

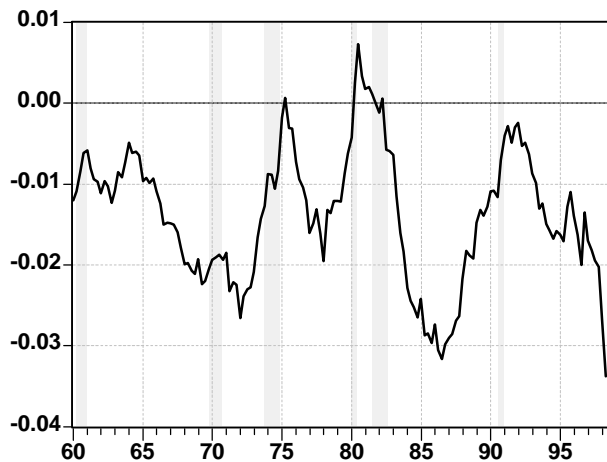
# SOME OBSERVATIONS ABOUT INTERNATIONAL TRADE AND GLOBAL INTERDEPENDENCIES

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One of the consequences of slow economic growth in the troubled countries of Asia combined with a relatively robust economy at home is that the U.S. trade deficit has widened significantly. In the second quarter of 1998 the National Income and Product Accounts measure of real net exports was -\$252.9 billion dollars — the largest ever recorded. Even as a share of GDP, real imports exceeded real exports by almost 3.4% of GDP which is only rivaled by the 3.2% share in the third quarter of 1986 (see Figure 1). This has once again raised concerns among policymakers, journalist and business people who predict dire consequences and campaign to protect U.S. markets from "cheap foreign

**Figure 1**  
**Net Exports as a Share of GDP: 1960-1998**



goods." This brief discussion is intended to make several simple but important points. First, trade deficits can be good or bad depending on the underlying fundamentals of the economy. Moreover, the causes of trade imbalances are best viewed as reflecting domestic choices rather than as an externally imposed outcome. Second, the current trade imbalance of the U.S. and other robust economies is a healthy stimulus for the ailing economies in parts of Asia. Third, despite the rhetoric surrounding the global

economy and its interdependencies, the U.S., as a whole, has a limited exposure to the struggling economies of Asia or Russia.

It is widely viewed by most non-economists that trade deficits are bad for a nation and trade surpluses are good. Even the words used to describe trade balances convey judgmental images of good and bad—deficit vs. surplus; favorable vs. unfavorable; in the red vs. in the black. This perspective clearly has its roots in 18<sup>th</sup> century mercantilism.

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Mercantilists measured the wealth of a nation by the amount of gold or specie accumulated by the government and selling more goods abroad than you purchased from abroad was a means to that end. Adam Smith argued in *The Wealth of Nations* that the consumption or living standard of its citizens should measure the true wealth of a nation and David Ricardo showed how free trade and comparative advantage raises everyone's standard of living.

Regardless of the source of non-economists misconceptions about the nature of international trade, the correct view is that trade deficits can be either a good or bad signal for a nation depending on the underlying fundamentals of the economy. To easily understand the important elements at work it is useful to reiterate the fundamental accounting identity that seems rarely appreciated by non-economists:

$$\text{savings} - \text{investment} = \text{exports} - \text{imports}.$$

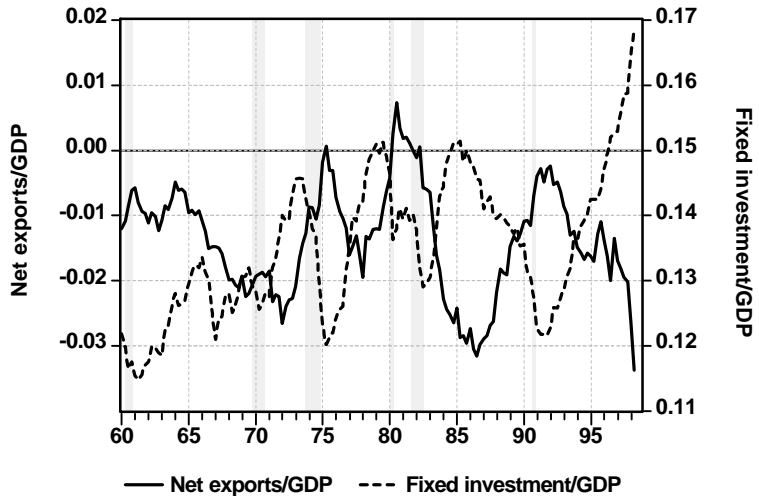
As an accounting identity this relation says that countries that save more than they invest (domestically) will run trade surpluses and those that invest more than they save will experience trade deficits. Looking at the trade balance in this fashion helps focus attention on the fact that the deficit or surplus is largely determined by domestic choices—saving and investment—and not imposed on a country by outside forces. Two examples can usefully illustrate how trade deficits can be either good or bad for the home country.

