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Trade Policy and Macroeconomic Balance in the World Economy

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Abstract

The paper explores the relationship between trade policy and current accounts. The effect on the current account of a change in protection at home and then abroad is analyzed, assuming that the exchange rate floats. The "savings-and-investment approach" is used. It shows that there is no presumption that protection would reduce a deficit. With a fixed exchange rate, the effect on savings and investment is brought about by the reduction in absorption that is required to maintain internal balance when restrictions are imposed. A current account deficit or real appreciation may generate protectionist pressures stimulated by "conservative resistance."

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Summary

The paper is concerned with the relationship between trade policy and the current account. First, it asks whether protection can be presumed to improve a country's current account given a floating exchange rate regime. Increased protection would normally lead to appreciation and can affect savings and investment in various ways. Notably, a tariff brings in revenue, which, if not spent, can reduce the budget deficit. Because of other possible effects (e.g., higher investment in protected industries), however, the presumption that the current account will improve is not necessarily valid. Furthermore, even if lowering protection abroad (say, in Japan) reduced the surplus there, this reduction would be likely to diminish the U.S. current account deficit only by shrinking U.S. investment.

If the exchange rate is fixed and the country is initially in "internal balance," protection will improve the current account because of its effects on savings and investment through the reduction in expenditure required to maintain internal balance when import restrictions are imposed.

A current account deficit may increase pressures for protectionism because of "conservative resistance,"--that is, pressure groups in the tradable-producing sectors will resist losses in real incomes. Through the real appreciation that results, protection then tends to put at a disadvantage producers of tradables who are unable to obtain adequate protection. But it is possible that conservative resistance is stimulated not so much by a current account deficit as by real appreciation--and these may not go together--or by a boom in exports from particular countries, especially if these exports are concentrated in particular products not associated with current imbalance at all.

The paper goes on to other questions. Is a current account deficit, as such, a problem? How should its possible stimulation of protectionism affect macroeconomic policy? Finally, the paper sketches various ways in which trade tensions may originate in macroeconomic developments in the future.



## I. Introduction

What do we mean by macroeconomic balance? We could mean inflation--i.e., its absence--or an appropriate short-term balance between inflation and resource utilization or growth. Here it will be given the currently fashionable meaning, namely that it refers to the reduction of the big current account "imbalances."

The relevant facts are very simple. From a current account surplus of \$1.9 billion in 1980, the United States shifted to a deficit which reached \$154 billion in 1987, when it was 3.4 percent of GNP. In 1987 the U.S. deficit was financed or balanced by large surpluses of Japan--\$87 billion--and Germany--\$45 billion--while the other three large surplus countries in that year were Taiwan Province of China (\$18 billion), the Republic of Korea (\$10 billion), and Switzerland (\$7 billion). It is worth noting that the "world deficit"--i.e., the estimation errors that have led to overstatements of deficits or understatements of surpluses--was \$37 billion, and also that developing countries as a whole were more or less in balance. 1/

The U.S. deficit is expected to decline but, on the basis of various assumptions (notably a constant real exchange rate), the IMF still projects it to be \$129 billion in 1989. The Japanese surplus is expected to be reduced to \$81 billion and the German surplus to \$41.5 billion. The trade imbalances among the big three are narrowing and by 1989 U.S. exporters are expected to regain most of the market share lost from 1981 to 1985, the gain being mostly at the expense of Japan. But current account imbalances are not improving to the same extent owing to dollar depreciation and to the servicing of net asset positions. Hence "imbalances" are likely to continue for some time, and this is generally perceived as a problem, a matter to which I return later. 2/

Now the question is: what does all this have to do with trade policy, a term I interpret to refer to the various devices of protectionism, such as tariffs, import quotas and voluntary export restraints? It is this relationship between trade policy and current accounts that will be explored here, mostly by applying the simplest theory and empirical generalizations, and generally with the United States in mind. Sections II and III consider how a change in protection would affect the current account and in Sections IV and V how a current account deficit affects protection. With regard to the first question, popular

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1/ All data in this paper come from IMF sources, principally International Monetary Fund (1988b).

2/ In a detailed analysis of prospects for the U.S. current account done at the beginning of 1988, Ralph Bryant concluded that an impressively large improvement in the constant price deficit was indeed in the pipeline for 1988-89 but that improvements would probably cease by 1990 if U.S. and foreign growth were similar and if the real exchange rate of the dollar remained at its end-1987 level. See Bryant (1988).

opinion takes it for granted that an increase in protection would reduce a current account deficit unless other countries retaliate by increasing their protection. As this view is so prevalent, it is analyzed in some detail, using theory that is certainly familiar but not often applied to this issue.

