THE UNITED STATES IN THE WORLD ECONOMY, 1983

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As the world’s largest economy, the United States has long had a profound influence on economic developments in the rest of the world. That was true at the end of World War II, when the U.S. share of world GNP was an astounding 50 percent, and it remains true today, when U.S. GNP represents about 20 percent of world income. The past decade has taught the often painful lesson that economic influence is now a two-way street. Some of the most profound influences on the U.S. economy in recent years have originated abroad. The oil and food shocks of the 1950s, and the international debt crisis of the past year have shattered the myth that U.S. economic management can go it alone, without regard for the rest of the world.

The coming year will reinforce this lesson. Several of the risks to a sustained, low-inflation recovery in the U.S. now involve the rest of the world. The international debt crisis will continue to pose
great risks to economic growth in the U.S. and the less developed countries (LDCs). The looming trade deficits of the U.S., now forecast to exceed $100 billion by the end of '84, pose threats of various sorts. The strong dollar of recent years might well collapse under the weight of these deficits, with inflationary consequences; or, the threat of such collapse could contribute to a new round of interest rate increases, if the Federal Reserve Board must intervene to protect the dollar. Equally serious, the historically unprecedented deficits could spill over into the flurry of protectionist actions, with longer term costs of great significance. Finally, there are reasons to believe economic recovery in Europe will be weak and slow to arrive with adverse consequences for U.S. trade, LDC debt repayments and world economic growth.

In short, the prospects for world economic recovery remain problematic in several ways, with important implications for U.S. economic prospects. This paper will review the major aspects of the world macroeconomic picture, and will propose several ways in which macroeconomic policies in the U.S. and the rest of the world might improve the chances for sustained economic growth.

I. Economic developments in the advanced economies

Figure 1 provides the most direct documentation of the stagflationary decade since 1973. The average
Figure 1: Unemployment and Inflation in the OECD Economies, 1965-1982

Inflation


16 14 12 10 8 6 4 2 0

Year

Unemployment

10 8 6 4 2 0

Year
annual inflation rate for the OECD economies is plotted against the unemployment rate for the group, during the period 1965-82. In the 1960s, economists spoke confidently of a negative long-run tradeoff between inflation and unemployment, but since 1969 the advanced industrial economies have experienced the simultaneous misfortunes of higher inflation and unemployment. Thus, for the OECD economies as a whole, the 1982 unemployment rate (8.2 percent) was approximately three times the 1969 rate (2.6 percent), while the inflation rate was nearly twice as high.

The diagram hints at several of the major themes taken up below. Note that the periods 1973-78 and 1979-82 show a very similar pattern: a sharp rise in inflation in the first year, together with a smaller increase in unemployment, and then a period of several years during which inflation is reduced at the same time that unemployment rises sharply. The years 1973-74 and 1979-80 are the two "supply shock" years, in which energy prices (and some other raw materials prices) exploded at a startling rate. The subsequent "disinflationary" years, 1975-78 and 1981-83 reflect the effects of monetary stringency around the world in fighting the inflationary effects of the supply shocks.

During 1980-82, almost all of the industrial countries turned their monetary policies sharply contractionary, with inflation fighting in mind. Table 1 illustrates the legacy of those policies. In each
TABLE 1

