INTERNATIONAL ECONOMIC POLICY
A Briefing of the Shadow Open Market Committee
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I. What's New?

President Carter may have tried to take the limousines away from the staff, but he certainly hasn't cut out their international travel.

The Secretary of the Treasury, Mr. Blumenthal, in presenting the President's domestic economic recovery program to the House Appropriations Committee highlighted the international economy (February 1, 1977).

The international aspect of the domestic program was two pronged and simple. American economic health depends importantly on our export markets. Slow-downs are foreseen in industrial countries. In addition, there is growing concern about the ability of a number of countries, both industrial and developing, to finance their continued current account deficits, that is, excess payments for imports of goods, services, and gifts over receipts from the same sources; in turn, this raises doubts about their capacity to sustain their growth, reduce unemployment, and control inflation.

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The solution to both problems according to the Secretary lies in the expansion of the financially and economically strong countries who must run current account deficits.

Underlying both problems, according to Secretary Blumenthal, is the persistent external surplus of the oil-producing countries. (The Organization for Economic Cooperation and Development, the OECD, which is the rich countries' club, projects these to continue in 1977 at about $37 billion compared with $42 billion in 1976; see its Economic Outlook, December, 1976, page 10.) The weak countries must reduce their deficits to preserve their credit worthiness and must "depend on us for export-led growth," according to Secretary Blumenthal. The strong countries must therefore reduce their current account surpluses.

The arguments were sharpened three days later, upon the return of the Vice President, Mr. Mondale, from ten days abroad. The Undersecretary of State for Economic Affairs-Designate, Mr. Richard Cooper, was reported to have estimated that the world was losing $300 billion in unused resources because of sluggish economic growth. The Assistant Secretary of the Treasury-Designate, Mr. Fred Bergsten, was cited, saying that the United States was seeking to induce Japan and Germany to move from a "small to big country psychology." They should think of themselves as "engines of the world economy." (Journal of Commerce, February 3, 1977).
As Mr. Blumenthal put it, "... the United States is asserting leadership and encouraging the stronger countries abroad to follow suit. We are implicitly and explicitly asking them to follow a course of stimulating their economies much as we are proposing for the United States ..."

Though the Administration did not specify its criteria, it is easy to see why the Federal Republic of Germany (FRG) and Japan were singled out. Of the seven largest countries, all ran current account deficits in 1976 except Japan and the FRG. And they also enjoyed the largest holdings of official international reserves, after the United States.

And one would not expect the Administration to name the particular countries where current account deficits might be hard to finance. But the numbers do not deny the possibility of the problem. For example, between 1973 and 1975, the external debt of the LDCs almost doubled and the ratio of debt service payments to merchandise exports rose from 15% to 20%. (International Economic Report of the President, January 1977, p. 30f.). The members of OECD accumulated net current account deficits of $60 billion since 1974, but $70 billion was accounted for by countries having only 30% of the combined gross product of the OECD nations. (OECD, Economic Outlook, December 1976, p. 10.)

Mixed in with this picture are estimates that commercial banks raised their share of the new external financing of the LDCs from
20% in 1971-73 to over 40% in 1974-76. The official multilateral sources seem to be running out of resources to lend, for example the International Monetary Fund had to turn to the General Arrangements to Borrow to finance the British loan and the IMF's Oil Facility ended in March 1976. (Morgan Guaranty Trust, World Financial Markets, January, 1977). With commercial banks holding $75 billion of the estimated external debt of $180 billion of the LDCs, concern over the willingness of the private sources to continue their support of current account deficits arises.
II. A Lone Ranger?

The Administration's diagnosis and proposed solution had support on the Hill. Worried about large U. S. budget deficits being "politically unattractive," the Senate Budget Committee wrote "There is no reason why," the U. S. alone must bear the responsibility for stimulating the world economy . . . "Other strong industrial economies - notably Germany and Japan - must share the responsibility to provide the fiscal and monetary stimulus that world economic recovery requires." (Wall Street Journal, December 17, 1976.)