## II. Would U.S. Protection Improve the U.S. Current Account?

Is there any presumption that increased protection would improve a country's current account? Partial equilibrium thinking suggests that the answer is obvious: how can a reduction in particular imports not improve the current account?

Much of the thinking on this subject is still governed by the assumption of fixed exchange rates. Conceivably--just conceivably--one might regard this as relevant for the current U.S. situation if one supposed that the U.S. authorities wanted to avoid both further dollar depreciation and appreciation by using either direct exchange market intervention or monetary (interest rate) policy. So this fixed exchange rate case will be considered below. It is, of course, relevant for some other countries and was the appropriate approach for the nineteen fifties and possibly sixties. But the greater part of this paper will deal with the case where the exchange rate is flexible or actually floats.

In analyzing this issue the guiding principle is the "savings and investment approach": a current account improvement requires a reduction in the budget deficit--i.e., in net public dissavings--a rise in private savings or a fall in private investment. If one wants to argue that protection must improve the current account, one must show that it must reduce the budget deficit, increase private savings or reduce private investment. 1/

Many special models could be produced where quotas or tariffs yield particular impacts on the budget and on private savings and investment. The implicit assumption of the partial equilibrium approach is that the whole of an initial reduction of imports resulting from protection would be saved, so that there would be no indirect effects on purchases of other imports or on exporting to take into account. But this is just an extreme case. One possibility is that the government does not spend extra tariff revenue so that a by-product of protection brought about by higher tariffs

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1/ With regard to devaluation, this approach was first put most clearly in Black (1959) but the basic idea originated in Alexander (1952) where the key point was made that a devaluation can only improve the trade balance if it increases "real hoarding" (i.e., savings minus investment). The extension to import restrictions was first made in Nurkse (1956). Most recently, Lawrence and Litan (1987, pp. 296-8) have explicitly put the central point here with regard to the U.S. current account. See also Kaempfer and Willett (1986).

would be a fiscal improvement. But the most casual thought suggests that there is no general presumption that, taking various possible effects into account, the net effect on the saving-investment balance would go one way or another. 1/

Nevertheless, the consequences for the current account of the imposition of import quotas when the exchange rate floats will now be traced out in some detail (though still in a highly simplified way. In this case there is no tariff revenue effect. There may be some value in showing the process by which the savings-and-investment story works, and especially the role of the exchange rate movement in that process.

In the first instance the quantitative import restrictions might lead to higher savings. It has to be emphasized that this is not an empirical generalization but just a possibility. Restrictions are likely to lead to quota profits and some part of these might be saved. Alternatively, if domestic prices are not fully adjusted upwards or users of imports are direct importers, excess demand for imported goods might result and, if the restrictions are expected to be temporary, some of the excess demand for the restricted products might be saved. The extra savings, and the improvement in the current account that can be shown to result, would thus be temporary. Let us suppose that the value of imports is initially reduced by \$100 million and that national savings at this stage rise by \$30 million, so that \$70 million is available to be spent on domestic goods.

The extra savings go on the capital market and domestic interest rates decline somewhat, so that investment rises by \$10 million. The rest of the extra savings replace foreign savings, so that capital inflow declines by \$20 million. With imports having fallen by \$100 million, if the exchange rate did not change the overall balance of payments (current and capital account combined) would now be \$80 million in surplus, assuming it was zero to start with. Reserves must thus accumulate. But in the absence of intervention the dollar must appreciate and (assuming as a first approximation that this appreciation does not itself affect savings and investment), it must appreciate sufficiently for \$80 million of demand to be switched from domestic goods to imports or to exportables. Hence, finally, the current account improves to the extent of the higher savings (\$30 million) less the extra investment (\$10 million). It must be stressed that if there had not been any increase in saving initially there would have been no effect on the current account at all.

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1/ The effects of a uniform import surcharge (uniform tariff) imposed in the United States, with revenue not spent by the government, are analyzed in Klein, Pauly and Petersen (1987) using Project LINK, and in Dornbusch (1987) using the Data Resources, Inc. model. Naturally, the current account is shown to improve in these cases.

The level of demand for domestic goods will stay constant: at first the increased demand was \$70 million, and this was supplemented by higher investment of \$10 million (assumed to have gone wholly on domestic goods), and then, as a result of the appreciation, expenditure was switched away from domestic goods to the extent of \$80 million.