Inflation and Unemployment in the Major Economies

<table>
<thead>
<tr>
<th>Inflation (CPI basis)</th>
<th>1980</th>
<th>1981</th>
<th>1982</th>
<th>1983&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>13.3</td>
<td>13.3</td>
<td>11.9</td>
<td>8.8</td>
</tr>
<tr>
<td>Germany</td>
<td>5.5</td>
<td>5.9</td>
<td>5.3</td>
<td>3.1</td>
</tr>
<tr>
<td>Japan</td>
<td>8.0</td>
<td>4.9</td>
<td>2.9</td>
<td>-1.3</td>
</tr>
<tr>
<td>U. K.</td>
<td>18.0</td>
<td>11.9</td>
<td>8.5</td>
<td>5.3</td>
</tr>
<tr>
<td>U. S.</td>
<td>13.5</td>
<td>10.4</td>
<td>6.2</td>
<td>4.9</td>
</tr>
<tr>
<td>OECD</td>
<td>15.5</td>
<td>12.2</td>
<td>9.8</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Unemployment&lt;sup&gt;b&lt;/sup&gt;</th>
<th>1980</th>
<th>1981</th>
<th>1982</th>
<th>1983&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>6.3</td>
<td>7.6</td>
<td>8.5</td>
<td>9.1 (9)</td>
</tr>
<tr>
<td>Germany</td>
<td>3.8</td>
<td>4.3</td>
<td>7.0</td>
<td>9.3 (10)</td>
</tr>
<tr>
<td>Japan</td>
<td>2.0</td>
<td>2.2</td>
<td>2.3</td>
<td>2.8 (9)</td>
</tr>
<tr>
<td>U. K.</td>
<td>6.8</td>
<td>10.7</td>
<td>12.7</td>
<td>12.3 (10)</td>
</tr>
<tr>
<td>U. S.</td>
<td>7.1</td>
<td>7.6</td>
<td>9.5</td>
<td>8.8 (10)</td>
</tr>
<tr>
<td>OECD</td>
<td>5.8</td>
<td>6.7</td>
<td>8.2</td>
<td>9.5&lt;sup&gt;c&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

<sup>a</sup> Most recent three months, at annual rate.

<sup>b</sup> 1983 observation is most recent month, indicated in parentheses.

<sup>c</sup> OECD forecast at end-1982.
of the major economies shown, the inflation rate has been brought down significantly since 1980, but at the cost of a very substantial increase in unemployment. Notice the important fact that the U.S. is the only economy of the five shown with an important reduction in unemployment since 1982, for reasons described below.

At least some of the unemployment, of course, results from causes other than monetary contraction. In particular, higher oil prices squeeze profits, and will reduce employment unless wages fall enough to compensate. In many unionized sectors, in the U.S. and Europe, the necessary wage adjustments have been slow in coming, and long-term unemployment problems have resulted (see Bruno and Sachs [1983] for details). Nonetheless, a major share of the jump in unemployment since 1979 lies with monetary policy, and it is on policy-induced unemployment that I shall focus.

II. Supply shocks and the Phillips Curve

The rise in unemployment and reduction in inflation since 1980 is in large part a consequence of the monetary policies pursued in the major countries in the past three years. Not only have the "economic laws" not broken down, as some argue; standard economic models can rather precisely account for the experience of disinflation, as well as for much of the jump in inflation in 1979. Ironically, the "supply-side" policies of the Reagan administration had relatively little to do with either the rise in unemploy-
ment or fall in inflation during 1980-82, though the President's policies received an enormous share of both the credit and blame during that period. Monetary policy, rather than fiscal policy, played the predominant role. Only with the third round of tax cuts in 1983 has the Administration's fiscal policy become of primary macroeconomic importance.

Much of the confusion over macroeconomic events in recent years arose from the simultaneous and seemingly paradoxical, increase in inflation and unemployment. High unemployment should restrain wage demands, and thus inflation; low unemployment should embolden unions and thus raise inflation. A sharp increase in both inflation and unemployment seems a violation of these simple principals. Of course, the explanation of events lies in the fact that labor costs are not the sole factor determining price increases, so that unemployment of labor is not the single factor behind rising or falling inflation. In both 1973-74 and 1979-80, the run-up in inflation had more to do with world energy and food prices (only loosely related to U.S. or OECD unemployment) than with changes in wage demands. And, indeed, to the extent that wages accelerated in those years, the wage increases were a response (in most countries) to the rising inflation rather than an independent cause.

In order to make this case, I will focus on the U.S. experience, noting that the experience in other economies has been quite similar. As a preliminary
point, it is crucial to make clear exactly what the U.S. inflation experience has been. In Figure 2, we show the U.S. inflation rate (using quarterly data, at annual rates), comparing the consumer price index (CPI) and the Private Consumption Deflation (PCD). Though the CPI is the most widely cited index of prices in the U.S. economy, it is seriously flawed relative to the PCD, which in principle measures the same set of consumer prices.

As shown in the figure, the CPI inflation reached a peak of almost 18 percent in 1980:I, and has since come down to 5.1 percent in 1983:II. On this measure, the 1979-80 inflationary bulge far exceeded that of 1973-74. The PCD tells a very different, and more accurate, story. This index reached a peak annual inflation rate of 11.4 percent in 1980:I, below the peak rate of 12.7 percent in 1974. The 1979-82 rise and fall of inflation closely resembles the 1973-76 pattern. The surprising feature, indeed, is not the "runaway" inflation of recent years, but rather the similarity of the 1979-80 episode to the inflation of the mid-1970s.

