

Why I Worry About the Trade Deficit

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There are four reasons why I worry about the chronic and now record level U.S. trade deficit. The four are largely distinct in their impact on the U.S. economy and, to some extent on U.S. foreign policy interests as well, but there is also a cumulative adverse impact as they all relate to the important question of what happens – hard or soft landing – when the external deficit reaches the point of unsustainability.

Worry #1. The protectionist backlash. The persistently large U.S. trade deficit is used by protectionist interests and other opponents of a U.S. liberal trade policy to undermine public support for such a policy. The trade deficit was used effectively by opponents of fast track authority to help defeat that legislative initiative twice and, more recently, by the steel industry to obtain bilateral quota restrictions on steel imports. A further protectionist backlash will undoubtedly surface at the troubled World Trade Organization (WTO) ministerial meeting in Seattle in November.

Trade policy, in fact, has not been a substantial cause of the deficit, and certainly not recent trade agreements such as the Uruguay Round Agreement and the North American Free Trade Agreement (NAFTA). Indeed, the NAFTA agreement, in particular, has had a net positive impact on the U.S. trade balance with Mexico because Mexican tariffs were several times higher than U.S. tariffs before moving to free trade and American exporters now benefit from preferential access to the Mexican market compared with their European and Japanese competitors. Nevertheless, protectionists continue to condemn NAFTA and any further trade liberalizing initiatives as contributing to the trade deficit and, regrettably, this false line of argument resonates with much of the American public.

The most worrisome aspect of this protectionist backlash to the trade deficit is that it has been significant even while the U.S. economy has been experiencing strong growth and full employment. If the U.S. economy should weaken, with rising unemployment, the protectionist arguments would gain further strength and make it even

more difficult for the current and next presidents to restore bipartisan Congressional support for liberal trade.

As to the cost to the U.S. economy and other U.S. interests, a recent study estimated a cost to American households of \$800,000 per year per steel worker protected by proposed import restrictions. The gains from trade foregone from the inability of the president, without fast track, to negotiate market openings abroad, are wideranging. In foreign policy terms, the collapse over the past several years of longstanding U.S. leadership for free trade, linked to support for economic reform and democratization throughout the developing and former communist worlds, is a significant setback.

Worry #2. Service payments on the foreign dept. A current account deficit, by definition, results in a coequal increase in borrowing abroad, and as a result of 18 consecutive years of external deficits, the United States has shifted from a net creditor nation of \$350 billion in 1980 to a net debtor of \$1.5 trillion (on a market value basis) in 1998. On current trend, the debt is headed for \$3 trillion by early in the next decade, which equates to about 20 percent of GDP this year and over 30 percent by mid-decade ahead.

This large and rapidly growing external debt involves substantial interest, dividend, and other service payments that will continue indefinitely, or until the U.S. current account is reversed into sustained large surpluses. Precise figures on the debt service payments are not available, but a net \$1.5 trillion external debt at 7 percent interest results in about \$100 billion of annual debt servicing now, with a projected doubling to \$200 billion early in the next decade. In other words, payments from the U.S. to foreign economies of 1-2 percent of GDP.

A critical question for this rapid run-up in foreign debt service payments is whether the additional foreign borrowing each year is used for incremental productive investment in the U.S. economy or for immediate consumption. If it is all used for incremental investment, a mutual interest for the United States and foreign lenders could result, and some experts come to this conclusion. The classic and oft referenced statement to this effect is by economist Herbert Stein in his article, "Don't Worry About the Trade Deficit" (The Wall Street Journal, May 11, 1989). The January 1999 report of President Clinton's Council of Economic Advisors comes to a similar conclusion.

Unfortunately, as explained in my August 5, 1999 article in the Financial Times (attached), this line of reasoning is wrong. The macroeconomic adjustment to maintain the identity between the current account deficit and foreign borrowing tends to increase both investment and consumption, and I estimate the shares as 80 percent consumption and only 20 percent investment. In effect, this means that the current consumption binge, to the extent it is financed through foreign borrowing, will be paid for by our children and grandchildren through debt service payments abroad.

This question of whether foreign borrowing is used for incremental investment or consumption is often ignored or obfuscated, including in college economic textbooks,

and I would urge the Commission to examine it carefully and to take a clear stand on it when assessing the net impact of the chronic trade deficit on the American economy, now and over the longer term.

Worry #3. Foreign government leverage against the United States. One important cause of the increased current account deficit during the 1990s has been the unprecedentedly large official purchases of dollars by foreign central banks, as explained in my attached essay, “The U.S. Trillion Dollar Debt to Foreign Central Banks” (The Institute of International Finance, September 1998). From 1990 to 1996, foreign central banks increased dollar holdings from \$486 billion to \$947 billion, or by \$461 billion, which equated to 90 percent of U.S. current account deficits and 82 percent of the increase in the net foreign debt during this period. The withdrawal from the market of 90 percent of dollars accumulated abroad from the current account deficit created upward pressures on the dollar exchange rate and a time-lagged increase in the U.S. trade deficit, which I estimate could explain half or more of the total deficit by 1996.

