uncontrolled dollar decline, which would also be accompanied by panic selling of US securities and a collapse in the US stock market,¹ would force a solution of the imbalances between saving, debt and consumption, but at enormous cost:

□ The problem of US indebtedness would be solved by the depreciation of foreign investments, although domestic confidence in the dollar and its internal value would not necessarily suffer.

□ Bilateral trade with the USA would come to a standstill; Americans would no longer be able to afford imported goods, while American goods would be so cheap that the rest of the world would have to protect itself by imposing import bans. Multilateral trade would also be affected; for example, South Korea could no longer use its surpluses from trade with the USA to buy

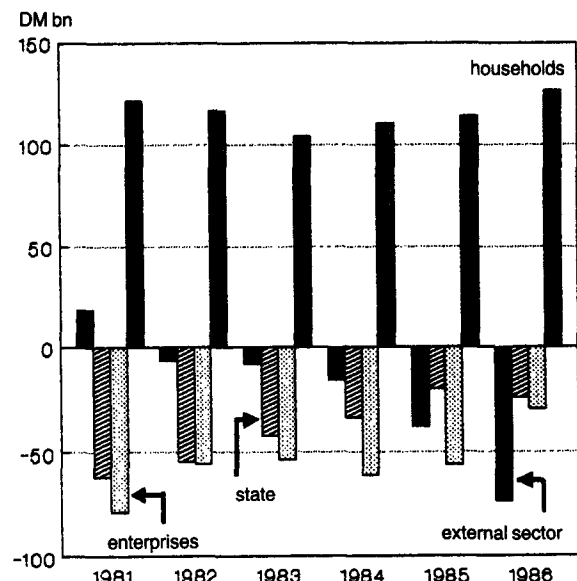
¹ In this case two factors would lead to a stock market crash: (1) investors' lack of confidence in the efficiency and solvency of the US economy (in view of foreign debt and trade deficits), and (2) the fear of capital losses engendered by expectations of currency depreciation. The fall in share prices in October 1987 had very little to do with either of these factors, otherwise it would not have happened two and a half years after the dollar had begun to depreciate and when it had already lost half its value. Moreover, share prices tumbled not only on Wall Street but worldwide and the US exchanges were not even the worst affected.

Figure 3
International Financing Deficits and Surpluses
(as a percentage of GNP)



(-) signifies borrowing abroad and (+) increase in claims on other countries.
Source: OECD Economic Outlook, December 1987.

Figure 4
Germany: Financial Balances according to Sector



Source: Deutsche Bundesbank: Monatsberichte, Gesamtwirtschaftliche Finanzierungsrechnung (May issues).

technology from Japan and oil from Indonesia. There would therefore be a trade-induced worldwide recession. The greater a country's involvement in world trade and the higher the proportion of its trade in complementary goods, the worse it would be affected.²

□ Correction of the American situation of undersaving/overconsumption; the shortfall in US domestic saving could no longer be offset by borrowing foreign savings. Moreover, domestic savings would be reduced by capital flight. The alternatives would be forced saving as a result of inflation (which would lead to a loss of domestic confidence in the dollar) or an increase in taxation and hence a reduction in the deficit. The decline in demand would have recessionary effects until the readjustment between consumption, saving and government expenditure was completed. In view of the precarious financial situation of many American companies and banks, there could be mass bankruptcies and a crash on Wall Street.

□ Correction of oversaving/underconsumption in the rest of the world; economic activity would decline sharply if countries did not succeed in drastically and quickly reducing the propensity to save or greatly increasing government expenditure, financed by borrowing or by increasing taxation.

Confidence Cycle Scenario

The depreciation of the dollar has slowed down considerably since the critical period in the first quarter of 1987. Private investors, and in particular Japanese institutional investors, have regained confidence and are again looking favourably on US securities. Yield differentials of no more than a few points are enough to make them forget their previous losses and the possibility of further dollar depreciation.