Many economists have noted the chief deficiency of CPI (see Blinder [1980] for an excellent discussion). The index gives too much weight to housing expenditures, and within that category, to interest rates rather than rental rates. Thus, in a period of rising interest rates, of which late 1979 and early 1980 qualify par excellence, the CPI inflation may
Figure 2
A Comparison of Inflation According to the Consumer Price Index (CPI) and the Private Consumption Deflator (PCB)

Inflation:
- Consumer Price Index
- Private Consumption Deflator

Chart showing data points for inflation over a period.
vastly overstate the rise in consumer costs.

There can be little doubt that rising import prices, rather than generalized excess demand accounted for the inflationary shocks of the mid- and late-1970s. But it is also true that some, though not all, of the rise in import prices can be traced to two episodes of rapid money growth throughout the world economy that preceded the supply shocks. Sharp increases in world liquidity during 1970-72, and then again during 1978-79, helped to trigger the extraordinary rises in oil prices, which then fed back to flame inflation in the OECD. But most of the blame for the higher oil prices must lie with the OPEC cartel (particularly Saudi Arabian oil supply behavior) and with the Iran-Iraq war in the more recent shock.

Figure 3 documents the close relationship between the peaks in PCD inflation and import-price inflation in the U.S. Of course, the inflationary bulges in the private consumption deflator look puny compared to the almost 50 percent import-price inflation rate during 1974 and 25 percent rate during 1980. But the timing of the domestic- and import-inflation patterns shows an unmistakeable pattern. Moreover, the picture hints at a related fact relevant to 1983: much of the drop in inflation in the past year is tied to the negative import-price inflation during 1982 and 1983.

A simple model can help to bring out the distinct roles played by import prices and unemployment in the
Inflation:

Private Consumption Deflator

Import Prices

Figure 3
Consumer Price Inflation (PCE basis) and Import Prices, in the U.S., 1964-1982
inflation process. Let $\hat{w}_t$ be the rate of wage inflation in period $t$, and $\hat{v}_t$ be the rate of (cyclically adjusted) labor productivity growth. $\hat{w}_t - \hat{v}_t$ is then the rate of increase in normal unit labor costs. Let $\hat{p}_t$ be the inflation rate for domestic goods, and $\hat{p}_{t}^{m}$ be the rate on imported goods (in dollar terms). Finally, let $\hat{p}_t^c$ be the increase in consumer prices. We propose the following relationships. First, wage inflation is a positive function of current and lagged consumer price inflation, and a negative function of the unemployment rate ($U_t$):

$$\frac{\Delta w_t}{w_t} = a_0 + a_1 \frac{\Delta p^c_t}{p^c_t} + (1-a_1) \frac{\Delta p^c_{t-1}}{p^c_{t-1}} - a_2 U_t$$

Next, consumer price inflation is a weighted average of domestic and imported price inflation:

$$\frac{\Delta p_t^c}{p_t^c} = b_0 \frac{\Delta p_t}{p_t} + (1-b_0) \frac{\Delta p_t^m}{p_t^m}$$

Third, domestic price inflation is equal to the rate of increase in unit labor costs, plus the change in profit margins, $\hat{m}_t$ (i.e. in the markup of prices over wages):

$$\frac{\Delta p_t}{p_t} = \hat{w}_t - \hat{v}_t + \hat{m}_t$$

Finally, the markup of prices over wages depends negatively on the level of unemployment, so that the change in the markup depends negatively on the change in unemployment:

$$\frac{\Delta m_t}{m_t} = -c_0 (U_t)$$

By combining these various components, we can
arrive at a single equation for inflation, of the form:

\[(5) \hat{P}_c^t = d_0 + d_1 \hat{P}_c^t - 1 + (1-d_1) \hat{P}_m^t - d_2 U_t - d_3 \dot{U}_t\]

In words, current inflation is a function of: lagged inflation; import prices; unemployment; and the change in unemployment.