Various additional effects on savings and investment are possible. Essentially, these result from the redistributive effects of the combination of protection and exchange rate appreciation. Profits of newly protected industries will rise and of other tradable producers will fall, and savings and investment propensities of these two categories may differ: on balance national savings and investment could rise or fall. For example, extra investment in protected industries might be stimulated by better profit prospects if the increase in protection is expected to last for a reasonable time. This effect could well outweigh both lower investment elsewhere and changes in savings, so that the current account would worsen. The same applies to effects on tax revenue. Industries and workers that have gained from higher protection will pay more taxes, and losers will pay less. Tax revenue could thus rise or fall, and if government expenditure were held constant, the budget deficit and hence net national savings could be affected through this route. If the restrictions took the form of voluntary export restraints (which allow foreign suppliers to charge higher prices), the terms of trade would worsen, as well as gains from trade being lost, so that total savings and tax revenue would be more likely to fall, and the current account would be more likely to deteriorate.

All these examples indicate that there is no general presumption about which way the overall effect of import restrictions on the current account would come out when the exchange rate floats.

### III. How Would Reduced Protection Abroad Affect the U.S. Current Account?

It is a feature of the U.S. Trade Act of 1988 and, in general, of popular current U.S. approaches, that threats of protection by the United States are to be used to induce trading partners to open up their markets more. This then raises the interesting question of how such opening might actually affect the U.S. current account. For example, if Japan reduced protection (explicit or implicit), how would this affect its savings-investment balance and then, through an international general equilibrium process, the U.S. current account and thus the U.S. savings-investment balance?

The issue can be analyzed in a two-stage process. In the first stage it can be assumed that the world interest rate is given to Japan and that the world outside Japan is willing to absorb any current account balance that emerges from Japanese savings and investment decisions. In other words, in the first stage Japan is assumed to be a small country on the world capital market. The second stage takes into account international



general equilibrium aspects. The question in the first stage is then: what would happen to Japanese savings and investment, public and private, as a result of further market opening by Japan?

It is obvious that the analysis will be the obverse of the one just presented for the United States. Reducing Japanese import restrictions will lead to depreciation of the yen and there need be no net change in the Japanese current account at all, or it could go either way. The Japanese current account surplus could well increase because of a reduction of investment in the industries that lose some of the protection provided by formal or informal import restrictions. But let us now assume that opening up the Japanese market would indeed lead to lower private savings in Japan and thus to some reduction in the surplus. This might have resulted from the decline in the profits of the industries where protection has been reduced, not offset by higher savings in other--notably export--industries which have benefited from depreciation, and also not offset by reduced investment in the previously protected industries. The same current account result would, of course be produced by a Japanese fiscal expansion, involving reduced net public dissavings.

The next step is to reconcile the reduced ex-ante Japanese current account surplus, if there is one, with a change in the current account balance of other countries, including the United States. Here the story will be told in terms of a two-country world. It will be assumed that there is no change in fiscal policy in the United States since we are interested in seeing what the effects of a Japanese market opening (or a fiscal expansion) on its own would be.

The most plausible story for current conditions assumes that there is little or no scope for aggregate output expansion in the United States, although the pattern of output can change. In other words, the United States is in a full capacity or "natural rate of unemployment" situation. The "Keynesian" case--where demand expansion would increase aggregate output--yields an alternative story outlined below. In the present case there is no particular reason to expect U.S. savings to increase just because Japanese demand for U.S. goods increases because there will be no change in aggregate U.S. output and hence incomes. Any impact on the U.S. current account has to come through effects on investment.

The reduced Japanese savings, whether public or private, will raise world interest rates, and hence also U.S. interest rates, and this would lead to a crowding-out of investment around the world, including investment in the United States and in Japan. The key point here is that U.S. investment is reduced, and it is through this mechanism that the U.S. current account would improve. The higher interest rates would also reduce Japanese investment, and to that extent the eventual reduction in the Japanese current account surplus would be less than the reduction in Japanese savings. It is worth stressing that U.S. advocates of Japanese or German fiscal expansion or of Japanese market-opening who believe that this is a way of getting a U.S. current account improvement--one way, if not the only one--are actually proposing a process that would bring about

a reduction of investment in the United States. It is hard to believe that this is what they really want.

The alternative mechanism which is often in mind--and which is probably not relevant at present, other than in the very short run--is essentially Keynesian: it is based on the assumption that output and employment in the United States can be increased as a result of extra demand. The extra Japanese net imports resulting from reduced Japanese savings, private or public, would raise demand for U.S. goods, and hence increase output and incomes, and so generate a familiar multiplier process. This process would increase U.S. imports--but also (if the U.S. marginal propensity to save is positive) would produce the extra U.S. savings that would finally yield an improvement in the U.S. current account position.