The OECD in its December report on the economic outlook pressed Japan, the FRG, and the United States for expansion. It forecast a slower rise in the real gross product of the OECD countries from 5% in 1976 to 3.75% in 1977. Compared with its report six months earlier, the latest was notably more pessimistic. It also expressed concern about the ability of some of its member nations to finance their expected current account deficits and added that some of the non-oil developing countries might be in trouble as well.

The Ford Administration raised the same problems that could have led to the same diagnoses as those of the Secretary but without coming down on policy prescriptions. (Economic Report of the President, January, 1977, Chapter 3.) Perhaps the major discernible difference between the present and previous Administrations
is that the shoe is on the other foot. The Ford Administration resisted entreaties from other nations including Japan and Germany to expand in 1975 and early 1976; this Administration is inviting selected, cooperative expansion.
III. Some Questions (and Answers?)

Is the world headed for a slow-down? Is the financing for expected current account deficits inadequate? If so, will the Federal Republic and Japan comply with the Administration's request? And if, they do will it turn the trick?

Obviously, these are not easy questions to answer.

A. Prospects for a Slow-Down

As for the OECD area, leaving aside the United States, there was an unmistakable decline in the rate of growth of the combined industrial production of the six other major members (Canada, France, Germany, Italy, Japan, and the United Kingdom) in the last quarter of 1976 over the year as a whole, supporting the notion of a slow-down in 1977. (CIA, Economic Indicators, February 16, 1977; I used 1974-75 shares of their combined gross product as weights.)

Furthermore, there was also a sharp decline in the rate of growth (it actually became negative) in the real money balances of those same members in the last quarter of 1976 over 1976 as a whole, further supporting the notion of a decline in economic activity in 1977. (Ibid.)

But this evidence is not decisive. For example, excluding the U. S., the OECD projects a decline in the rate of increase of the gross product from 3.8% to 3.3% between 1976 and 1977, well
within the possible range of forecasting error. More importantly, perhaps, the sharp decline in real money balances noted above is almost entirely attributable to developments in Italy and the United Kingdom. These are the only two of the seven to show an increase in their rates of price inflation in the last three months of 1976 over the year as a whole. And, in comparison with their average rates of inflation since 1970, they are also the only two to display faster inflation in the last three months or, except for France by a small margin, over the year as a whole. By creating uncertainty, inflation in Italy and the United Kingdom may have been the chief cause of their unemployment and recessions. Declining real balances may slow price inflation, create more uncertainty, and thereby stimulate their growth and employment.

And for those who like large-scale econometric models, Professor Lawrence Klein projects a rise in the OECD real output from 3.15% to 5.5% between 1976 and 1977. (International Financial News Survey, January 10, 1977)

It is hard to know that the Administration is wrong, but it is also difficult to be confident that it is right.

B. Current Account Financing

The Administration's concern about the ability of countries to finance their current account deficits is extremely difficult to assess.
The reasons are obvious.

The assessment of a country's ability to carry present or added debt is a judgement call, where the answer depends upon a wide range of political and economic variables, including whether or not those variables would permit a policy-directed reduction in the deficit to be financed.

The easiest argument in support of the Administration is that if its proposals and pressures would induce inflation in the creditor countries (which it explicitly does not desire), the real burden on foreign debtors would fall. But in a world where nominal rates of interest seem to adjust quickly to expected rates of inflation, so that inflation would raise debt service payments, this line of reasoning is far from persuasive.

Another argument which would support the Administration would be that the problem of current account deficits and their financing is so general that a series of defaults, world-wide, would ensue that might break the fabric of the financial system.

But the problem seems to be more localized than general. Without mentioning their names, the OECD seems to be worried about the U.K., France, and Italy. (See the countries not mentioned by the OECD, Economic Outlook, December, 1976, p. 10.) But since these countries have floating exchange rates, there is no reason to assume that the current account deficits are intractable; after all, capital and current transactions adjust to one another to equate total
inflows and outflows of foreign exchange. (The OECD forecasts assume no change in exchange rates.)

As for the LDCs, in the eye of one keen observer, "The judgement of the United States Government, the World Bank, and most private bankers is that there is no global problem, no serious threat of massive defaults or debt repudiation. (Edwin L. Dale, Jr., *The New York Times*, January 30, 1977.) Again, it is difficult to show that the Administration is wrong, but it is hard to be confident that it is right.