Such a simple model does amazingly well in accounting for the U.S. inflation experience in the past twenty years. Using annual data, (5) is estimated for the period 1961-1979, using ordinary least squares, with the following results:

\[(6) \hat{P}_c^t = 2.26 + 0.89 \hat{P}_c^t - 1 + 0.11 \hat{P}_m^t - 0.43 U_t
\]

\[- 0.36 \dot{U}_t\]

All variables have the correct sign, plausible magnitude, and statistical significance at the 5.0 percent level. A one percentage point rise in \(\hat{P}_m^t\) raises inflation by 0.11 percentage points. This is consistent with the fact that imports are approximately 10 percent of GDP. A percentage point rise in \(U_t\) reduces inflation by 0.36 percentage points, and a percentage point higher level of \(U_t\) reduces inflation by

1/ Specifically,

\[d_0 = a_0 b_0 / (1 - a_1 b_0)\]
\[d_1 = (1 - a_1) b_0 / (1 - a_1 b_0)\]
\[d_2 = a_2 b_0 / (1 - a_1 b_0)\]
\[d_3 = b_0 c_0 / (1 - a_1 b_0)\]
0.43 percentage points.

Figure 4 shows the within-sample fit, and out-of-sample forecasting ability of the equation. Notice that the equation has no difficulty in accounting for the sharp rise in inflation in 1973-74 and the subsequent decline in 1975-78. Similarly, the equation readily explains the out-of-sample rise in inflation in 1980, and the recent disinflation. The slowdown in inflation is not a miracle of Reaganesque, or a repeal of the laws of Keynesian economics; it is the predictable consequence of a fall in $\hat{P}^m$ and rise in unemployment since 1980. Other researchers have also demonstrated recently that inflation equations based on the period up until 1979 can account for the slowdown in inflation since that time.

Without pretending a false precision, we can ask how much the factors $\hat{P}^m$, $U$, and $\dot{U}$ have played in the slowdown in inflation since 1980. Inflation declined approximately 7 percentage points between 1980 and 1982 (from 12 to 5 percent). In 1980, $\hat{P}^m$ was 25 percent, while in 1982, $\hat{P}^m$ was -2 percent. Thus, approximately $0.11 \times [25-(-2)]$, or 3 percentage points of the slowdown is the reversal in import-price inflation. By similar calculations, we can arrive at the following rough accounting:

\[\text{See in particular Perry [1983].}\]

\[\text{Because of the role of lagged inflation in the equation, there are indirect effects of } U, \dot{U}, \hat{P}^m \text{ on future inflation through the lagged-inflation term. These effects are (crudely) allocated in the decomposition shown in the paper.}\]
Figure 4  Inflation Equation for the U.S., 1961-82

\[
\% \Delta P_t = 2.26 + 0.89 \% \Delta P_{t-1} + 0.11 \% \Delta P^M_t - 0.43 U_t - 0.36 (U_t - U_{t-1})
\]

(3.13)  (7.63)  (3.26)  (2.01)

Inflation Equation:

Actual

Fitted

WITHIN-SAMPLE FIT  (1961-1979)

Professor Otto Eckstein has performed a similar set of calculations, using his influential concept of "core inflation." He divides the causes of inflation among "core" inflation, based on unit labor costs and interest rates (and related to $P^c_{t-1}$ and $U_t$ in out equation); "shock" inflation (like $P^m_t$ in our equation); and "demand" inflation (a combination of $U_t$ and $U_t$ effects). His overall inflation variable is the CPI (remember that ours is the PCD). His results are as follows:

<table>
<thead>
<tr>
<th></th>
<th>1980</th>
<th>1982</th>
<th>Slowdown ('80-'82)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>13.5</td>
<td>6.2</td>
<td>-7.3</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Core</td>
<td>9.3</td>
<td>7.8</td>
<td>1.5</td>
</tr>
<tr>
<td>Shock</td>
<td>2.4</td>
<td>-0.6</td>
<td>3.0</td>
</tr>
<tr>
<td>Demand</td>
<td>0.4</td>
<td>-1.4</td>
<td>1.8</td>
</tr>
<tr>
<td>(Residual)</td>
<td>(1.4)</td>
<td>(0.4)</td>
<td>(1.0)</td>
</tr>
</tbody>
</table>

Source: Eckstein [1983], Table A.