To the extent that the US savings gap is not closed internally, the United States must continue to rely on foreign savings, so that a trade deficit or current account deficit is necessary. However, this and the growing foreign debt will increasingly strain the confidence of private investors until the point is reached at which they will purchase no new securities and dispose of those they already hold. Such changes in mood can be sudden and strong "herd instincts" can rapidly trigger a massive spate of selling. Central banks must then intervene to compensate, but they only have a chance of

restoring confidence in the dollar if they buy dollars promptly, resolutely and in concert. If they are successful, the debt roundabout can continue to revolve for a while.

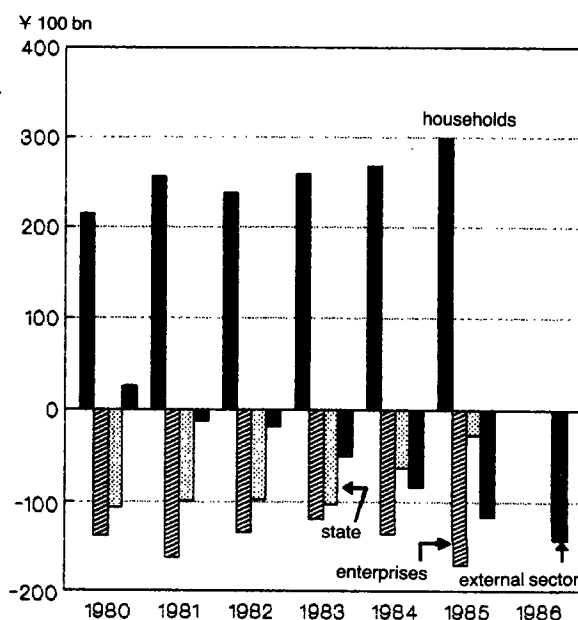
The debt roundabout can function perfectly well in a context of relatively stable exchange rates; the dollar need only be overvalued enough to create the current account deficit required to finance American overconsumption. However, it rests on three shaky foundations:

- the growing burden of interest payments borne by the Federal budget and the current account;
- distrust of the United States' ability and preparedness to redeem its debts;
- the ability of the central banks to oppose and contain waves of speculation against the dollar.

In the final resort, the central banks would have to be prepared to buy all the dollars they were offered. In this way they would be financing not only the current US savings gap but also existing debt, since they would have to purchase the dollars private investors had acquired from the sale of previously issued US securities.

In these circumstances the central banks would acquire claims on the United States that could never be

Figure 5
Japan: Financial Balances according to Sector



Sources: Economic Planning Office; National Accounts 1987; Bank of Japan.

² The USA would probably be less affected by the collapse of its foreign trade than the rest of the world, since it is not highly integrated into world trade, a significant proportion of its imports are substitute goods (e.g. motor cars) that can be replaced relatively easily by American products and its technological dependence on other countries is relatively low.

redeemed or only at a substantial discount. In the final analysis, the confidence cycle scenario would therefore mean the rest of the world providing America with goods and services free of charge.

In addition, the central banks' dollar purchases will increase the money supply. The excess liquidity can be

- ☐ mopped up by inflation, or
- ☐ neutralised by means of open market operations (whereby the central banks would acquire ultimately irredeemable claims).

The confidence cycle scenario is therefore unstable, economically nonsensical (since export surpluses would be simply given away) and politically irresponsible and deceitful (regarding the level and distribution of the cost involved).

Redistribution of Burdens Scenario

Defence spending has been an important factor in the growth of the budget deficit under President Reagan. Whether one regards it as right or not, it is a fact that Germany and Japan contribute comparatively little to the Western defensive alliance in relation to their economic strength, while the United States' contribution is large. Depending how far it went, a redistribution of the defence burden could take much of the sting out of the US double deficit:

☐ Higher defence spending would increase government expenditure in Germany and Japan. If it were financed by means of new government borrowing, the savings surplus (Figures 4 and 5) would diminish accordingly. Overall demand would remain unchanged. On the other hand, an increase in taxation would have an adverse effect on consumption and saving and would be deflationary.

☐ The US budget deficit would be reduced by the amount of the transfers.

☐ The deficit on the US current account would also be reduced as a result of the transfers.

It would be difficult to achieve the necessary political conditions for increasing military expenditure in Germany and especially in Japan. On the other hand, the way in which the US savings gap has been financed hitherto, which can be seen as a concealed form of international financing for the Strategic Defence Initiative, scarcely makes economic sense and lacks political legitimacy.