#### IV. How Current Accounts Affect Protection: Two Exchange Rate Regimes

So far, the paper has been concerned with the possible effects of protection on the current account. Now the obverse will be considered: the effects of a current account imbalance on protection. This is essentially a political economy issue since it is a matter of explaining why a particular policy instrument is used. Are there reasons why the existence of current account deficits might lead to more protection? Three different exchange rate regimes have to be distinguished here if the analysis is to be complete and apply not just to the United States and the major countries with floating or highly flexible exchange rates. Only the third case --the floating rate case--is relevant to the current U.S. situation.

##### a. Fixed exchange rate

In the first case the country has a firmly fixed exchange rate in terms of some major currency or a basket. Let us assume that a current account deficit has to be reduced, for whatever reason, and that the country is initially in "internal balance." Suppose that import restrictions on their own would not generate any extra savings, nor affect investment, given that the initial situation is one of internal balance. If restrictions--which switch the expenditure pattern toward home-produced products--were imposed it would be necessary to bring about a simultaneous reduction of aggregate demand (i.e., "disabsorption") through fiscal or monetary policies to maintain "internal balance." This is standard "internal-external balance" analysis.

The way this policy prescription is usually put is that the import restrictions are targeted on external balance and the "absorption policy" on internal balance, bearing in mind that reducing absorption also reduces demand for imports and exportables and thus also improves the current account. The use of import restrictions is often justified in purely partial equilibrium terms, but this standard two-instruments two-targets

approach also appears to justify them, given that for historical or other reasons the market device of exchange rate adjustment has been ruled out.

But what about the savings-and-investment approach in this case? If import restrictions do not increase savings or reduce investment they cannot improve the current account. How can import restrictions then be targeted on the "external balance" objective? The answer has to be that the increase in national savings (and decrease in investment) required for the current account improvement is brought about by the associated disabsorption policies--i.e., by fiscal and monetary contraction--which are designed apparently to maintain internal balance. But then, one might ask, what is the need for import restrictions?

The answer is that the assignment of instrument to target should really be reversed. Reduction of aggregate expenditure (disabsorption) brings about the required improvement in the current account through generating the necessary increases in savings and declines in investment, but in the absence of downward flexibility of domestic prices and wages, disabsorption on its own would reduce employment and capacity utilization. It would lead to departure from internal balance. Import restrictions or similar "switching policies," notably devaluation, are needed to divert the expenditure reduction toward imports (or, more generally, toward tradables) so as to maintain at the same time internal balance. Hence policies that reduce absorption through raising savings, public or private, or reducing investment, should be assigned to the current account target while import restrictions are assigned to the target of internal balance. <sup>1/</sup> Of course, if the exchange rate were available as an instrument of policy, devaluation could be used to maintain internal balance.

b. Import restrictions versus devaluation

In the second case to be considered the exchange rate is pegged but is available to be changed. This case applies at the present time to many more countries than the previous case. The exchange rate is available as a policy instrument and governments can at various times make a choice between using import restrictions and using devaluation as "switching" devices to be associated with the required disabsorption policy that is required to improve the current account. The question then is why governments prefer to use import restrictions.

Governments have a number of reasons, often implicit, for choosing import restrictions. These reasons have been much discussed in the trade

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<sup>1/</sup> This was the central theme of Hemming and Corden (1958): given initial "internal balance," import restrictions cannot improve the trade balance on their own, but they are required to accompany policies that reduce absorption in order to avoid a decline in real income. This was called the "real income" approach to the use of import restrictions. See also Nurkse (1956).

theory literature. Essentially they all represent second-best, third-best or worse arguments for protection. I will just mention two examples.

Firstly, devaluation may be expected to stimulate extra exports, which are expected to be saleable abroad only at substantially lower prices. The aim of choosing import restrictions in preference to devaluation is to avoid this decline in the terms of trade. This is a version of the terms of trade argument for protection. 1/ The first-best policy from the national point of view would be to tax or otherwise restrict those particular exports where terms of trade effects are expected to be significant, bearing in mind that longer-run effects of restrictions may be adverse as substitution elasticities rise over time and terms of trade effects wear off.

Secondly, nominal devaluation may be expected to lead to higher nominal wages to compensate for higher domestic prices in an environment of implicit or explicit wage indexation, and this might then negate the effects of devaluation. Of course it has to be remembered that import restrictions would also raise domestic prices; the assumption implicit in this view is that the effect of devaluation on prices and hence wages would be greater, so that import restrictions are preferred. This is the real wage rigidity (Cambridge) argument for protection, which can also be shown to be second-best or worse, and which, in any case, depends on an assumption that is not necessarily justified. 2/

It is interesting to note that the appropriate analysis of the use of import restrictions for apparently macroeconomic purposes still requires the standard trade-theory approach. The detailed analysis by trade theorists of various arguments for protection is completely relevant. Where trade theory asks: what are the gains or losses from protection compared with free trade, or compared with lower protection, here one asks: what are the gains or losses from the use of trade restrictions relative to sufficient devaluation?

