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Central Intelligence Agency



Washington, D.C. 20505

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29 APR 1987

MEMORANDUM FOR: See Attached Distribution

SUBJECT: Analysis of Global Trade Imbalances

One of our analysts has just completed an analysis of global trade imbalances that I believe you may find useful. Its chief finding is that on the volume side, the adjustment of world trade flows is underway and, even with no further policy or currency changes, the US deficit and key foreign surpluses may be approaching a turnaround. Should you have questions, you should address them to

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Chief, Economics Division  
Global Issues

Attachment:

Global Trade and the US Dollar

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GI M 87-20075, April 1987,

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SUBJECT: Analysis of Global Trade Imbalances

OGI/ECD/IT [redacted] (28 April 87)

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Central Intelligence Agency



Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

28 April 1987

Global Trade and the US Dollar

Summary

Global trade imbalances have reached record levels despite the continuing depreciation of the US dollar against other major currencies. The US trade deficit hit a record \$149 billion last year, while trade surpluses in West Germany, Japan, and Taiwan reached all-time highs. Signs of a possible turnaround in underlying trade patterns have begun to appear, however. Several factors could work against this optimistic outlook. Continued sluggishness in Japan's and West Germany's domestic economies; continued US consumer preferences for foreign imports, despite higher import prices; and the threat of increased protectionism could partially offset the positive impact of the depreciation of the dollar on global trade patterns.

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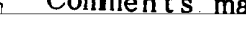
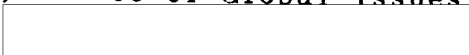
This memorandum was prepared by  
Branch, Office of Global Issues  
author



International Trade  
Comments may be directed to the

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[REDACTED]

## GLOBAL TRADE AND THE US DOLLAR

Global trade imbalances have reached record levels. Last year the US deficit was the highest ever, as were the trade surpluses in Japan, West Germany, and Taiwan. This trend has persisted into 1987: recent data indicate that the US trade deficit in February was the second highest monthly deficit on record. Although conventional economic wisdom indicates that the decline of the US dollar should narrow the trade deficit and reduce the surpluses being run by major US trading partners, such improvement has not been realized. The depreciation of the dollar has, however, begun to alter underlying trends in export and import prices and volumes for the US and its trading partners. [REDACTED]

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### Trade and Exchange Rate Trends, 1983-84

Trade data indicates that the US trade deficit nearly doubled during 1983-84. Import volume surged throughout the period as the rapid appreciation of the dollar in 1983 and 1984 reduced dollar import prices. This price drop, coupled with strong US economic growth, fueled the rapid growth of import volume. Concurrently, export earnings showed little change, as the dollar's appreciation raised US export prices and made US exports less competitive in world markets. [REDACTED]

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Major US trading partners reaped the benefits of a rising dollar and strong US economic growth--Japan, France, Canada, South Korea, and Taiwan all recorded improvement in their trade balances during 1983-84. The rising dollar allowed foreign exporters to raise export prices (measured in domestic currency), and higher US demand for foreign goods boosted export volume. On the other hand, import prices (also measured in domestic currency) rose sharply as a result of the dollar's appreciation, depressing the demand for imported goods in Western Europe and the Far Eastern NICs. Individually, Japan's trade surplus jumped \$26 billion during 1983-84, while Canada recorded a gain of nearly \$2 billion. France recorded an \$11 billion decline in its trade deficit, and South Korea's trade deficit narrowed \$1.5 billion over the period. [REDACTED]

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### The Falling Dollar and Growing Trade Imbalances, 1985-86

Although the dollar began to depreciate against other major currencies in early 1985, the decline had little impact on global trade balances because of the lag in the response of trade volumes to changes in trade prices. As a result, US imports continued to rise, though at a slower pace than in earlier years, and exports remained depressed. Western European trade balances continued to improve, with

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[Redacted]

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France's trade deficit declining and West Germany's trade surplus reaching a new high. Japan's trade surplus jumped \$13 billion, and Taiwan recorded a gain of \$2 billion. [Redacted]

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Signs of a turnaround in underlying trade trends began to appear in the last half of 1986.

--US export earnings showed signs of recovery, as volumes increased at a 7 percent annual rate after mid-1986. Import prices started to rise in the last half of the year, leading to a drop in import volume in the fourth quarter of 1986 following three years of sharp gains.