Consolidation and Repayment Scenario

Under what circumstances could the USA cease to borrow abroad and begin to redeem its debt? Until now, foreign producers have been able to make good the shortfall in US supply because they had competitive advantages over US manufacturers, mainly on account of the overvaluation of the dollar (Figure 6). If the US supply gap is to be closed domestically these advantages for foreign suppliers must obviously be reduced and the competitiveness of the US economy improved. The imbalances between consumption and saving in both deficit and surplus countries should also be eliminated or reversed.

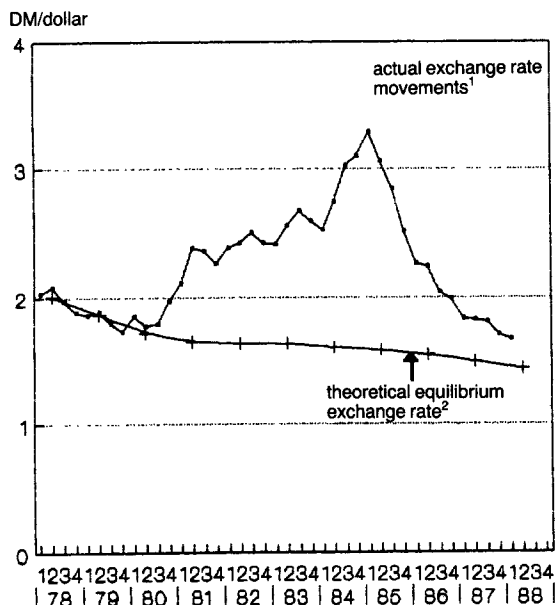
A change in competitive conditions could be brought about in two ways or by a combination of both:

1. Protectionist measures in the United States: this would divert import demand to the home market. A (non-recurring) burst of inflation would be unavoidable owing to the lower US productivity. The reduction in imports and accompanying measures such as export subsidies and currency depreciation could bring the US current account into balance or even into surplus.

However, such a policy could be successful only if internal equilibrium could be established between saving and consumption. If the shortfall on the supply side remained, an inflationary spiral would be unavoidable. Since this would necessitate ever higher levels of protection or continual devaluations, it would be self-defeating and have a destabilising effect.

Figure 6

Equilibrium and Actual Exchange Rates



¹ Middle spot rates.

² Adjusted for inflation differentials (base year 1978).

Sources: Deutsche Bundesbank, OECD.

2. Devaluation of the dollar: in 1979 and 1980 the US current account was more or less in balance, as was Germany's in 1978 and 1979. The dollar/DM exchange rate was in the region of DM 2.00 in 1978 and above DM 1.80 in 1979. These rates can be regarded as a kind of equilibrium exchange rate. In Figure 6 the "theoretical equilibrium exchange rate" based on the 1978 exchange rate has been extrapolated to 1988 in the light of the inflation differentials between the two countries.

In recent months the dollar has been trading at around DM 1.65-1.70, and thus remains significantly above this estimated equilibrium rate (which errs on the side of caution). Of course, it is not only inflation differentials that influence competitiveness, and other factors indicate an even lower equilibrium rate for the dollar:

□ The export of agricultural products was one of the United States' strengths ten years ago. Today there is worldwide overproduction in this sector, so that it is even more important for the USA to become competitive in industrial goods.

□ The highly profitable trade foreign companies were able to conduct with the USA during the phase of dollar appreciation enabled them to further modernise and

rationalise their production and hence gain additional advantages vis-à-vis US competitors.

□ Many US firms have ceased production in the eighties and could therefore only resume supplying the domestic and foreign markets in the medium term. They often lack the financial resources needed for investment. If anything, only a significant improvement in their competitive position can help them.

□ Given the high profits made during the period of dollar appreciation, foreign companies can now defend their market shares by making price concessions.

□ Other things being equal, any redemption of Third World countries' debt towards US creditors increases the US current account deficit. If the current account is to be in overall balance, the US surpluses vis-à-vis other countries (e.g. Japan and Europe) must be all the larger.