Though a precise comparison of the two methods is difficult, both procedures show that the elimination of "shock" inflation has reduced $P^c_t$ by about 3 percentage points, with demand factors (working their way

into wages and profit margins) accounting for the rest.

III. Understanding the global disinflation process

As already mentioned, the oil price shocks of 1973-74 and 1979-80 encouraged most of major economies in the OECD to adopt antinflation policies. The results have been predictable, with a fall in inflation and rise in unemployment of significant dimensions. The policies have also had important effects on the crucial $P^m$ (import price) variable in each country, but here the effects have varied widely within the OECD.

There are three reasons that $P^m$ stopped rising rapidly (and even fell!) in the U.S., two of which are common for all OECD countries, but one of which has been quite particular to the U.S. First, and common to all, the rise in oil prices was a one-shot affair, due largely to the cutback of Iranian and Iraqi oil exports in 1979-80. Oil prices would not continue to double each year unless there were new supply cutbacks each year. Second, and again common to all, the ensuing world recession of 1981-83 reduced the demand for oil and other raw materials, and thus drove down their prices in a typical cyclical manner. But third, the value of the U.S. dollar rose sharply relative to other currencies after the end of 1979 (when U.S. monetary policies turned contractionary). This has further reduced the dollar prices of
commodities in world trade, even as it has raised the Deutschmark or Yen prices. For example, the dollar price of crude oil fell from $33/barrel during 1980:IV to $30/barrel in 1983:III, while the DM price rose from 63 DM/barrel to 79.5 DM/barrel in the same period. Thus, the third factor reducing import-price inflation in the U.S., a stronger exchange rate, has actually worsened inflation in the European countries and Japan.

The rising dollar plays an important role in the rest of the analysis, so it is worthwhile to discuss it in some detail at this point. Table 2 shows the effects of fiscal and monetary policies on the exchange rate, unemployment consumer price inflation, and the trade balance. We see, for example, that a U.S. monetary contraction strengthens the U.S. dollar, while raising unemployment. It reduces inflation for two reasons: higher unemployment slows inflation, while a stronger dollar reduces import prices. Note that by making the dollar stronger, and our export sector less competitive, we worsen our trade balance in the process.

A fiscal expansion has somewhat different effects. The expansion reduces unemployment by raising aggregate demand in the economy. Also, by raising domestic interest rates (assuming that monetary policy is fixed, and so does not accommodate the fiscal expansion), the fiscal expansion tends to induce a capital inflow and a strengthening of the dollar. The effects
Table 2
Short-Run Effects of U.S. Macroeconomic Policies

<table>
<thead>
<tr>
<th>Monetary Policy</th>
<th>Unemployment</th>
<th>Inflation</th>
<th>Value of the Dollar</th>
<th>Trade Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary Contraction</td>
<td>+</td>
<td>-</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Fiscal Expansion</td>
<td>-</td>
<td>+</td>
<td>+</td>
<td>-</td>
</tr>
</tbody>
</table>

See Bruno and Sachs [1984], Chapter 6, for a discussion of these standard results.
on inflation are ambiguous: on the one hand, unemployment falls, tending to raise inflation; while on the other hand, the strong dollar tends to reduce import-price inflation. Note that a fiscal expansion, like a monetary contraction, worsens the trade balance.

Now, let us return to the global policy environment as of 1980. Faced with sharp rise in import (especially oil) prices, all of the major countries swung towards contractionary monetary policies. To the extent that all countries chose to contract by the same amount, their currency exchange values relative to each other would not change (e.g. a comparable monetary contraction in the U.S. and Germany would leave the $/DM rate approximately unchanged). But in fact, the U.S. contraction was more severe, with the result that the U.S. dollar strengthened relative to the other major currencies, by a whopping 30 percent between the end of 1979 and mid-1983! This appreciation contributed to slower inflation in the U.S., but higher inflation in Europe and Japan. In effect, the U.S. exported some of its inflation to these other economies.

Once the contractionary policies got under way, it proved extremely difficult for any of the European countries or Japan to break the contractionary momentum. For a country to pursue a monetary expansion when other countries are pursuing contractionary policies can threaten a significant weakening of the
exchange rate, with inflationary consequences. Though France attempted such a unilateral expansion during 1981-82, the exchange rate and inflationary consequences ultimately led his government to a reversal in policies.