--Changing trends also were evident in Western Europe and Japan. Import prices plunged in 1986--in part because of the drop in the dollar--and import volumes showed marked increases. The dollar's decline also raised the relative prices of European and Japanese goods in foreign markets, reducing export volumes and forcing foreign exporters to cut the domestic-currency prices of their exports in an attempt to maintain competitiveness. As a result, West Germany's trade surplus, measured in domestic currency, declined in the fourth quarter of 1986, and Japan's surplus showed no change. In both countries, early 1987 trends indicated an uptick in the surpluses, however. [Redacted]

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Has the Bottom been Reached?

Private forecasts for 1987 indicate that the continuing decline of the dollar will have a more noticeable impact on trade trends. US import prices are forecast to increase, sharply reducing the growth of import volume. The dollar's decline will increase the competitiveness of US exports, boosting export volume and allowing exporters to raise their prices slightly. The forecasts indicate that the impact of the depreciation will not be sufficient to actually reduce the trade deficit, but will hold the increase well below those of the previous three years. [Redacted]

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The dollar's decline also will have a dramatic impact on the 1987 trade outlook for major US trading partners [Redacted]

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[Redacted] The depreciation of the dollar should sharply reduce their import prices, measured in domestic currency units, and fuel continued increases in import volume. Their exports will continue to become less competitive, leading to sharp cutbacks in the growth of export volume and depressed export prices. The trade balances, as measured in US dollars, are forecast to increase, but the gains will be much

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[Redacted]

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smaller than in previous years. When measured in domestic currency units, however, the trade surpluses for Japan and West Germany are forecast to show substantial declines, while the trade balance gains for South Korea and Taiwan will be far smaller than in 1986. [REDACTED]

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#### A Cautiously Optimistic Outlook

We believe that beyond this year world trade imbalances will ease as the impact of the past depreciation of the dollar becomes stronger. We believe this outcome will occur even if the dollar falls no further. Should it continue to slide, the initial impacts on trade imbalances will be adverse, due to the price changes leading volume adjustments, but the eventual turnaround will be even more pronounced. [REDACTED]

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However, several factors could work against this outlook. The exchange rate is not the only factor affecting trade flows, nor is it the most powerful. Real GNP growth and consumer preferences also play important roles. Domestic demand in Japan and West Germany remains sluggish, depressing import demand in these countries and reducing the impact of the dollar's decline on their large trade surpluses. Consumers in the United States continue to show a preference for foreign goods despite increased prices for many of these products. Should this trend continue, US import demand would remain strong, partially offsetting the positive impact of depreciation of the dollar on the US trade deficit. Finally, increased protectionism--at a time when trade patterns are finally beginning to change--could be counterproductive, further increasing trade tensions and inviting retaliatory action by trading partners. [REDACTED]

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THE SLOW ADJUSTMENT OF TRADE FLOWS TO EXCHANGE RATE CHANGES

The slow response of world trade balances to the decline of the dollar is puzzling at first glance. A depreciation of the US dollar raises US import prices and lowers import prices in foreign countries--curbing the growth of US import volume and boosting import demand in our major trading partners. US export prices decline and foreign export prices increase, making US exports more competitive in world markets. As a result, the US trade deficit should fall and the large trade surpluses of major US trading partners should be reduced.

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While an exchange rate depreciation immediately affects export and import prices, the same is not true for export and import volumes, however. Businessmen and consumers must first recognize that a depreciation is occurring and that export and import prices are changing. Decisions regarding new orders and use of existing inventories must be made in response to these changing conditions. Finally, goods must be produced and delivered once these decisions are made. Because orders are often placed well in advance of delivery, the lag time between a change in the exchange rate and an actual change in trade flows can be quite substantial.

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The first effect of a dollar depreciation therefore will be to raise US import expenditures, because the price of imports will rise while import volumes will remain unchanged, leading to a deterioration of the trade balance. As time passes, the quantity adjustments take place, whereby US import volumes are depressed while exports become more attractive to foreign buyers, and the trade balance will begin to improve. This process is described by economists as the "J-curve" effect, and academic studies have indicated that for manufactured goods the response of trade flows to exchange rate changes can stretch out over four or five years. As a result, the lack of a significant response of world trade balances to the dollar's depreciation during 1985-86 should not be surprising.