#### V. How Current Accounts Affect Protection: Conservative Resistance

The third case is the one that applies to the United States currently. This time the country is assumed to have a floating exchange rate system. While there may be some exchange market intervention, it is not designed to prevent exchange rate adjustment in response to fundamental macroeconomic conditions (including fiscal policy). It was shown in Section II that import restrictions may or may not improve the current account in that case, depending on what happens to savings and investment, and that there is certainly no general presumption that the effect would be one way rather than another.

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1/ See Corden (1974, Chapter 7, especially pp. 179-81).

2/ The argument is analyzed in detail in Corden (1985, Chapter 20).

I shall introduce here the term "conservative resistance," rather similar to John Hicks' term "real wage resistance" introduced many years ago. I do not use the term "conservative" in the curious American usage as representing a particular ideological mixture which leads to recommendations that are often quite radical, especially in the economic sphere. I refer to the widely observed tendency for public policy measures to be used--often in response to pressures from interest groups--to moderate, if not prevent, adverse sectoral income effects of various exogenous changes, notably those originating from abroad. This could be explained in two ways.

Firstly it could be explained as a manifestation of a kind of social welfare function--the "conservative social welfare function"--which expresses the idea of protection as a form of social insurance designed to prevent severe income losses to losers, while other members of society who willingly pay the cost of protection presume that they also might need such help one day i.e., that they also are insured. 1/

Secondly, and more relevantly for the United States, pressure groups may apply more effort or resources to obtain protection when the task is to protect existing real incomes from declining--i.e., to conserve what exists--then when the aim is actually to obtain increases. The point is simply that the marginal utility of a dollar of income lost is, on average, greater to them than a dollar of income gained, so that more resources will go into pressure group activities designed to maintain one dollar of income that might otherwise be lost than would go into activities designed to maintain an increase of one dollar of income. It is this process--motivated by pressure groups rather than by a "conservative social welfare function" with an insurance motivation--that is best described by the term "conservative resistance." 2/

The question then is whether a shift to a large and prolonged current account deficit resulting from macroeconomic policies gives support to conservative resistance and leads to more protection even when the exchange rate floats or is clearly available as an instrument of policy. It is certainly a common view that the recent increase in protectionist pressures in the United States can be explained in these terms. A current account deficit is normally associated with an absolute or relative decline of some import-competing and export industries. If only the current account imbalances could be reduced protectionist pressures would

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1/ See Corden (1974), Eaton and Grossman (1985) and Deardorff (1987).

2/ This is, of course, only one possible explanation of relative protectionist pressures and, more generally, of the "political economy of protection." See Baldwin (1984) for a review, and also Bhagwati (1988). Takacs (1981) contains an empirical analysis of pressures for protection and of actual changes in protection in the United States as measured by escape clause actions, and this is further discussed in Feigenbaum, Ortiz and Willett (1985).

ease. 1/ Apart from the influence of pressure groups, there are, of course, those who consider the current account deficit to be undesirable in its own right--i.e., to represent excessive borrowing by the United States--and who believe on the basis of fallacious partial equilibrium thinking that protection must reduce it.

Coming back to the conservative resistance motivation one weakness of this approach should be spelt out. When a country goes into current account deficit, or when the deficit increases, other things equal, incomes of tradable producers, whether of exportables or of import-competing products, tend to decline while those of nontradable producers tend to rise. Conservative resistance from tradable producers is then not surprising. But if protection does not improve the current account it will simply reshuffle the losses among tradable producers, essentially through the real appreciation to which it will give rise. This will be true even when the current account does improve to some extent--i.e., when import restrictions generate some extra savings--as long as there is still some real appreciation. In practical terms, protection tends to intensify the adverse effects on those producers, mostly exporters, who are not able to obtain quotas, subsidies, and so on, or who obtain increases in protection that are, in some sense, below the average. First they lose through the current account deficit or other factors that gave rise to it, and then they lose more through the indirect effects of protection obtained by other industries. The losses will thus tend to be concentrated on exporters and on those sectors where lobbying has been less effective.

