

Trade Deficit Review Commission

Impacts of the Trade Deficit on the U.S./ Economy

Statement of Geza Feketekuty September 9, 1999

Mr. Weidenbaum and other members of the Trade Deficit Review Commission, I want to thank you for inviting me to present my views on the impacts of the trade deficit on the U.S. economy. I approach this issue both as an economist and a former U.S. trade official, and hope my observations will add another dimension to your assessment of this important topic.

When we talk about the varying impacts of the trade deficit, there are three different questions we could ask. First, we could ask how the U.S. economy would have performed differently if policy makers had adopted policy measures to remove the causes of the trade deficit. Second, we could ask how the U.S. economy would have performed differently if the trade flows had been restrained by policy measures in such a way as to keep imports and exports balanced. Third, we could ask how the U.S. economy has been affected by the very fact that we had a trade deficit, regardless of the causes or the measures that could have been taken to prevent the trade deficit from developing.

The point I am trying to make is that we can't get very far in addressing the impact of the trade deficit without asking what would have been different about the U.S. economy if the trade deficit could have been avoided, either by removing some of the underlying causes, or by taking policy actions to avoid the impact of those causal factors on trade flows. The impact on the U.S. economy would be quite different if policy makers had chosen to restrain the growth of consumer demand as compared to investment demand, or if they had chosen to manipulate the exchange rate as compared to imposing quotas or tariffs on imports.

In other words we can't get very far without either considering the causes or the solutions. Having made this point, however, let me address the third question first, namely the impact of the trade deficit per se, before considering the alternative means by which it could have been avoided.

In the absence of the trade deficit, Americans in recent years would have had fewer goods and services to consume or invest, and foreigners would have had fewer dollar denominated assets in their possession. The short-term impact on the American economy overall in recent years has undoubtedly been modest and benign. The net imports of goods and services undoubtedly helped to cushion inflationary pressures. The net

accumulation of dollar assets by foreigners undoubtedly contributed to the stock market boom, which undoubtedly has been a mixed blessing. It has made Americans feel richer, fueling both consumption and investment in the United States. The difficult question, of course, is how vulnerable we have become as a result of the further decline of real household savings and the further accumulation of liquid dollar assets by foreigners.

The large accumulation of liquid financial assets by foreigners increases the potential future impact of a decision by foreigners to switch out of dollar assets into alternative assets, and this in turn will impose increasing constraints on future U.S. macroeconomic policies. The United States will increasingly need to manage its macroeconomic policies with an eye on the reaction of foreign dollar asset holders. This has been a long-term trend, which has accelerated as a result of the recent increases in the trade deficit. U.S. policy choices are likely to be further constrained by the continuing drop in the U.S. savings rate. Since the U.S. savings rate has proven to be rather sticky, any major portfolio adjustment by foreigners out of dollar assets will leave U.S. policy makers with some difficult decisions with respect to fiscal and monetary policy.

The increasing vulnerability of the U.S. economy and the increasing constraints imposed on the management of U.S. macroeconomic policy are not, of course, the result of the recent increase in the trade deficit. It is a cumulative process however, which has been accelerated by the growth of the trade deficit. Before exploring the constraints on U.S. macroeconomic policy more deeply, I would like to turn to the microeconomic and political effects of the trade deficit.

I mentioned earlier that the overall impact of the recent trade deficit on the U.S. economy as a whole has been relatively modest and benign. This is not true for all sectors of the economy, however. Any movement in the trade area has a much larger impact on the tradable sectors of the economy, than on the domestic nontradable sectors. In particular, the shift in trade flows has had a particular impact on industries with high price and income elasticities. Industries such as steel have experienced a double whammy. The recession in Asia in the aftermath of the Asian financial crisis has sharply reduced foreign demand for U.S. steel and significantly expanded foreign supply of steel to the United States. At the same time, the rise in the value of the dollar has further accentuated the negative impact on U.S. industries such as steel.