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Key Trading Countries:  
Selected Trade Trends

| UNITED STATES                       | 1983  | 1984   | 1985   | 1986   |
|-------------------------------------|-------|--------|--------|--------|
| Trade Balance(\$bil)                | -57.6 | -107.8 | -132.2 | -148.9 |
| Export Volume(pct chg)              | -6.4  | 6.8    | -1.8   | 1.6    |
| Import Volume(pct chg)              | 10.4  | 23.9   | 8.7    | 11.3   |
| Export Price <sup>a</sup> (pct chg) | 1.1   | 1.3    | -0.8   | -2.7   |
| Import Price <sup>a</sup> (pct chg) | -4.1  | 1.8    | -2.5   | -3.7   |
| JAPAN                               |       |        |        |        |
| Trade Balance (\$bil)               | 31.5  | 44.3   | 56.0   | 82.6   |
| Trade Balance (tr yen)              | 7.5   | 10.5   | 13.4   | 13.6   |
| Export Volume (pct chg)             | 8.7   | 16.0   | 3.7    | -1.7   |
| Import Volume (pct chg)             | 1.2   | 10.8   | -0.2   | 13.0   |
| Export Price (pct chg)              | -6.7  | -0.4   | 0.0    | -14.5  |
| Import Price (pct chg)              | -9.2  | -2.7   | -3.6   | -34.7  |
| Export Price <sup>b</sup> (pct chg) | -2.2  | -0.4   | -0.4   | 21.0   |
| Import Price <sup>b</sup> (pct chg) | -4.8  | -2.2   | -3.7   | -7.6   |
| Exchange Rate<br>(yen/US\$)         | 237.5 | 237.5  | 238.5  | 168.5  |
| WEST GERMANY                        |       |        |        |        |
| Trade Balance (\$bil)               | 21.5  | 22.0   | 28.7   | 54.9   |
| Trade Balance (bil DM)              | 54.9  | 62.7   | 84.4   | 119.4  |
| Export Volume(pct chg)              | -0.3  | 9.1    | 5.9    | -0.6   |
| Import Volume(pct chg)              | 4.0   | 5.2    | 4.2    | 10.2   |
| Export Price (pct chg)              | 1.4   | 3.5    | 3.9    | -1.2   |
| Import Price (pct chg)              | -0.3  | 5.9    | 2.6    | -17.7  |
| Export Price <sup>b</sup> (pct chg) | -3.6  | -7.1   | 0.3    | 34.4   |
| Import Price <sup>b</sup> (pct chg) | -5.2  | -4.9   | -0.9   | 11.6   |
| Exchange rate<br>(DM/US\$)          | 2.55  | 2.85   | 2.94   | 2.17   |

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| FRANCE                              | 1983  | 1984  | 1985  | 1986  |
|-------------------------------------|-------|-------|-------|-------|
| Trade Balance (\$bil)               | -8.8  | -4.7  | -4.5  | -2.2  |
| Trade Balance(bil Franc)            | -67.1 | -41.1 | -40.5 | -15.2 |
| Export Volume (pct chg)             | 3.4   | 5.3   | 2.8   | -2.1  |
| Import Volume (pct chg)             | -1.9  | 2.3   | 4.1   | 7.2   |
| Export Price (pct chg)              | 10.1  | 11.8  | 4.7   | -4.4  |
| Import Price (pct chg)              | 7.8   | 10.4  | 2.0   | -13.4 |
| Export Price <sup>b</sup> (pct chg) | -5.1  | -2.4  | 1.7   | 24.1  |
| Import Price <sup>b</sup> (pct chg) | -7.1  | -3.7  | -0.9  | 12.4  |
| Exchange Rate<br>(francs/US\$)      | 7.62  | 8.74  | 8.99  | 6.93  |
| UK                                  |       |       |       |       |
| Trade Balance (\$bil)               | -1.3  | -5.9  | -2.3  | -12.7 |
| Trade Balance(bil pds)              | -0.9  | -4.4  | -1.8  | -8.7  |
| Export Volume (pct chg)             | 0.6   | 8.7   | 7.3   | 3.3   |
| Import Volume (pct chg)             | 7.7   | 9.5   | 5.3   | 7.7   |
| Export Price (pct chg)              | 7.8   | 8.1   | 5.4   | -4.7  |
| Import Price (pct chg)              | 8.2   | 9.2   | 3.7   | -7.6  |
| Export Price <sup>b</sup> (pct chg) | -6.9  | -4.9  | 2.7   | 7.9   |
| Import Price <sup>b</sup> (pct chg) | -6.8  | -3.8  | 1.0   | 4.6   |
| Exchange Rate<br>(pounds/US \$)     | 0.66  | 0.75  | 0.77  | 0.68  |
| ITALY                               |       |       |       |       |
| Trade Balance (\$ bil)              | -3.2  | -6.0  | -6.9  | -1.6  |
| Trade Balance(tr Lira)              | -4.9  | -10.6 | -13.2 | -2.4  |
| Export Volume(pct chg)              | 5.2   | 6.5   | 7.5   | -1.6  |
| Import Volume(pct chg)              | 1.4   | 9.0   | 8.8   | 5.8   |
| Export Price(pct chg)               | 5.7   | 9.6   | 8.1   | -1.9  |
| Import Price(pct chg)               | 3.3   | 11.3  | 7.4   | -8.5  |
| Export Price <sup>b</sup> (pct chg) | -6.0  | -5.2  | -0.4  | 25.6  |
| Import Price <sup>b</sup> (pct chg) | -8.1  | -3.7  | -1.1  | 17.0  |
| Exchange Rate<br>(Lira/US\$)        | 1519  | 1757  | 1909  | 1491  |



