The NBER Digest
NATIONAL BUREAU OF ECONOMIC RESEARCH, INC.
September 1987

The United States and Competition in Latin America

A new analysis by NBER Research Associate **Sebastian Edwards** shows that, contrary to popular belief, there has been no significant deterioration in recent years in the U.S. competitive position in Latin America. U.S. exports to Latin America have indeed fallen precipitously since 1980, but that is because the foreign debt crisis has forced Latin countries to sharply curtail their imports from all nations. In real terms, aggregate imports by 16 Latin countries dropped 45 percent between 1980 and 1985. When market share, rather than total exports, is used to measure competitiveness, there is no evidence of a drop in the U.S. position in Latin America over the last 15 years or so.

In **The United States and Foreign Competition in Latin America** (*NBER Working Paper No. 2218*), Edwards also finds that there have been substantial changes in the composition of U.S. exports to Latin America. There is a clear decline in the importance of U.S. sales of machinery and transport equipment and an increase in the U.S. share of sales of chemicals, foodstuffs, and live animals. Edwards says this change reflects the shifting pattern of U.S. comparative advantage away from traditional labor-intensive manufacturing industries toward natural resources and capital-intensive (including human capital) products. The U.S. share of manufacturing sales was not lost to Japan, but rather to Korea, Taiwan, and the Latin countries themselves.

Latin American countries slashed their imports in response to the debt crisis by means of contractionary demand policies, changes in real exchange rates, and the imposition of fairly massive import controls. The lower imports have enabled many Latin countries to achieve impressive gains in their current account balances. Indeed, one remarkable and little noted fact about the improvement in Latin trade balances is that it has come entirely through lower imports. In many Latin countries the real value of exports also has declined since 1980, mainly as a result of the drop in commodity prices.

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The import controls—in the form of higher tariffs, more nontariff barriers, and multiple exchange rates for different types of goods—mark an important turn away from the trend toward more liberal trade policies that had been underway throughout most of Latin America since the mid-1970s. Edwards notes that this form of adjustment to the debt crisis is not sustainable in the long run. Latin countries cannot rekindle strong economic growth without higher exports, and export growth is unlikely unless the countries also rationalize their import sectors.

A sustained increase in Latin American exports depends on a number of conditions, including sustained economic growth in the industrial world (to provide a steady increase in demand for Latin goods) and greater productive efficiency. But growth in Latin exports depends even more on reversing the current protectionist trend in industrialized countries. Edwards presents data showing that there has been a

significant increase in nontariff trade barriers in the United States and the rest of the industrial world in recent years. Moreover, these barriers are greater for goods originating in Latin America than for products from other industrial countries.

Finally, Edwards notes that in the aftermath of the debt crisis, direct foreign investment will be one of the few sources of foreign funds to finance capital accumulation and growth in Latin America. The United States is still the largest source of direct investment in the region, but its relative importance has declined in recent years. Latin America remains an attractive area for investment, from the standpoint of both resources and labor costs. But whether significant investment does materialize will depend on expectations about economic and political stability, and on innovative changes in local regulations.

AE

Hedging against Inflation

By buying futures contracts on Treasury bills, investors can eliminate 30 to 40 percent of the risk that inflation will erode the real value of their assets, according to NBER Research Associate **Richard Zeckhauser** and **Jayendu Patel.** A futures contract is an agreement to buy a Treasury bill up to six months in the future. While buying a Treasury bill today will protect investors against expected inflation, agreeing to buy a Treasury bill in the future will protect investors against a substantial portion of the risk of unexpected inflation.

In **Treasury Bill Futures as Hedges against Inflation Risk** (*NBER Working Paper No. 2322*), Zeckhauser and Patel observe that only the portion of inflation that cannot be anticipated represents a risk to investors. To the extent that investors can predict the rate of inflation in advance, they demand a nominal interest rate that includes both a real return on their money and an added return to compensate for the rate of inflation. Since we cannot predict inflation with complete accuracy, nominal interest rates include only a premium for expected inflation. The risk of *unexpected* inflation remains. Indeed, its impact carries into future periods: one percentage point of unexpected inflation results in an upward revision of 0.43 percentage points in expected inflation for the forthcoming year and one percentage point for the years beyond that.

Zeckhauser and Patel calculate the unexpected change in the quarterly inflation rate from 1953–84 using data for the actual inflation rate, the real interest rate, and the nominal interest rate. They find that the unexpected rate of inflation differed from the expected rate by more than two percentage points

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in over two-thirds of the quarters between 1953 and 1984. At the same time, they find no evidence that investors underpredict inflation six months in advance when it is high or overpredict inflation when it is low. However, when investors feel the sting of unexpected inflation, they tend to increase their subsequent estimates accordingly.

The Cost of Capital in the United States and Japan

Over the past two decades, "the before-tax cost of corporate capital was higher for U.S. firms than for their Japanese counterparts, . . ." according to NBER Research Associates **Albert Ando** and **Alan Auerbach.** They calculate that the average difference in capital costs, measured by the return to corporate capital, was as much as 5.8 percentage points. If Japanese firms indeed face a lower cost of capital, then those firms in capital-intensive industries will have a competitive advantage over their American rivals.

In *NBER Working Paper No. 2286,* Ando and Auerbach report that differences in taxation between the United States and Japan do not explain the differences in cost of capital. Corporate taxes are generally higher in Japan than in the United States, so they cannot explain the gap. The tax deductibility of interest payments in the United States and the greater Japanese use of debt explain only a small fraction of the difference, Ando and Auerbach find.