Case 1: Consider an economy that has excellent real investment opportunities in that there are many projects that have a positive net present value at the appropriate risk adjusted cost of capital. Such countries will attract capital inflows to finance these projects and because the projects are sound, the payoffs are ample to reward both the investor and the residents of the home country. The classic example of this situation might be the U.S. during most of the 19<sup>th</sup> century and it is most likely relevant even today for the U.S. In this case a trade deficit is a desirable and healthy state for the economy.

Case 2: Now consider the case where a government intervenes in the investment process by subsidizing risk (including exchange rate risk by promising to maintain a fixed parity with the dollar) and/or directing capital to specific projects with implicit government guarantees. The result is likely to be over-investment in highly speculative or low net present value projects funded in part by capital inflows from abroad. This can be a recipe for disaster as some of the troubled countries of Asia can now attest.

The current trade balance is large by historical standards, but two fundamental factors are at work that suggest there should be no cause for alarm. First, the growth rate of imports has exceeded the growth of exports by about 2% per year on average between 1991 and 1997. This is partially due to a robust U.S. economy and a gradually strengthening dollar (at least since 1995). However, the increase surplus on the capital account (i.e. the capital inflows associated with the trade deficit) has been associated with a growing share of GDP being invested. Figure 2 shows the pattern of real net exports as a share of GDP with real fixed investment as a share of GDP. As discussed above, it is easy to see the relation between these measures. It is not merely coincidence that as the

**Figure 2**  
**Net Exports and Fixed Investment**  
**as a Share of GDP: 1960-1998**



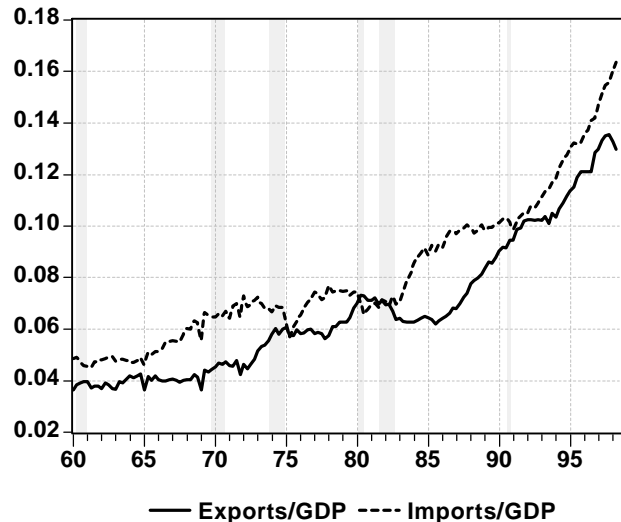
trade deficit has reached record levels as a share of GDP so has real investment. Thus a healthy investment boom is partly responsible for the growing trade deficit since 1991.

The second important factor to take into consideration is that robust economic growth in the U.S. is helping to maintain a strong demand for foreign goods, especially from those countries whose currencies have depreciated relative to the dollar. This is a market response to the troubled economies in parts of Asia and an important element in their recovery. For the U.S. to take action to reduce imports from this part of the world would make it much more difficult for those struggling economies to recover.

The importance of the global economy and how we are now more dependent than ever on the performance of other economies is now a mantra that has wide acceptance and appeal. While it is true that the U.S. is more involved in trade and international capital markets than ever, it remains true that we are largely an economy that produces and consumes domestically and our economic health is not as dependent on the small

developing economies as is frequently asserted. Figure 3 shows imports and exports shares of GDP. It is evident that the role of international trade has grown significantly since the 1970's when exports and imports were only 5-7% of GDP each. Today exports represent 13% of GDP and imports about 15%. Thus 85% of U.S. expenditures and 87% of production is domestic in nature. By contrast, in the U.K. and Switzerland imports and exports each have about a 25% share of GDP and in The Netherlands exports count for over 50% of GDP and imports 48%.

