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# FRBSF WEEKLY LETTER

May 1, 1987

## Trade and the Western Economy

Since early 1985, when the U.S. dollar began declining in value against the currencies of many of our trading partners, economists have expected the trade deficit to shrink and thereby to stimulate the national economy. For the Twelfth Federal Reserve District (Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington), an improvement in the trade balance is no less important. Most forecasts of these states' economies, like forecasts of the national economy, anticipate that a turnaround in international trade will stimulate economic growth this year.

This *Letter* argues that the trade balance is on the verge of turning around despite recent large monthly deficits. Moreover, because a large proportion of the products that pass through Twelfth District ports are traded with Japan, against whose currency the depreciation of the dollar has been particularly pronounced, there is greater evidence of a current turnaround in the West's trade balance than in the balance of the rest of the nation.

### **Importance of western ports**

Trade through western ports represents a large proportion of total U.S. trade. In 1985, 24 percent of U.S. exports and imports passed through ports in Customs Districts located in the Twelfth Federal Reserve District. These Customs Districts include, in approximate order of their importance, Los Angeles, San Francisco, Seattle, Portland, San Diego, Nogales (Arizona), Honolulu, and Anchorage. By comparison, the nine western states of the Twelfth District account for about 18 percent of U.S. population, employment, and personal income.

The West's easy access to the increasingly important Pacific trade routes renders the region a more and more critical component of the nation's international trade picture. Customs District data do, however, overstate the significance of international trade in the western economy since not all products exported from West coast ports are produced in the West and not all

imports that come through those ports are purchased by westerners. Los Angeles, for example, is an important trans-shipment point for products from Asia destined for the middle of the country.

### **Trade patterns in the West**

In many respects, trade patterns in the West differ from those of the U.S. Because of the West's proximity to the Far East, products that pass through western Customs Districts are much more likely to be traded with Pacific Basin nations than are American traded goods generally. In 1985, 21.0 percent of the dollar volume of western trade was with Japan, compared to 16.5 percent for the U.S. Other Pacific Basin countries that accounted for more than one percent of western trade volume include Taiwan, Korea, Australia, Hong Kong, Singapore, the People's Republic of China, and Malaysia.

By the same token, a smaller proportion of western trade, compared to U.S. trade, involves European countries. West Germany accounts for 2.1 percent of western trade compared with 5.3 percent for the U.S., while the United Kingdom accounts for 1.8 percent of western and 4.7 percent of national trading volume. Canada and Mexico also are less important trading partners for the West than for the nation. Canada accounts for 20.3 percent of U.S. trading volume, but only 3.1 percent of the trade through Pacific ports. Mexico provides 5.7 percent of U.S. trade activity, but only 2.4 percent of western trade.

Another difference in trade patterns is that western ports serve a more diffused range of trading partners. While the top ten trading partners of the U.S. accounted for 57 percent of all U.S. trade volume during 1985, the top ten western trading partners accounted for only 44 percent of all trade through western ports.

The mix of products traded through western ports also differs from the product mix for the nation. For example, while 24 percent of U.S. imports entered the country through western

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ports during 1985, those ports accounted for 50 percent of all imports of office machinery and 35 percent of motor vehicle imports. Western ports are relatively unimportant in terms of petroleum imports, accounting for only 7 percent of the U.S. total. These divergences between the U.S. and the West are consistent with differences in the countries of origin for these important products. Asia, with relatively easy access to West Coast ports, is an important source of office machinery and cars, while most petroleum products come from the Middle East, for which gulf and eastern ports provide better access to the U.S. market.

On the export side, the western ports accounted for large proportions of U.S. exports of such products as office machinery (32 percent), electronic machinery (51 percent), aircraft and spacecraft (54 percent), and petroleum (43 percent). These figures reflect both the West's importance in making these products and Asia's importance as a market for them.

## **Impact of the declining dollar**

These differences in trade patterns suggest that the declining foreign exchange value of the U.S. dollar may have affected the western and U.S. economies differently. For example, the differences in importance of various trading partners could cause divergences between the U.S. and western experiences since the value of the dollar has fluctuated in varying degrees and even in different directions against different currencies.