C. Will Japan and the FRG Respond?

Who knows?

The Vice President, upon his return, stated that the three countries are in "substantial agreement" on the need to help "stimulate" world recovery. But he acknowledged that the three governments may differ on the "size" of the necessary stimulus. (*Journal of Commerce*, February 3, 1977.) While reports emanating from abroad suggested that Japan and Germany reacted to the Administration's recommendations less favorably than that, it is difficult to tell how much of this was for domestic consumption and how much was for real.

D. Will It Turn the Trick?

Obviously the Administration, by its own words, is not sure. Secretary Blumenthal testified on January 27 that "... it is easy
to overestimate the magnitude of the contribution that faster
growth in Japan, Germany, and the United States can make in
fostering the needed adjustments in the weaker countries. A
one percent rise in the real GNP of the "big three" would result
in an increase in their combined import demand on the order of
$4 billion in 1977, of which only 60% or about $2.4 billion, could
directly benefit the financially weaker countries." (House
Budget Committee, p. 6) For ball-park comparison, the world GNP
excluding those three countries and the Soviet Union and China
is probably around $5,000 billion. (International Economic Report
of the President, op.cit. Table 2.)

The Secretary's scenario depends upon some "ifs" which could
deny him his objectives. More fundamentally, can prosperity be
transmitted from one country to another or is prosperity chiefly
made at home?

First, look at the issue from the Keynesian point of view, a
view which focuses on the effects of changes in the current account
on aggregate demand.

Suppose that the FRG expands its internal demand. Germany's
imports increase. And, by definition, exports to Germany also rise,
adding, at least potentially, to aggregate demand in the rest of
the world.

When Germany's imports rise, this increases the supply of
marks on the foreign exchange market. If the German central bank
does not buy up those marks, the value of the German mark on the
foreign exchange market must fall. This makes German goods more
competitive. Other countries will divert their purchases toward German products and away from their own goods. This reduces aggregate demand in the rest of the world. If nothing else happens, German exports must rise by an amount equal to the increase in its imports, causing no net decrease in Germany’s current account surplus and thus no decline in the current account deficits of other countries. In short, there is no net transmission of demand from Germany to the outside world. In fact, the transmission might work perversely. If the expansion of demand in Germany is achieved through lower interest rates, capital will flow out of the FRG, further increasing the supply of marks on the foreign exchange market. This depresses the mark even more against foreign currencies. In the end, the mark will fall in value until the extra imports by the FRG plus the flow of capital from the FRG just matches the increase in German exports. The German current account surplus rises to finance the extra capital exports, exactly the opposite of the desired result.

From the monetarist point of view, the exercise also fails. As German imports rise, foreign exporters receive additional marks which they sell on the foreign exchange market for their own currency. If the foreign central bank does not buy and hold those extra marks, it does not issue newly-created money to buy those marks; the stock of money outside of Germany does not rise, and aggregate demand abroad therefore cannot increase despite the rise
in exports. The currency simply appreciates until the inflow of
marks and the outflow of marks are equal.

For the scheme to work, on the Keynesian analysis, the German
central bank must buy up the extra marks when Germany's imports and
capital exports increase. This prevents the decline in the value
of the mark on the foreign exchange market. As a consequence,
German exports won't rise, and the German current account surplus
must diminish. If the German expansion brings internal inflation,
this result is strengthened as German goods become less competitive
while the exchange rate stays constant.

Alternatively, in the monetarist framework, if the foreign
central banks buy the marks to hold, they will issue their own
new local money to buy those marks from those who export to
Germany; this expands the stock of money at home and stimulates
internal demand as exports rise.

The central problem is now apparent. Fine tuning with an
international orchestra requires a strong conductor—fixed exchange
rates. But Germany, Japan, and the United States do not automatically
fix their rates of exchange or, in our example, buy up their
currencies as their imports of goods or capital exports rise. Much
of the rest of the industrial world is floating so that it cannot
receive the German transmission. Some of the developing countries
tie their currencies to one of the major currencies, chiefly the
dollar, but then their currencies float automatically against
non-dollar currencies.
This is not to say that the Secretary is wrong. It is just to say that the process is complicated and the results are therefore problematical.