For these reasons, the US current account cannot be in balance or in surplus without a further drastic depreciation of the dollar, although here too a depreciation without simultaneous action to close the savings gap internally would come to nothing due to a resurgence of inflation.

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Leonhard Firlus

ZWISCHEN SCHOCK UND KALKÜL

Die permanenten Verschuldungsprobleme der
Entwicklungsländer

BETWEEN SHOCK AND CALCULATION

The Permanent Debt Problems of the Developing Countries

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The debt crisis of the developing countries is among the most discussed problems of the world economy. Exogenous shocks and mistaken economic policies are generally named as the causes of the crisis. From an historical perspective, however, periods of debt servicing problems are the rule. It is thus too narrow a view to interpret debt problems solely as a consequence of exogenous shocks and mistaken economic policies. This study examines the question in how far calculated behaviour by decision-makers in developing countries must be included in attempts to explain debt problems, in order to be able to explain their permanence.

VERLAG WELTARCHIV GMBH-HAMBURG

Elimination of the imbalances between consumption and saving in the USA: Current account adjustment is not possible without closing the US savings gap. A current account surplus requires a savings surplus. A shift between consumption and saving could come about:

- ☐ as a result of inflation (forced saving);
- ☐ by reducing the budget deficit or achieving a budget surplus (i.e. an increase in taxation or a corresponding reduction in government expenditure);
- ☐ by increasing households' propensity to save;³
- ☐ as a result of a decline in investment by the corporate sector.

The success of an inflationary policy depends partly on the behaviour of the exchange rate and real wages. Implementation of the other three options would necessarily lead the US economy into recession unless export demand provided strong stimulus.

Elimination of the imbalances between consumption and saving in creditor countries: If the savings surpluses of Japan and Germany were no longer absorbed by the USA they would either have to be reduced or invested elsewhere (such as in developing countries, where in the long term the greatest growth potential undoubtedly lies). If the USA made net redemptions of debt, Japan and Germany would have to absorb US savings surpluses, in other words they would have to have domestic savings and supply gaps. The necessary correction could come about:

- ☐ by expanding the central government budget deficit (increasing government consumption or reducing taxation);
- ☐ by increasing households' propensity to consume or reducing their propensity to save;
- ☐ by increasing corporate investment.

An autonomous increase in corporate investment could not be expected. On the contrary, companies would be more likely to invest less, since their competitiveness both at home and abroad would be significantly reduced. Expectations of a recession would lead to "panic saving" by households, again with negative effects on demand. It would therefore be left to the state alone to counter the recessionary effects stemming from the reduction in disequilibria and to sustain economic activity.

Japan has already embarked on this course; even the public has recognised that the export of savings on the

scale of recent years is neither sustainable nor sensible and that greater attention must be paid to the domestic market. Partly as a result of pressure from enterprises associations, no less, the balanced budget objective was abandoned in mid 1987 and fiscal policy once again became expansionary with the adoption of a comprehensive package of economic measures. The economy responded quickly; in March 1988 industrial production was 9% higher than a year earlier, exports were stagnating and imports (from East Asia and Europe but not from the USA) were increasing rapidly. The current account surpluses have also been much smaller in recent months.

In Germany, by contrast, domestic demand is still weak and both net investment and employment remain at the depressed levels of recent years. Monetary policy continues to be restrictive. The Federal budget is unintentionally in deficit, but there is still no realisation of its central role in eliminating macro-economic disequilibria.

New Order Scenario

Exchange rates are determined by two fundamental factors:

- ☐ trade flows (which tend to iron out purchasing power differences between currencies and to turn productivity advantages to the benefit of all);
- ☐ capital flows (which compensate for international differences in the behaviour of consumption, saving, borrowing and investment).

Leaving central bank intervention aside, a country's balance-of-payments equilibrium is determined by the sum of the trade and capital accounts. If a country makes savings available to the rest of the world (in other words, has a deficit on capital account), it must achieve a corresponding trade surplus. For this its currency must be undervalued (in comparison to a balanced trade account). The picture for a borrowing country is the mirror image, with a trade deficit and overvaluation of its currency. Hence the inflow or outflow of savings gives businesses "false" signals in the sense that their competitiveness is respectively reduced and enhanced. Since an inflow or outflow of capital cannot be sustained indefinitely, especially if it is being used to finance consumption, the balances on the capital and trade accounts and hence the situation regarding exchange rates and competitiveness must eventually be reversed. In this way international financial markets can cause

³ In view of the associated wealth effects, the stock market crash of 19th October 1987 probably led to a slight rise in the saving propensity of US households.

disorder in the real economy, distort its structure and pose serious problems of adjustment.