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| CANADA                                   | 1983  | 1984  | 1985  | 1986  |
|--|-------|-------|-------|-------|
| Trade Balance(\$bil)                     | 15.0  | 16.7  | 13.3  | 5.9   |
| Trade Balance (bil/<br>Canadian Dollars) | 18.4  | 21.7  | 18.2  | 8.2   |
| Export Volume (pct chg)                  | 7.8   | 18.5  | 4.2   | 4.8   |
| Import Volume (pct chg)                  | 11.1  | 18.6  | 6.6   | 9.7   |
| Export Price (pct chg)                   | 0.1   | 4.6   | 1.7   | -3.3  |
| Import Price (pct chg)                   | 0.4   | 6.2   | 3.2   | -1.3  |
| Export Price <sup>b</sup> (pct chg)      | 0.1   | -1.1  | -3.4  | -4.6  |
| Import Price <sup>b</sup> (pct chg)      | 0.4   | 0.5   | -2.2  | -2.6  |
| Exchange Rate<br>(Canadian\$/US\$)       | 1.23  | 1.30  | 1.37  | 1.39  |
| SOUTH KOREA                              |       |       |       |       |
| Trade Balance (\$bil)                    | -1.8  | -1.0  | 0.0   | 3.4   |
| Trade Balance(tr won)                    | -1.4  | -0.8  | 0.0   | 2.9   |
| Export Volume(pct chg)                   | 16.8  | 15.1  | 7.7   | 25.3  |
| Import Volume(pct chg)                   | 13.5  | 15.9  | 6.2   | 26.0  |
| Export Price (pct chg)                   | 2.1   | 7.4   | 4.0   | 2.0   |
| Import Price (pct chg)                   | 1.1   | 5.2   | 3.4   | -10.7 |
| Export Price <sup>b</sup> (pct chg)      | -3.9  | 3.5   | -3.7  | 0.7   |
| Import Price <sup>b</sup> (pct chg)      | -4.8  | 1.4   | 4.2   | -11.8 |
| Exchange Rate<br>(Won/US\$)              | 776   | 806   | 870   | 881   |
| TAIWAN                                   |       |       |       |       |
| Trade Balance (\$bil)                    | 6.3   | 9.2   | 11.2  | 15.9  |
| Trade Bal(bil NT\$)                      | 252.6 | 364.7 | 445.8 | 601.0 |
| Export Volume(pct chg)                   | 18.6  | 15.7  | 5.9   | 25.9  |
| Import Volume(pct chg)                   | 13.1  | 2.1   | -5.2  | 39.1  |
| Export Price (pct chg)                   | -1.9  | 2.9   | -2.8  | -2.3  |
| Import Price (pct chg)                   | -2.4  | 5.8   | -3.9  | -10.6 |
| Export Price <sup>b</sup> (pct chg)      | 0.3   | 4.2   | -3.3  | 3.0   |
| Import Price <sup>b</sup> (pct chg)      | -0.2  | 7.1   | -4.3  | -5.9  |
| Exchange Rate<br>(NT/US\$)               | 40.1  | 39.6  | 39.8  | 37.8  |

<sup>a</sup>In National Currency units.

<sup>b</sup>In US dollars.

