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# The deficit trap

**by Ernest H. Preeg***

The U.S. current account deficit could reach a record $350 billion this year, the eighteenth deficit in a row. As a consequence, the United States has shifted from a net creditor nation of $350 billion in 1980 to a net debtor of $800 billion in 1996 and $1.5 trillion in 1998, headed for $2 trillion early in the next decade. This foreign debt equates to almost 20 percent of gross domestic product now, projected to 30 percent by 2005.

An important question is whether these large external deficits – which are principally trade deficits – are a good or bad thing for the United States. Many and perhaps most observers believe the deficits are not something to worry about and could in fact be beneficial to the United States. I disagree.

The disagreement hinges largely on whether the growing foreign indebtedness is used to finance incremental U.S. productive investment or immediate consumption. The non-worriers believe that all or most of the deficit reflects additional investment whereas my conclusion is that about 80 percent goes to immediate consumption.

The classic statement in support of incremental new investment was made by Herbert Stein in The Wall Street Journal ten years ago ("Don't Worry About the Trade Deficit", May 16, 1989): "The U.S. has a trade deficit because people in the rest of the

world invest their savings here…. As a result of the capital flow…the stock of productive capital in the U.S. is…higher than it would otherwise have been…. This inflow of capital has been mainly of benefit to American workers who as a result of it work with a larger capital stock and have higher productivity and real incomes".

In February 1999, the Annual Report of President Clinton's Council of Economic Advisors came to a similar conclusion: "Since 1993…current account deficits have been driven by increases in investment, with foreign financing taking the form of both direct and portfolio investment".

These assessments, unfortunately, are analytically flawed. It is true that an increase in the trade deficit, by definition, goes hand in hand with an increase in foreign investment in U.S. assets. The dollars accumulated from the trade deficit have to be invested somewhere, including in bank accounts and U.S. Treasuries.

The key question, however, is not whether foreign investment increases but rather whether such foreign investment leads to a higher level of aggregate investment in the U.S. economy or to a switch by Americans from domestic investment to domestic consumption. The reality is that the latter, switching effect, is probably dominant.

For example, the Asian financial crisis of 1997-98 caused an increase in the U.S. trade deficit on the order of $100 billion. U.S. exports fell as Asian economies declined and U.S. imports grew from the lower, more competitive Asian exchange rates. The

resulting $100 billion deterioration in the trade account, in keeping with the inexorable definition cited above, corresponded with $100 billion of additional foreign investment.

The impact of the additional foreign investment on aggregate U.S. investment and consumption, including the critical switching effect, is nevertheless not self-evident and depends on various forces in play to bring about the macroeconomic adjustment. The decline in the U.S. export sector and cheaper imports from a strengthened dollar could together shift the aggregates toward greater personal consumption. A somewhat lower interest rate from the dampening effect of the growing trade deficit on inflation would tend to stimulate both investment and consumption. Higher stock market prices from foreign investors would stimulate consumption through the "wealth effect".

There is no available analysis that shows clearly whether investment or consumption would be stimulated disproportionately as a result of the various macro economic forces engaged, and the best that can be assumed is that the proportional effects are more or less neutral. However, U.S. personal consumption, in absolute terms, is more than four times larger than gross private investment ($5.8 versus $1.4 trillion in 1998), and hence the conclusion drawn here that about 80 percent of the increase of the trade deficit is likely to be translated into additional private consumption, and only 20 percent into incremental investment.

A similar macro-policy assessment, including the switching effect, can be made if a larger current account deficit is initially triggered by the capital rather than the trade account.

The non-worriers make one other spurious argument in support of incremental investment during the 1990s. They point out that the investment share of U.S. gross domestic product has increased by two percent from 1993 to 1998 while the consumption share has declined by one percent, with the additional foreign investment recorded during these years given credit for much of this rise in investment share. There is no justification, however, for assigning such causality. The U.S. economy has indeed experienced an extraordinary investment-led growth in 1990s, but it is far more likely to have been driven by new technology application and industrial restructuring within the U.S. economy than by the growing trade deficit. If, without an Asian financial crisis, the trade deficit had not increased by a $100 billion, there would still have been investment driven growth in the U.S. economy, but the increase in the investment share of GDP would have been somewhat smaller, and the drop in the consumption share would have been a little larger.

The foregoing is the principal analytic basis for my worry about continuing large U.S. trade deficits. Interest and dividend payments on accumulating net foreign debt are already about $100 billion per year, and this figure could more than double by 2005. These debt servicing payments, of course, would continue to be made by the children and

grandchildren of those Americans now on a consumption binge, thanks to almost 20 years of unprecedented foreign borrowing.

This concern about a generational income transfer abroad, moreover, raises an additional worrisome prospect. The deficit on current course is simply not sustainable, and the longer it prevails, the more likely will be a disruptive and costly adjustment, for both the U.S. and the global economies. It makes more sense to take the appropriate steps to reduce the deficit now rather than later. Regrettably, as long as the Stein/Clinton assessment prevails that the trade deficit is nothing to worry about, any official steps will be hesitant at best.

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