The experience with the double deficit in the USA illustrates precisely this link; an expansionary fiscal policy and the reduction in the US savings ratio in conjunction with Volcker's restrictive monetary policy led to a worldwide crowding-out in the capital markets, the appreciation of the dollar and substantial US trade and current account deficits. As a consequence, the competitive positions and structures of the economies were distorted and the world economy is now faced with adjustment problems that will be very difficult to overcome.

The use of the savings of other countries to expand the productive apparatus or improve the infrastructure and hence to improve the country's economic performance is unproblematical and even desirable. However, if foreign savings are used to finance additional consumption, serious problems can arise within a very few years. Flexible exchange rates and the freedom of international capital movements then become a curse and must be questioned.⁴

The underlying problem is therefore the use of savings to finance consumption in another country rather than for productive purposes. Since government and private overconsumption can hardly be prevented by international economic policy co-ordination, this problem can be tackled only by imposing controls on capital movements. There would be a relatively simple criterion for this, namely to restrict foreign exchange trading essentially to the financing of foreign trade (such a system applied, for example, in Japan until 1979), in other words to:

- ☐ imports and exports of goods and services of all kinds;
- ☐ long-term borrowing to finance imports of capital goods and technology (since future consumers will benefit from these, they should also bear the burden in the form of worse terms of trade in the future);
- ☐ the financing of direct investment, but only up to the amount of foreign exchange required in this context (if

the financing provided exceeds the foreign exchange needed to import capital goods or technology, such a capital import is not neutral as far as exchange rates and resource allocation are concerned);

- ☐ unilateral transfers of income between countries, but only up to the amount of foreign exchange actually required to finance development projects and the like.

In these circumstances the advantages of flexible exchange rates and international capital movements could be fully realised:

- ☐ Exchange rates could perform their function of balance-of-payments adjustment while retaining the advantages stemming from trade. Only correct signals would be given to enterprises. (Short-term and seasonal fluctuations in the supply of and demand for currencies could be evened out by central banks or forward markets.)
- ☐ Budgetary discipline could no longer be evaded by borrowing abroad. In other words, budget deficits could be financed only by crowding out private borrowing on domestic capital markets or through inflation.
- ☐ Monetary and fiscal policies would be decoupled at the international level, in other words countries would regain economic policy independence.
- ☐ The cyclical trends of individual countries would also be largely decoupled (trade, which would tend to be in balance, would be the only remaining and desirable linkage).
- ☐ Protectionist measures, subsidies and the like would no longer have to be a bone of contention between countries; any damage would be sustained by the protecting or subsidising country's own economy and would therefore only have to be justified at home.
- ☐ Capital flight and the destabilising influence of short-term capital movements⁵ would be largely avoidable.

The argument is not therefore that savings should be used only within the domestic economy but that it should be possible to invest them abroad only if they will bring an increase in economic efficiency. High saving is desirable, since there is a serious dearth of private and public capital in industrial countries (to reduce unemployment) and especially in developing countries. Hence it cannot be sensible to reduce German or Japanese oversaving via increased domestic consumption. In short, the lesson to be drawn from the events of recent years is that conditions must be created that make it possible to use available and growing savings to expand output and income both nationally and internationally.

⁴ This is even acknowledged by people such as Wilfried Guth: "Were it not for greater freedom of capital movements and the wide range of investment opportunities, it is barely conceivable that the massive American current account deficits could have been financed, which obviously raises the question whether they could have reached this magnitude in the absence of such freedom" (Wilfried Guth, *Frankfurter Allgemeine Zeitung*, 12th May 1987).

⁵ A Tobin tax on foreign exchange transactions reduces the short-term mobility of capital but cannot affect international savings gaps and deficits. It therefore does not represent an alternative to controls on capital movements.