In the U.S., a major fiscal expansion (together with an easing, since August 1982, of the monetary restraint) has led to a partial recovery of the U.S. economy. In accordance with Table 2, the fiscal expansion has further strengthened the U.S. dollar, and thus has further exported inflation abroad. The European economies have not matched the U.S. fiscal expansion with an expansion of their own, for political and economic reasons, and the risks of a further depreciation of their currencies vis-a-vis the dollar have made these economies reluctant to undertake a major monetary expansion. The result is that: (1) the dollar remains strong; (2) the U.S. mix of expansionary fiscal policy and contractionary monetary policy is now, on balance, contributing to recovery; (3) the European pattern of contractionary fiscal and monetary policy is, on balance, contributing to further stagnation.

Figure 4 illustrates the sharp appreciation of the dollar since 1979. The solid line is the effective nominal exchange rate, i.e. a weighted average index of the exchange rate of the dollar versus other OECD currencies. The dotted line is a "real" exchange rate measure, specifically the relative price of U.S.
exports versus an index of OECD export prices. Evidently, the rise in the value of the dollar has been accompanied by a nearly equivalent loss of U.S. export price competitiveness (about 30 percent since 1979). Figure 5 is included to refute the popular, and misguided, notion that the Yen is particularly undervalued (some commentators have gone so far as to suggest that its undervaluation results from the manipulation of the Japanese government). The figure shows the DM/$ and Yen/$ rates since 1979, indicating clearly that the Deutschmark has depreciated more vis-à-vis the dollar, than has the Yen (a rise in the curve indicates a strengthening of the dollar vis-à-vis the foreign currency). The Yen is not especially undervalued. On the contrary, the dollar is overvalued relative to almost every major currency.

Remember that the dollar overvaluation results from the mix of expansionary fiscal and contractionary monetary policies. As seen from Table 2, both aspects of the mix conduce to a trade balance deficit, along with the currency appreciation. Indeed, all forecasts now point to a 1984 merchandise trade deficit in the U.S. of historically unprecedented levels. In 1982:II, the deficit was at a $56 billion annual rate. For 1984, the deficit may well top $90 billion.

A second myth relating to Japan, closely tied to the misunderstanding concerning the Yen, is that our worsening trade picture is importantly accounted for by a growing bilateral trade deficit with Japan. In
Figure 4
The Appreciation of the U.S. Dollar since 1979

Value of the U.S. Dollar:
- Effective Nominal Exchange Rate
- Effective Real Exchange Rate

Relative Export Prices, from IMF
Figure 5
The Deutschmark/Dollar and Yen/Dollar Exchange Rates
fact, the worsening trade picture involves a falling surplus with Europe, and a growing deficit with Latin America, rather than a surge of Japanese imports into the U.S. Table 3 documents this pattern. Since 1981, the bilateral deficit with Japan has risen $2.3 billion, our surplus with Europe, meanwhile, has declined $7.6 billion; and our position with the major Latin American debtor countries has turned from a $4.4 billion surplus to a $9.5 billion deficit, a swing of $14.3 billion in two years! America is losing markets in Europe and Latin America, rather than "abandoning" domestic markets to the Japanese. Our loss of foreign markets reflects both the overvalued dollar and the deep recession in Europe and virtual depression in Latin America.

Table 3
U.S. Merchandise Trade Balance, Various Regions ($ billion)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>-26</td>
<td>-28</td>
<td>-36</td>
<td>-46</td>
</tr>
<tr>
<td>Japan</td>
<td>-10</td>
<td>-15.8</td>
<td>-16.8</td>
<td>-18.1</td>
</tr>
<tr>
<td>Europe (OECD)</td>
<td>20.3</td>
<td>13.3</td>
<td>7.5</td>
<td>5.7</td>
</tr>
<tr>
<td>Argentina, Brazil, Mexico</td>
<td>5.1</td>
<td>4.4</td>
<td>-4.4</td>
<td>-9.5</td>
</tr>
</tbody>
</table>

a First six months, at annual rate
b -$75 billion in 1983:III, at annual rate

Source: Overall balance is from the IMF. Regional balances are from the OECD Trade Statistics Series A.