One might argue that it is not a current account deficit but rather a real appreciation that gives rise to conservative resistance initially. There is certainly some evidence that on various occasions when the dollar has appreciated significantly in real terms--i.e., when there has been a decline in competitiveness--protectionist pressures have increased. 2/ Recent experience shows that the exchange rate can be depreciating while the current account still worsens. Hence, when one is interested in what stimulates protectionism, the focus should possibly be not on the current account position itself but on the movement in the real exchange rate. This presumed relationship between the real exchange rate and protectionist pressures in the United States was clearly a major factor in influencing the finance ministers of the Group of Seven when they reached the Plaza Agreement of September 1985 that was designed to bring down the dollar. The question is whether the recent dollar depreciation has

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1/ It should not be assumed that the increase in "protectionist pressures" as evidenced by the 1988 Trade Act and the "pressures" that preceded it, has brought about an equivalent actual increase in U.S. protectionism. In particular, the paper presented by Bela Balassa in this Symposium ("U.S. Trade Policy Towards Developing Countries") suggests that the U.S. market is still very open to products from developing countries, more so than the markets of Japan and the European Community.

2/ See Bergsten and Williamson (1983), Cline (1984) and Clifton (1985).

moderated protectionist pressures in the United States: it is my impression that it has.

Another explanation for protectionist pressures in terms of conservative resistance may actually be more important. Any boom in exports from particular countries, especially if concentrated in particular products, is likely to give rise to such resistance. This need not be associated with current account imbalances at all since the same countries could be increasing their imports at the same time.

The boom in labor-intensive clothing and textile exports mainly from the four Asian newly industrializing economies (NIEs) generated widespread conservative resistance from the clothing and textile industries of the "old" industrialized countries and led to the increase in protection of these industries in all developed countries. Yet the exporting countries generally did not run current account surpluses. Korea consistently ran current account deficits until 1985. Germany practiced this form of protection not only of clothing and textiles but also of agriculture while consistently having current account surpluses. Nor could arguments about level playing fields and retaliatory protection hold much water, bearing in mind that Hong Kong has been a uniquely free trade territory, Singapore, also, has been one of the world's most open economies and Korea, while by no means free trade has been no more protectionist than many other developing and possibly some developed countries.

Another example can be given from Japan's response to the first oil shock and the reaction in other countries to the resultant Japanese export boom. The rise in oil prices put Japan into big current account deficit in 1974 but by means of massive export expansion she was able to convert this into fairly modest surpluses of 1.6 percent of GNP by 1977 and 1.7 percent in 1978. From 1975 to 1981 the volume of Japanese exports increased by 71.5 percent, most of the increase compensating for the deterioration of her terms of trade. This generated strong conservative resistance in other countries, a resistance that was not applied to exports by the OPEC countries which were actually generating the large current account surpluses.

Here one should return to the earlier analysis of the effects of a reduction of protection by Japan. It was noted that "opening up" would not necessarily reduce Japan's savings-investment balance but would lead to more yen depreciation, or less appreciation than otherwise. In fact Japan's imports would increase as a result of her protective barriers being reduced, but her exports would also, an inevitable implication of the current account remaining unchanged. Hence, while the playing field might have become more level, and there would be the familiar and important gains from trade accruing both to Japan and to her trading partners, increased conservative resistance against Japanese export expansion might well result.

## VI. Reducing a Current Account Deficit to Avoid Protectionist Pressure

The possible effect of a current account deficit in stimulating protection has a normative implication for macroeconomic policy. To discuss this, an issue that is only peripherally related to trade policy should first be noted here: does a prolonged current account imbalance represent a problem not only because of its possible effects in increasing protectionist pressures but also for other reasons?

Firstly, a current account deficit is a flow phenomenon, representing a change in a country's net financial asset position. One cannot make a judgment about it without judging the optimality--or departure from optimality--of the stock at a point in time.

Secondly, the current account deficit is the excess of national investment over national savings, so even if one considers saving to be too low for some reason a judgment still has to be made about the optimality of the investment rate. The shift of the United States current account from near balance to large deficit has been associated with an increase in the Federal deficit and a decline in the personal savings ratio. Since public investment has not increased and private investment as a proportion of GNP has not risen, the concern with the current account really implies that U.S. savings, public and private, are thought to be too low.