Between the first quarter of 1985, when the dollar began its decline, and the second quarter of 1986 (the latest period for which inflation data are available for all relevant countries), the dollar fell in real terms by 33 percent against the Japanese yen and 28 to 29 percent against the West German mark, French franc, Italian lire, and British pound. However, it fell (in real terms) by much smaller percentages against the Australian and Hong Kong dollars, remained stable against the Canadian dollar and Taiwan new dollar, and rose against the Mexican peso, Korean won, and Singapore dollar. Exchange rate data unadjusted for inflation suggest that the value of the dollar stabilized during the second half of 1986 and has fallen, particularly against the yen, during early 1987.

To compare the impact of the dollar's declining value on the West with that on the U.S., we calculated trade-weighted indices of the dollar that use only the ten most important trading partners of the West (Japan, Taiwan, Korea, Canada, Mexico, Australia, West Germany, Hong Kong, Singapore, and the United Kingdom) and of the U.S. (a similar list that excludes Australia and Singapore and includes France and Italy). Because Japanese trade is more important in the West than it is nationally, whereas trade with Canada and Mexico is less important, the value of the dollar has fallen more when calculated using trade weights for western ports than when calculated using national trade weights. Specifically, the trade-weighted value of the dollar fell 14 percent for the U.S. and 18 percent for the West on an inflation-adjusted basis between the first quarter of 1985 and the second quarter of 1986.

## **Current trade situation**

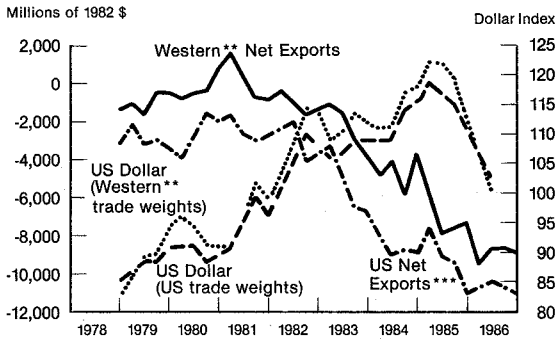
Because the two indices indicate that the dollar has declined more for the West than it has for the nation, we might expect that the trade balance for western Customs Districts, adjusted for inflation, would have improved more than the trade balance for the nation. However, the factors that have slowed improvement nationally have affected the West as well.

For example, import price increases attributable to the reduced value of the dollar have been slow to materialize when compared to past episodes of dollar depreciation. In addition, the U.S. dollar actually has increased in value against the currencies of many "newly industrialized countries," or NICs, including particularly Mexico, Korea, and Singapore. More generally, because many trading contracts cover periods of a year or more, changes in relative prices cannot be incorporated immediately into business transactions.

The chart shows the relationships between inflation-adjusted bilateral trade-weighted exchange rates and inflation-adjusted trade balances for the U.S. and for the eight western Customs Districts.

Generally, the western and U.S. lines trace similar paths over the time period shown. The trade-weighted dollar shows more short-term volatility

## REAL NET EXPORTS AND THE DOLLAR\*



\* Weights based on the ten largest trading partners.

\*\* Eight Western Customs Districts: Los Angeles, San Francisco, Seattle, Portland, San Diego, Nogales, Honolulu, and Anchorage.

\*\*\* For comparison, US Net Exports are divided by three.

and wider swings for the West than for the nation during the period. Between the fourth quarter of 1978 and the first quarter of 1985 when it reached its peak, the western dollar index rose 48 percent while the U.S. index rose 39 percent. Since that peak, the western index has fallen by 18 percent while the U.S. index has fallen only 14 percent. These differences reflect the relatively greater importance of Japan to the western index and Canada to the U.S. index.

In comparison, neither series exhibits a significant trend in its trade balance until 1982, when deterioration began. The western trade data indicate that the sharper increase in the value of the dollar caused the trade balance to deteriorate more than was true for the U.S. Both trade balance series exhibit substantial volatility as it was not at all unusual to see one- or two-quarter aberrations from longer term trends. The quarterly volatility appears to have been greater for the West than for the nation.