There are both short-term and long-term risks associated with the rising trade deficit. As the
U.S. borrows more and more in the world capital markets to finance these deficits, it is quite likely that portfolio holders will attempt to diversify away from U.S. assets. Such diversification, as occurred when the U.S. had much smaller deficits in 1978, can cause a rise in U.S. interest rates and/or an abrupt decline in the value of the dollar. Over the longer term, the trade deficits could result in so much borrowing from abroad that the U.S., in the aggregate, could become a net debtor vis-a-vis the rest of the world. In 1982, U.S. claims on the rest of the world exceeded foreigners' claims on the U.S. by approximately $168 billion. Two years of trade deficits above $100 billion would wipe out this net creditor position. It seems plausible to suggest that at least some of the U.S. political-economic power around the world, and the special role of the U.S. dollar in trade and finance, are tied to the U.S. creditor status in the world economy.

Without going into detail we note that the entries in Table 2 suggest that a switch in the U.S. policy mix (from contractionary monetary and expansionary fiscal policy) to the opposite (expansionary monetary and contractionary fiscal policy), could maintain the

\footnote{In fact, the change in net claims vis-a-vis the rest of the world is approximately equal to the current account balance, not the trade balance. In 25 years, the current account balance has exceeded the merchandise trade balance by approximately $25 billion. In 1982, for example, the current account balance was $-11 billion, with a merchandise trade balance of $-36 billion.}
the current recovery, while allowing a substantial improvement in the trade balance, and a reversal of the dollar appreciation. Of course that policy mix would also require that the U.S. re-import some of the inflation that it has successfully exported to the rest of the world economy. One substantial advantage of such a change in course would be to give greater scope in Europe to more expansionary monetary policies.

IV. Some thoughts about the LDC debt crisis

Consider the following commentary concerning the debt crisis:

"Critics of our foreign lending during the 1970s have frequently claimed that overoptimism, if not downright irresponsibility, on the part of the bankers was the major cause of the defaults. Without, however, attempting to deny that insufficient care was exercised, and that Latin American countries were encouraged to borrow excessively, one may question whether these factors were decisive. If the recession of the 1980s had been mild, and if the steady expansion of world trade and capital exports had continued thereafter, defaults probably would have been infrequent and could have been settled without much difficulty. ... The enormous shrinkage of foreign trade, however, which actually took place after 1979, together with the almost complete cessation of
foreign lending, placed the Latin American debtor countries in a position where most of them would probably have found the maintenance of even a smaller debt service excessively burdensome. Thus, it is the unprecedented severity of the recession rather than the negligence of the bankers which must be regarded as the primary cause of the defaults." 6/

One finds tremendous wisdom with this statement when applied to the current situation. In fact, it was written in 1943 by Henry Wallich, now Governor of the Federal Reserve System, with respect to the defaults on Latin American debt during the Great Depression of the 1930s. (The word "banker" was substituted for "underwriter" in the original, in view of the shift from bond lending to bank lending in the past half century: "1920s" was made into "1970s", and "1930s" was changed to "1980s".) The reason for reviewing Wallich's commentary is not to suggest that the financial collapse of the 1930s is necessarily upon us, but rather to indicate that the underlying causes of the debt crisis are the same as in the earlier period: worldwide deflation, with contractionary monetary policies and declining levels of world trade. In both cases, the severity of the downturn was unanticipated by debtors and creditors alike.

In both cases, a sharp decline in export prices and export volume made the continued servicing of the debt difficult in the extreme.

Some pundits argue that the debt crisis has followed from bankers' stupidity or inefficient government policies in the debtor countries. Milton Friedman has recently written, for example, "Every successful country has relied primarily on private enterprise and free markets to achieve economic development. Every country in trouble has relied primarily on government to guide and direct its economic development." 7/

Such arguments are factually incorrect, and neglectful of the deep world recession of 1981-83. The "free-market" case of Chile, for example, has perhaps the greatest per capita external debt, and the deepest debt crisis, anywhere in the world! Table 5 shows a much sounder predictor of debt problems than Friedman's, based on the decline in export-earning-power of debtor countries. Since the imposition of contractionary monetary policies around the world in 1980, the export prices of most primary-goods producers have plummeted on world markets, relative to the prices of imports that these countries face. The so-called "terms of trade," the ratio of export prices to import prices, has declined by over 30 percent in