The facts here are well known. The U.S. Federal budget deficit was 2.3 percent of GNP in 1980 and jumped to a peak of 5.6 percent in 1983. By 1987 it was down to 3.3 percent and by 1989 the IMF projects it to be 2.6 percent. Personal savings as a percentage of personal disposable income averaged about 7 percent from 1976 to 1981 and by 1987 was apparently down to a remarkably low 3.7 percent. For the Group of Seven as a whole the figure was 8.9 percent, for Japan 16 percent and for Germany 13.5 percent. <sup>1/</sup>

One might argue that the proper approach is not to focus on the current account but rather to focus directly on the budget deficit and its various determinants, and on private savings and investment. On what principles are they too high or too low, and what would be an optimal budget deficit or an optimal rate of private savings? It is not the current account itself that matters but only the various elements that determine it. A discussion of the complex considerations that determine optimal private savings, optimal private investment and optimal fiscal policy would obviously go well beyond the scope of this paper, but on this argument it is these considerations that underlie the issue of the optimality of a current account deficit.

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<sup>1/</sup> The budget deficit figures come from International Monetary Fund (1988b) and the savings figures from International Monetary Fund (1988a, p. 9).



The current U.S. problem as it is widely perceived is that the budget deficit is too high for various reasons, and that personal savings are too low by at least some criteria. The current account deficit might be regarded as a signal of these problems. All this views the issue from the point of view of the United States. From a world point of view further considerations enter, notably the effects of U.S. policies on world interest rates. A reduced U.S. budget deficit, increased personal savings or a reduction in U.S. investment demand would all tend to reduce world interest rates, which would certainly be of great benefit to indebted developing countries.

The discussion of the effects of current account deficits on conservative resistance and thus on protectionist pressures has a normative implication for macroeconomic policy. Let us assume now that, for a constant current account (and hence appropriate real exchange rate adjustment to maintain it), protection has adverse effects for all the usual reasons analyzed in trade theory. There are of course numerous, mostly second-best, qualifications to this, but if it is granted one conclusion follows.

If a prolonged and large current account deficit gives rise to protectionist pressures and there is a high probability that these would be converted into actual increases in protection, there is a reason for pursuing appropriate macroeconomic policies designed to reduce the deficit (such as fiscal contraction) which is additional to other possible reasons connected with optimal public borrowing or inadequate private savings. The aim is to avoid an increase in protection. Possibly there is even a case for seeking to reduce the current account deficit when there are no such other reasons. The extent to which this consideration should weigh in determining macroeconomic policy must, of course, depend on one's estimate of the social cost, in the form of distortions, rent-seeking, and adverse effects on the world trading system, that additional protection resulting from these pressures might impose.

## VII. The Future

Finally, in considering the relationship between macroeconomic "balance" in the broad sense and trade policy, one should look ahead a little. What trade tensions originating in macroeconomic developments are likely to arise in the future? The catalogue to follow can be regarded as a pessimistic catalogue of problems on the principle that every silver lining has a cloud somewhere. One should not overstate these prospective problems--most of which are assumed to originate in "conservative resistance." But the prospects suggest that, irrespective of the analytical simplicity of the arguments against protection from a national or international point of view, the protection issue will not go away.

1. Inflation in the industrial countries might accelerate again and if it did, it would in due course compel contractionary demand policies, leading to world recession, and the usual protectionist pressures that go

with recession. This story supposes that history does repeat itself and, especially, that inflation is allowed to go on long enough to compel eventually severe counter measures. Hopefully lessons have been learnt so that this can be avoided.

2. The current account "imbalances" among the major economies will no doubt in due course be reduced, and indeed the process is already under way. At some stage, as interest and dividend payments mount up, the United States will have a trade surplus and Japan and Germany trade deficits. Declines in the trade surpluses of Germany and Japan, and their eventual conversion into deficits, are inevitable for this reason even with constant current account surpluses. How will interest groups and ideologies in countries that now have trade surpluses react to this? Of course the transformation will not happen suddenly and at the same time their nontradable producers will be gaining.

The same attitudes that produced protectionist pressures in the United States as a result of the growing trade deficits should presumably produce trade optimism and free trade enthusiasm when the U.S. trade balance improves, as it must eventually. The required reversal in the trade balance situation may (on some analyses) have to be associated with a further real depreciation of the dollar, a development that should surely reduce protectionist pressures in the United States.

It is thus possible that the protection debate will shift from the United States to Japan and Germany, as it has shifted or spread in the last seven years or so from countries like Canada, Australia and developing countries to the United States. The hopeful aspect is that Japan may adapt smoothly to a trade balance shift as she has to most other necessary changes.

3. Conceivably action to reduce the U.S. fiscal and current account deficits may not be taken in time and there could be some kind of "hard landing," essentially reflecting an increasing reluctance by holders of financial portfolios around the world to continuously raise the share of dollar-denominated assets in their portfolios. 1/ It is by no means inevitable that the landing be "hard"--i.e., that the demand for dollars falls suddenly rather than gradually and that policy reactions (for example, through exchange rate intervention) would be unable to prevent sudden disruptive effects. But perhaps it is worth exploring the implications of a "hard landing" for protectionism.