They propose three possible explanations: First, Japanese firms may be less risky than U.S. firms are, or Japanese investors may be less risk averse than U.S. investors are. In either case, a lower risk premium would satisfy Japanese investors. Second, Japanese households may require lower returns because of the favorable individual tax treatment of capital income in Japan. Finally, implicit and explicit barriers to exporting capital may have forced Japanese savers to invest at home, at lower rates than were available in the United States. Ando and Auerbach point out that market returns in the two countries varied by far less than estimated capital costs over the past 20 years. Both numbers should be viewed with caution, though, because of the different accounting standards in the United States and Japan and the variability of market rates over time.

For their estimates, Ando and Auerbach use market data and the financial statements of a large group of

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nonfinancial corporations in Japan and the United States for 1967–83. This sample is larger and covers a longer period than the one used in their preliminary work (*NBER Digest*, February 1986); thus, the results of this study are stronger. They base their estimates of the cost of capital on returns to capital because, in the long run, corporations will earn a pretax rate of return (relative to the value of their securities) just sufficient to achieve their cost of capital, taking account of risk, taxes, and required returns to holders of debt and equity. In any given year, this need not be the case, so the authors look at data for nearly two decades.

Pensions and Firm Performance

Over 57 million Americans were covered by about 788,000 private pension plans in 1984, and 8 million elderly actually received pension benefits from these plans. At the same time, the proportion of wage and salary workers in the private sector covered by an employer pension was over 50 percent, up from 25 percent in 1950. In **Pensions and Firm Performance** (*NBER Working Paper No. 2266*), NBER Research Associate **Steven Allen** and **Robert Clark** show that firms with pension plans do not have lower rates of profit than similar firms without pensions do.

Industries with high rates of pension coverage seem to have the same rates of profit as industries with low rates of coverage. Profits on average are not reduced by pension costs, which therefore must be offset either through a reduction of other labor costs or through an increase in productivity.

Allen and Clark find no evidence that the presence of a pension results in a reduction in wages or other forms of compensation. Indeed, firms with pensions pay higher compensation to their current workers. Nor do the authors find any significant direct effect of pension coverage on productivity within industries on average. However, pension coverage is correlated with greater productivity in nonunion industries with low new hire rates, high wages, and younger workers.

Firms providing pensions do obtain indirect productivity effects, though: they use pensions to achieve such personnel objectives as reduced employee turnover and increased retirement rates among older workers.

Lower mobility rates for workers covered by pensions may reflect a higher overall level of compensation than for those in nonpension firms. Or, pension benefit formulas may be structured so that there is a loss of pension wealth (the amount of money to be received after retirement) for those leaving the firm. Finally, workers who expect to stay with a firm may be attracted to firms with pensions, while those who do not intend to stay prefer a different compensation structure.

Whatever the reason, lower turnover allows the firm to spend less on hiring and training new workers. Lower turnover also increases the job tenure of the average worker and raises labor productivity. Earlier retirement among older workers also may reduce average salaries and boost the average productivity of workers.

Allen and Clark also note that the average pension benefit for newly retired workers in 1984 was $6360, representing 23 percent of their final earnings. A total of $70 billion was paid to retirees in pension benefits in 1984.

Further, pension funds represent a growing proportion of invested funds in the United States. According to one estimate, total assets of U.S. pensions were $1 trillion in 1984. That represents 23 percent of all corporate equity and 50 percent of all corporate bonds. In 1950, pensions held less than 1 percent of corporate equity and only 13 percent of all corporate bonds. Pension assets amounted to $10,907 per worker in 1981, equivalent to 75 percent of their average annual earnings.

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The authors also point out that those who have jobs covered by collective bargaining agreements are more likely to be included in a pension plan than nonunion workers are. According to 1983 data, the coverage rate for workers in the private sector is 82 percent for union versus only 44 percent for nonunion workers. Further, big companies are more likely to have pension coverage. Only 28 percent of workers in establishments with fewer than 25 workers are covered by pension plans, versus 51 percent in establishments with 25 to 99 workers, and 86 percent in establishments with 1000 or more workers.

Only a quarter of workers between 16 and 24 years of age are covered by pension plans. But as they age, workers apparently shift gradually to companies offering pensions. Pension coverage rises to 50 percent for those between 25 and 34, and is above 60 percent for older workers. DF

Recent NBER Books

Feldstein Volume Available

The Effects of Taxation on Capital Accumulation, edited by Martin Feldstein, is now available from the University of Chicago Press for $55.00.

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Feldstein is the George F. Baker Professor of Economics at Harvard University and President of NBER.

Public Sector Payrolls

Public Sector Payrolls, edited by David A. Wise, is available from the University of Chicago Press for $40.00.

This volume includes papers presented at an NBER conference that was part of the project studying "The Government Budget and the Private Economy." Several of the papers discuss compensation. Others consider employment of youth, especially by the military. There is also an analysis of how wages and employment in the public sector respond to economic conditions; a detailed study of government pension plans; an analysis of comparable worth in the public sector; and a look at the salaries of public schoolteachers in relation to the quality of American education.

This volume is particularly relevant for policymakers, as well as for academic economists. Wise is the John F. Stambaugh Professor of Political Economy at Harvard University and a Research Associate at NBER.

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