Quarterly Trade Data for 1986 <sup>a</sup>

|                          | 1986I | 1986II | 1986III | 1986IV |
|--------------------------|-------|--------|---------|--------|
| <b>UNITED STATES</b>     |       |        |         |        |
| Trade Balance (bil\$)    | -34.8 | -36.6  | -38.8   | -38.7  |
| Export Volume (pct chg)  | 1.9   | -2.1   | 1.5     | 1.9    |
| Import Volume (pct chg)  | 0.2   | 5.3    | 2.5     | -2.2   |
| Export Price (pct chg)   | -0.2  | -1.3   | -0.2    | 0.9    |
| Import Price (pct chg)   | -1.7  | -4.9   | 0.8     | 3.8    |
| <b>JAPAN</b>             |       |        |         |        |
| Trade Balance (bil\$)    | 12.4  | 21.7   | 24.6    | 23.9   |
| Trade Balance (tr Yen)   | 2.3   | 3.7    | 3.8     | 3.8    |
| Export Volume (pct chg)  | -4.4  | 1.5    | 0.3     | -2.3   |
| Import Volume (pct chg)  | 9.6   | 15.0   | -0.2    | -1.7   |
| Export Price (pct chg)   | -3.7  | -4.2   | -3.9    | 2.0    |
| Import Price (pct chg)   | -11.6 | -22.6  | -11.5   | 3.7    |
| Exchange Rate (Yen/US\$) | 187.9 | 170.1  | 155.8   | 160.3  |
| <b>WEST GERMANY</b>      |       |        |         |        |
| Trade Balance (bil\$)    | 13.0  | 15.1   | 15.1    | 11.7   |
| Trade Balance (bil DM)   | 30.6  | 34.0   | 31.4    | 23.4   |
| Export Volume (pct chg)  | 1.8   | -0.5   | -0.2    | 0.7    |
| Import Volume (pct chg)  | 0.7   | 3.4    | 7.5     | 0.6    |
| Export Price (pct chg)   | 0     | -1.1   | -0.3    | 0.5    |
| Import Price (pct chg)   | -2.5  | -7.9   | -5.7    | 8.2    |
| Exchange Rate (DM/US\$)  | 2.35  | 2.25   | 2.09    | 2.01   |

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|                          | 1986 I | 1986 II | 1986 III | 1986 IV |
|--------------------------|--------|---------|----------|---------|
| SOUTH KOREA              |        |         |          |         |
| Trade Balance (bil\$)    | -0.6   | 0.8     | 1.1      | 2.1     |
| Trade Balance(tr Won)    | -0.5   | 0.7     | 0.9      | 1.8     |
| Export Volume (pct chg)  | 29.3   | 21.0    | 20.4     | NA      |
| Import Volume (pct chg)  | 23.5   | 15.1    | 22.3     | NA      |
| Export Price (pct chg)   | 1.3    | -0.9    | 3.1      | NA      |
| Import Price (pct chg)   | -3.9   | -8.2    | -8.6     | NA      |
| Exchange Rate (Won/US\$) | 887.1  | 887.0   | 882.2    | 869.5   |

<sup>a</sup> Data are seasonally adjusted. Changes in export and import prices and volumes are changes over the previous quarter.

US Trade Balance:  
Accounting for the Deterioration

|   | 1982  | 1983  | 1984   | 1985   | 1st half<br>1986 <sup>a</sup> | 2nd half<br>1986 <sup>a</sup> | 1st qtr.<br>1987 <sup>a</sup> |
|---|-------|-------|--------|--------|-------------------------------|-------------------------------|-------------------------------|
| Balance(\$bil)                                      | -31.7 | -57.6 | -107.8 | -132.2 | -71.4                         | -77.5                         | -38.2                         |
| Change(\$bil)<br>(over same period<br>in prev. yr.) | -4.4  | -25.9 | -50.2  | -24.4  | -17.1                         | -12.2                         | -3.4                          |
| Due to changes in (\$bil):                          |       |       |        |        |                               |                               |                               |
| Export Volume                                       | -24.4 | -13.8 | 14.2   | -3.5   | 0.3                           | 3.3                           | 1.8                           |
| Import Volume                                       | 12.7  | -24.7 | -62.3  | -25.5  | -20.8                         | -20.4                         | -3.9                          |
| Export Price  | 3.0   | 2.0   | 3.2    | -1.3   | -4.0                          | -2.0                          | 0.3                           |
| Import Price  | 4.3   | 10.7  | -5.4   | 5.9    | 7.4                           | 6.9                           | -1.7                          |
| Percentage<br>changes in:                           |       |       |        |        |                               |                               |                               |
| Export Volume                                       | -10.6 | -6.4  | -6.8   | -1.8   | 0.3                           | 3.2                           | 3.2                           |
| Import Volume                                       | -5.0  | 10.4  | 23.9   | 8.7    | 12.5                          | 11.8                          | 4.2                           |
| Export Price  | 1.1   | 1.1   | 1.3    | -0.8   | -3.6                          | -1.9                          | 0.5                           |
| Import Price  | -1.6  | -4.1  | 1.8    | -2.5   | -3.9                          | -3.7                          | 1.9                           |

<sup>a</sup>Changes are over same period of previous year.



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