**Figure 3**  
**Exports and Imports as a Share of GDP: 1960-1998**



It is revealing to note the amount of trade that occurs between some of the key countries that have experienced economic turmoil during the last year. Table 1 shows the

volume of U.S. imports to and exports from a number of countries in Asia and also Russia. It also gives the country's respective share of U.S. imports and exports.

**Table 1**  
**U.S. Imports and Exports with Selected Countries: 1996\***

	Imports		Exports	
	\$ Billions	%	\$ Billions	%
U.S. Total	965.0	100.0	873.8	100.0
China (PRC)	51.5	5.2	12.0	1.4
Hong Kong	9.9	1.0	14.0	1.6
Indonesia	8.2	0.9	3.7	0.4
Korea	21.7	2.2	33.3	3.8
Malaysia	17.8	1.8	8.5	1.0
Philippines	8.2	0.9	6.1	0.7
Russia	4.8	0.5	2.9	0.3
Singapore	23.1	2.4	21.6	2.5
Taiwan	29.9	3.1	18.4	2.1
Thailand	11.1	1.2	6.9	0.8
Totals	186.2	19.3	127.4	14.6

\*Source: U.S. State Department, *Economic Policy and Trade Practices Report*, January 1998.

These countries neither individually nor in total account for much of U.S. total export volume. By contrast, Canada alone accounts for over 15% of total U.S. exports. Of course, since exports account for only 13% of GDP, the share of GDP attributed to exports to all the above countries combined is less than 2%.

**Table 2**  
**U.S. GDP Compared with**  
**Selected States and Countries: 1996\***

	\$ Billions	%		\$ Billions	%
U.S. Total	7636.0	100.0			
California	962.7	12.6	Thailand	185.9	2.4
China (PRC)	816.9	10.7	Indiana	155.8	2.0
New York	613.3	8.0	Hong Kong	155.0	2.0
Korea	483.3	6.0	Malaysia	99.5	1.3
Florida	360.5	4.7	Alabama	99.1	1.3
Taiwan	272.3	3.6	Singapore	94.0	1.2
Indonesia	221.1	2.9	Philippines	83.8	1.1

\*Source: U.S. State Department, *Economic Policy and Trade Practices Report*, January 1998, and Bureau of Economic Analysis, U.S. Department of Commerce.

Another useful perspective is obtained by comparing the relative size of these countries to the U.S. in terms of GDP. For example, it is frequently cited that Korea is the 11<sup>th</sup> largest country in the world in term of GDP. While that may be correct it is only 6% of the size of the U.S. economy, about one-half the size of California and only about four-fifths the size of New York. Hong Kong's economy is only about the size of Indiana's and Malaysia and Singapore are about the economic stature of Alabama or just over 1% the size of the U.S.

Finally, it is instructive to get a sense of the exposure that U.S. banks have in these foreign countries. According to the Federal Reserve Board, total assets of domestically chartered U.S. banks were \$4,157 billion at the end of 1997. The Federal Reserve also reports the total cross-border exposure of banks by country. Cross-border exposure includes all forms of lending, public and private, exposures resulting from foreign exchange holdings and derivative products as well as claims in the local currency. These exposures, by selected country, are reported in Table 3. Note first that the total cross-border exposure is about \$500 billion or about 12% of total assets. With the exception of Korea, none of these countries comprise more than 2% of the foreign exposure of U.S. banks which is less than 0.25% of total assets. While it is not desirable or pleasant, the U.S. banking system could weather significant defaults. The worst might be that some individual banks would face problems and the prospect of being bought if their portfolios were not sufficiently diversified.