The dollar would depreciate relative to other major currencies, and interest rates would rise in the United States. Monetary policy reaction in the United States would determine how much of the effect were taken in higher interest rates and how much in dollar depreciation. U.S. tradable producers would benefit from depreciation while losing from higher interest rates. A recession in the United States would not be inevitable,

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1/ The "hard landing" possibility was popularized in Marris (1985).

bearing in mind both the stimulating effect of depreciation and the possibility of offsetting monetary policy reactions. But recession would be at least a possibility, especially as monetary expansion designed to avoid recession would lead to more depreciation.

Such a recession could have very adverse effects on developing countries, even though there could be offsetting effects in other countries where one might expect interest rates to decline as investors sought to increase the non-dollar contents of portfolios. With developing countries in greater difficulties their protection might well increase. Real appreciations of non-dollar currencies could conceivably intensify protectionist pressures outside the United States. In the United States itself the depreciation itself should surely ease protectionist pressures, but against this must be set the effects of a recession. One thing does seem clear: macroeconomic instability--which this scenario implies--is unlikely to be conducive to reducing protection, in particular to foster progress in the Uruguay round.

4. For some years, at least, Japan is likely to continue with large current account surpluses and hence with the need to export capital on a large scale. Inevitably this means continuously increasing Japanese ownership of property and enterprises in other countries. In stock terms the magnitudes are generally small, but the flows are large, and some tensions are inevitable, no doubt affecting trade policy in various ways.

The real depreciation of the dollar that has already taken place, as well as further depreciation that could still come, may reduce trade protectionist pressures in the United States. But a continuing though declining current account deficit, leading to an increasing stock of foreign-owned assets in the United States, could lead to more "foreign-investment protectionism" which also involves pressures to interfere with market processes. As in the case of trade protection, there are countervailing forces, notably from those who gain from higher employment or from expenditures financed by tax revenue that is generated by foreign investment in their regions.

5. It is difficult to predict what will happen to the trade and current account balances of the developing countries as a group. In 1987 their aggregate current account balance was near zero, implying, of course, a substantial trade surplus and also big differences within the group. The combined surplus of the Republic of Korea and Taiwan Province of China was \$28 billion so that this was also roughly the combined deficit of the rest. For 1989 the IMF projects an aggregate deficit of \$26 billion. A number of different stories could be told for the future.

One scenario is that the indebted countries meet their debt service payments even though they would not be getting much in the way of new funds, at least for some time. The countries would be "growing out of debt," with their debt service ratios falling as a result of steady export growth. This would require substantial and prolonged trade

surpluses. Here the example--perhaps an extreme example--has been set by Korea which has actually been amortizing its debt ahead of time. As a result of substantial prepayments of debt in 1986 and 1987 Korea's gross external debt fell from 56 percent of GNP at the end of 1985 to 30 percent at the end of 1987. The volume of Korean exports rose 28 percent in 1986 and 36 percent in 1987.

We know that this has generated conservative resistance in the United States. The emphasis has been not so much on the debt repayment itself but on the real appreciation of the won that goes with the process. Presumably if many developing countries followed this road, if only to meet their regular debt service obligations without rescheduling, the resistance would be stronger and more widespread.

Another--opposite--scenario is that the developing countries would again become capital importers on a large scale, more than sufficient to finance their interest obligations, so that as a group they could run a substantial trade deficit. Conceivably this could result from large inflows of funds into a small group of developing countries which have "taken off" and will be the "new NIEs." In that case it might be possible for Japan and Germany to continue with their surpluses even though the U.S. deficit were gradually reduced, and eventually turned also into a trade surplus.

6. It was noted earlier that protectionist pressures result much more from large export expansions by particular countries, especially if concentrated on a few products, than from their current account surpluses. One can certainly envisage massive trade pattern shifts and take-offs into self-sustained growth by various developing countries, especially China. The full trade implications of an effective and prolonged Chinese transformation seem quite awe-inspiring. And why should not Brazil and Mexico eventually resume their higher growth rates and hence high export and import expansions bearing in mind their impressive growth records in the nineteen fifties and sixties? It is difficult to assess this prospect. But the problem of conservative resistance and protectionist pressures generated in response to fundamental and generally highly desirable changes in developing countries, leading to export expansions by them, is unlikely to go away. Reducing current account "imbalances" will not solve that problem. Wider understanding of the costs imposed by protectionism in the developed countries--especially costs imposed on the developing countries--as well as the growth of "counter-resistance" from export interests, would certainly help.

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