In comparison with the last major period when the United States faced a sharp increase in the trade deficit, which was in the mid 1980's, the impact this time around has been more modest, though still significant. There are a number of reasons for this, including the fact that domestic demand has been robust throughout this period. Another moderating factor has been the large increase in foreign investment in industries such as the automobile industry, which has tended to reduce the impact of exchange rate shifts and differences in growth rates on trade. Moreover, the added impact of long-term structural changes on the labor market in the basic industries is less now than it was in the 1980's.

This brings me to the political impact of large trade deficits, which is to increase pressures for import protection. In part, these added protectionist pressures are the result

of the impact of trade shifts on employment, wages and industry profits. The overall political impact however goes beyond these real sectoral effects, as politicians seize on the trade deficit as the explanation for an assortment of economic problems. Foreign imports make a convenient scapegoat when the trade deficit is presented as evidence that foreigners are unfair.

This discussion of the microeconomic impact of the trade deficit brings me back to a discussion of the impact of the foreign accumulation of dollar assets on U.S. macroeconomic policy. I was a senior staff member of the Council of Economic Advisors in the early 1970's when we were debating the relative virtues of fixed and floating rates. I remember that I, along with other members of the Council, was arguing then that floating rates would both enable us to have greater independence in national macro economic policies and reduce the pressure for protectionist intervention. After 20 years in the Office of the U.S. Trade Representative I have become convinced that the degree of freedom for national macroeconomic policy provided by exchange rate movements is considerably less than we had thought, and that large increases in the exchange rates can raise protectionist pressures as much as a sharp rise in the current account deficit under fixed exchange rates. This, in turn, imposes real constraints on the fiscal/monetary mix underlying U.S. macroeconomic policy. When the burden to slow inflation falls on monetary policy rather than fiscal policy, the inevitable impact is to push up exchange rates and to depress the tradable portion of the economy, and in particular the import competing industries.

How is the issue of the monetary/fiscal mix linked to the trade deficit? First, the continuing accumulation of dollar assets increases the potential impact of foreign portfolio adjustments on the U.S. economy, and the differential impact of exchange rate movements on the balance between the tradable and nontradable segments of the economy puts an increasing burden on fiscal policy.

This brings me back to the question of the economic impact of alternative policy choices for eliminating the trade deficit. In discussing the impact of the trade deficit we have to consider whether the cure would be worse than the disease, or which remedies are likely to be less desirable than the disease.

The policy choices basically are to take measures that impact on trade flows directly, or indirectly by affecting the demand and supply of dollars in foreign exchange markets, or by affecting the relative demand for goods by U.S. and foreign residents. The first of these policy options, policy measures that directly impact on trade flows, is quite limited by current trade rules, the limited tolerance of foreign countries for unilateral American actions in the trade area, and the negative growth effects of a decline of trade. Other countries through equivalent measures of their own can easily offset the use of trade restrictive measures by the United States. The resulting effect on global and U.S. growth could be devastating. Trade has been one, if not the major, engine of growth over the past 50 years, and a reversal could be expected to have a major negative impact on the economy.

A reduction of foreign trade barriers would go in the right direction. The question is how that can be best achieved. The United States has tried to convince other countries to reduce many of their barriers unilaterally, but it is not clear that much more could be achieved through policy tools such as Section 301.

The United States has quite rightly urged foreign governments with excessively restrictive macroeconomic policies to adopt more expansionary policies. Where domestic demand can be expanded without creating a risk of inflation, everyone gains. Moreover, the United States has quite legitimately argued that other countries should not use export growth as the principal tool for generating domestic growth, and instead should adopt a balanced growth strategy. We all presumably could agree that the United States should not throttle back its growth for the sake of eliminating the trade deficit.

This brings us to policies that affect the demand and supply for dollars. I would argue that it would be sensible over time to adopt policies that would gradually tend to reduce the foreign demand for dollars. One of these policies would be to encourage the use of other currencies as reserve currencies.