**Table 3**  
**Amounts Owed U.S. Banks by Foreign**  
**Borrowers by Country: 12/31/97\***

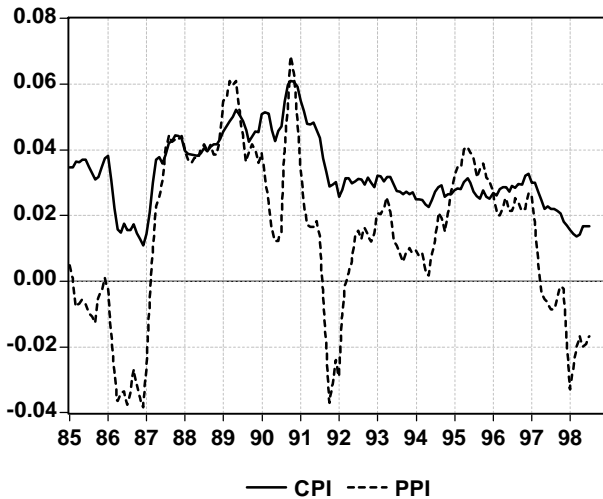
	Outstanding Cross- Border Exposure	
	\$ Billions	%
All Countries	499.2	100.0
China (PRC)	3.1	0.6
Korea	21.4	4.2
Taiwan	4.1	0.8
Indonesia	6.8	1.4
Thailand	5.9	1.2
Hong Kong	8.0	1.6
Malaysia	3.4	0.7
Russia	5.8	1.2
Singapore	5.6	1.1
Philippines	2.5	0.5
Total	66.6	13.3

\*Source: Board of Governors Federal Reserve System, Country Exposure Lending Survey: Statistical Release, April 8, 1998. Washington, D.C.

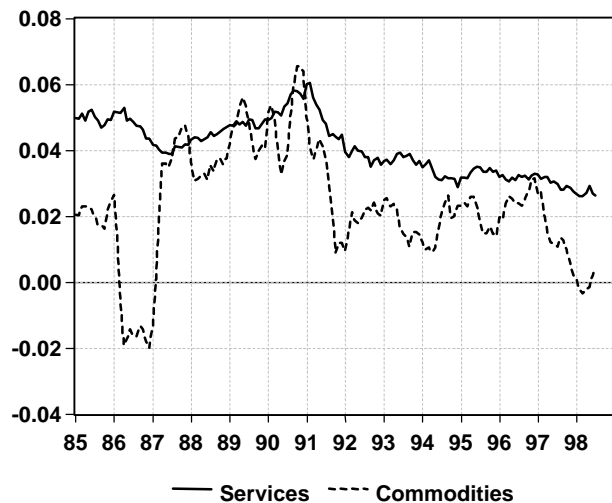
Of course the measures of interdependencies that have been highlighted here are not exhaustive. The most notable deletion is direct foreign investment by U.S. residents and corporations in these countries. However, the picture is not much different from that told by the other measures discussed above. For example, in 1997, on a historical-cost basis, U.S. direct investment positions abroad totaled \$861 billion. Of that amount, less than 1% was invested in each of the following countries: China, Indonesia, Korea, Malaysia, Philippines, Taiwan and all of Eastern Europe (including Russia). Hong Kong and Singapore each made up about 2% of U.S. direct foreign investment. Japan's share was about 4%.

While the U.S. as a whole has only limited exposure to these countries, it is certainly true that some individual companies are much more exposed in that their earnings are much more dependent on the health of these nations than the economy as a whole. Thus, it is to be expected that some firms will be more adversely effected than others. But, it is a mistake to identify the overall health of the U.S. economy solely with the health of the more exposed, although in some cases very visible, firms.

**ANNUAL RATES OF INFLATION  
FOR THE CPI AND PPI  
1985-1998**



**ANNUAL INFLATION RATES FOR THE  
COMMODITY AND SERVICE COMPONENTS OF THE CPI  
1985-1998**



Lastly, as a footnote, Allan asked me to update the charts I did in March when I discussed the prospects for deflation. The figures below include data through July 1998. As pointed out before the PPI is more volatile than the CPI, in part, because it is more heavily dependent on commodities and manufactured goods of various kinds. The figure on the left shows that the PPI continues to exhibit declining prices (year over year) but this is not the first time it has happened nor does it typically predict deflation for the CPI. The CPI is much less volatile because it is more heavily weighted towards services reflecting the consumption patterns in the economy. The figure on the right shows the service and commodity components of the CPI.