7/ Friedman, M., "'No' to More Money for the IMF," Newsweek, November 14, 1983.
Table 5  
Terms of Trade, Various Countries (1980 = 1.0)  

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>1980</th>
<th>1981</th>
<th>1982</th>
<th>Percent Decline Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>1.21</td>
<td>1.00</td>
<td>0.85</td>
<td>0.82</td>
<td>32%</td>
</tr>
<tr>
<td>Chile</td>
<td>1.20</td>
<td>1.00</td>
<td>0.77</td>
<td>0.78</td>
<td>35%</td>
</tr>
<tr>
<td>East Asia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>1.20</td>
<td>1.00</td>
<td>0.98</td>
<td>1.01</td>
<td>16%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>1.02</td>
<td>1.00</td>
<td>0.85</td>
<td>0.80</td>
<td>22%</td>
</tr>
<tr>
<td>Phillipines</td>
<td>1.19</td>
<td>1.00</td>
<td>0.88</td>
<td>0.86</td>
<td>28%</td>
</tr>
<tr>
<td>Singapore</td>
<td>0.95</td>
<td>1.00</td>
<td>1.02</td>
<td>1.04</td>
<td>-9%</td>
</tr>
</tbody>
</table>

a 1982 over 1979

Source: Export prices (or unit values) divided by Import prices (or unit values), from the International Financial Statistics of the IMF.
many Latin American countries, and by less on average in East Asia, where exports are more heavily in manufac-
tured goods. The debt crisis has, in general, been most severe in countries where the terms-of-
trade deterioration has been sharpest (this is why the Phillipines, among the East Asian economies, is now showing the most serious debt-servicing strains).

The debt crisis followed, therefore, upon the anti-inflationary policies in the advanced industrial economies (and particularly in the U.S.). The crisis was reflected first in declining GNPs and living stan-
dards in the debtor countries, during 1980-81. In mid-1982, a full-fledged financial panic ensued when Mexico announced that it could not continue to serv-
ice its short-term debt obligations without a major infusion of new foreign capital. Since that announce-
ment, almost all Latin American countries have been unable to roll-over existing debts at normal commer-
cial terms; the banks have simply stopped lending, en masse, to these countries. The cessation of new funds has created severe short-term liquidity prob-
lems for even fundamentally sound economies, so that the lending has had to take the form of emergency reschedulings of existing debt, under International
Monetary Fund (IMF) auspices, rather than the normal commercial re-financing. Threats by Congress to "punish the banks" have, of course, exacerbated the situation. It's as if the authorities responded to a run on a local bank by announcing that the depositors
unfilled in the 1930s. In fact, there is good reason to believe that if the countries, with IMF help, can surmount their short-term liquidity problems, the longer-term prospects for debt repayment are quite good. Most of the debt burden facing Mexico and Brazil, for example, is principal, not interest. In a normal banking environment, the principal could simply be refinanced, so that the interest payments alone would represent the real burden on the economy. By most measures, the interest payments appear to be well within the long-term servicing capacity of the debtor countries. 

V. Conclusions

Not since the 1930s has the world economy been subject to such a consistent set of contractionary monetary policies in the major economies. These policies have had their standard effect, of moderating inflation while at the same time raising unemployment throughout the world. The U.S. monetary constraint

8/ In Mexico, for example, principal repayments due in 1982 were 92% of exports, while interest due was 37% of exports. The interest burden will presumably be reduced in 1983 by the fall in interest rates relative to 1982. And, certainly, long-term export prospects for the Mexican economy are far brighter than indicated by the world-recession year 1982.
was perhaps most severe in the major industrial economies, at least until August 1982, and thus contributed to a sharp rise in the value of the U.S. dollar, with beneficial effects on inflation but harmful effects on employment and the trade balance. Expansionary fiscal policies in the U.S. are now contributing to a U.S. recovery, and a further strengthening of the dollar. Since the Europeans and Japanese have so far followed the U.S. monetary stringency but not the fiscal ease, they are not yet enjoying any significant recovery. Various risks remain to the U.S. recovery, emanating from the enormous trade deficits and the continuing world debt crisis. On both fronts, a shift to monetary ease and tighter fiscal policies would likely contribute to a reduction in these risks.