Both series show that the trade balance tended to deteriorate as the value of the dollar rose, although with a substantial lag. The dollar began its sharp increase in value in early 1981, but noticeable deterioration in the two trade balances was not evident until mid-1983. The delay was partly due to a normal one-year lag in foreign exchange effects, and partly to relatively slow income growth in the U.S. that restrained U.S. demand for imported products.

Likewise, an improvement in the trade balance can occur with a lag. Neither series exhibits substantial improvement in the trade balance as yet from the depreciation of the past two years, but both provide preliminary indications that deterioration in the trade balance may have been arrested.

### A turnaround in the offing?

Although the aggregate data do not provide convincing evidence that the trade balance has begun to improve, there are reasons to expect that both the western states and the U.S. will benefit from an improved trade balance during 1987, and that the western states may lead the nation. In particular, the dollar has depreciated more relative to the currencies of western trading partners than against those of the nation's partners, therefore any impact ought to be stronger in the West than in the nation.

In addition, exports of many products important to the economies of western states already have shown substantial improvement. During the second half of 1986, the value of exports rose more than five percent for a diverse range of products that included aircraft and spacecraft; electronic components; automatic data processing equipment; wood products such as lumber and wood-pulp; vegetables, fruits, and nuts; cotton; and measuring and scientific instruments.

Some of these improvements, including those for wood products and nuts, are directly related to the reduced value of the dollar, which has improved the products' competitiveness on world markets. Other improvements are more closely tied to developments in particular industries or commodity markets. For example, the value of cotton exports grew largely because the 1985 farm bill led to substantial acreage reductions and consequently to higher prices, particularly for California's premium quality cotton.

In summary, the modest extent to which the trade balance has turned around thus far suggests further improvement in 1987. Western exporters have particular reason to be optimistic since the trade-weighted value of the dollar has declined even more for the West than it has for the nation, and exports of some western products already have improved substantially.

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Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**  
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount	Change	Change from: 4/2/86	
	Outstanding 4/1/87	from 3/25/87	Dollar	Percent <sup>7</sup>
Loans, Leases and Investments <sup>1 2</sup>	205,835	2,176	1,674	0.8
Loans and Leases <sup>1 6</sup>	184,419	1,838	1,034	0.5
Commercial and Industrial	54,300	519	400	0.7
Real estate	68,054	232	1,682	2.5
Loans to Individuals	37,038	— 90	3,599	8.8
Leases	5,440	— 10	211	3.7
U.S. Treasury and Agency Securities <sup>2</sup>	14,301	342	3,494	32.3
Other Securities <sup>2</sup>	7,115	— 4	786	9.9
Total Deposits	213,691	8,271	7,061	3.4
Demand Deposits	57,778	7,038	6,004	11.5
Demand Deposits Adjusted <sup>3</sup>	38,253	2,314	3,532	10.1
Other Transaction Balances <sup>4</sup>	20,072	713	3,858	23.7
Total Non-Transaction Balances <sup>6</sup>	135,842	521	2,801	2.0
Money Market Deposit Accounts—Total	46,615	316	197	0.4
Time Deposits in Amounts of \$100,000 or more	32,180	— 88	5,732	15.1
Other Liabilities for Borrowed Money <sup>5</sup>	23,247	404	5,458	19.0
<b>Two Week Averages of Daily Figures</b>	Period ended 3/23/87	Period ended 3/9/87		
<b>Reserve Position, All Reporting Banks</b>				
Excess Reserves (+)/Deficiency (—)	87	91		
Borrowings	11	18		
Net free reserves (+)/Net borrowed(—)	77	72		

<sup>1</sup> Includes loss reserves, unearned income, excludes interbank loans

<sup>2</sup> Excludes trading account securities

<sup>3</sup> Excludes U.S. government and depository institution deposits and cash items

<sup>4</sup> ATS, NOW, Super NOW and savings accounts with telephone transfers

<sup>5</sup> Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

<sup>6</sup> Includes items not shown separately

<sup>7</sup> Annualized percent change