The reasons for these large official dollar purchases were the rapid, uneven pace of economic globalization and related mercantilist-oriented exchange rate policies by some other nations, most notably Japan and China, and the net result is that other governments now have considerably greater political leverage against the United States in terms of how they use, or threaten to use, their enlarged dollar holdings. One Japanese prime minister, irritated by U.S. pressures on trade issues, spoke of the “temptation to sell dollars”, and two Chinese military strategists recently published a book, Unrestricted War, that included “financial war” as one component of a possible integrated response to U.S. threats against China. A new development which facilitates the use of official reserves for political or economic leverage is the launching of the euro as a second-key currency, whereby governments, such as Japan and China, with most of their reserves in dollars, could switch or threaten to switch large amounts of dollars into euros.

The potential threat of other governments selling dollars or switching into euros is not immediate in that most other governments are more than comfortable with a strong dollar which keeps their export sectors more competitive and, incidentally, the U.S. trade deficit at record levels. Indeed, after a two-year hiatus in official dollar purchases in 1997-98 related to the Asian financial crisis and the consequent exceptionally strong dollar, large official dollar purchases are surging again, most notably by Japan, as explained in my letter to the editor of The Journal of Commerce, attached.

The threat rather would become more credible if and when the United States should confront a relatively hard landing for the dollar, with a rapidly weakening dollar, rising interest rates, and increased unemployment. If, at that time, strong economic growth had resumed in Asia, a new confrontation with China over Taiwan, for example, could lead China to begin a major shift in its \$150 billion of official reserves (up from \$21 billion in 1992) out of dollars and into yen and euros, which would exacerbate the hard landing of the dollar and could cause the United States to soften its Taiwan policy. Other governments might tend to switch out of dollars to avoid the exchange rate loss of

a depreciating dollar and to reduce the “hyperpuissance” of the United States in world affairs.

The possible adverse impact on the U.S. economy and foreign policy from the political leverage created by increased official dollar holdings cannot be quantified. The fact is, however, that as record U.S. current account deficits continue, related to renewed growth in foreign official dollar holdings, the magnitude of the leverage grows as well.

Worry #4. Market volatility against the dollar. The large net capital inflow in 1997-98 from a high-growth U.S. economy and financial crises or sluggish growth abroad has kept the dollar strong, but a change in relative economic paths around the world would lead to a reduction in the capital inflow at current exchange rates, and hence downward pressure on the dollar. This pressure would be intensified by the continuing large current account deficit because, in conformance with the unyielding definition noted above (i.e., a current account deficit has to equate to an increase in foreign borrowing at the end of the day), a large net inflow of capital would still be required. This combination of downward pressure on the dollar and the continuing need to borrow abroad, in turn, could be the triggering circumstances for a “hard landing” for the dollar and the U.S. economy.

A hard landing, in this current context, can be defined as a relatively large depreciation of the dollar (20-30 percent), a corresponding increase in interest rates to brake the decline in the dollar and counter the inflationary pressures of higher import prices, a substantial fall in stock prices (2000-3000 points on the DJ), a related decline in personal consumption from the “wealth effect” from falling stock prices and general economic uncertainty, and an overall reduction in economic growth toward recession. Such a definition is not Indonesia in 1997 or Russian in 1998, but it would clearly be bad news throughout the U.S. economy.

How and when such an adjustment will take place cannot be predicted with precision. The best that can be done is to examine alternative scenarios to assess the timing and the relative degree of hard or soft landing. For example, resurgent growth in Asia, Europe, and Latin America together with a stalled U.S. economy would lead to an earlier, harder landing compared with strong growth in all major regions. An interacting global recession is the most difficult to predict, region by region, although the overall impact would clearly be adverse for all.

Additional insights can be obtained from comparison with the experience of the moderately hard landing of the dollar in the mid-1980s, when the dollar fell 40 percent from its high in 1984 to its low in 1987, interest rates were raised significantly, and a recession ensued in 1989-90 that, in political terms at least, had significant if not decisive influence on the 1992 presidential elections. (One can speculate with acute irony about a possible generational repeat performance within the Bush family.)

In economic terms, there are important differences, however, in the current situation compared with the mid 1980s. The “new paradigm” of technology-driven high

growth and job creation, within a more competitive global economy, could cushion the effects of a decline in the dollar and facilitate necessary structural adjustments. In the other direction, much more highly integrated capital markets now exert stronger and potentially more volatile pressures on foreign exchange and interest rates. In policy terms, the policy instruments available to governments are much weaker in relation to capital market forces than they were in the 1980s, while the international financial system, contrary to rhetoric about “a new architecture”, has lost its moorings through a shift to managed floating rates but without rules for management, as explained in the attached article, “The New International Financial Architecture”, American Outlook, Summer 1999. And finally, the conversion of the United States from a creditor to a \$1.5 trillion debtor nation casts an unsettling cloud over capital markets and the continued willingness of others to increase lending to the United States.

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These are the four specific reasons why I worry about the continuing, record level U.S. current account deficit. Moreover, in addition to their individual downsides, the four could converge and become mutually reinforcing toward a hard landing scenario whereby the initial downward movement of the dollar, together with rising interest rates and unemployment in the U.S. economy, would be exacerbated by protectionist actions by the Congress, higher debt service payments abroad, and an increased temptation by foreign governments to shift official holdings out of dollars, for economic and/or political reasons.

Overarching these specific worries is the most bothersome worry of all, namely the failure of the U.S. government to understand or admit that the chronic current account deficit is a significant problem. A strong dollar continues to be the overriding U.S. policy objective, while the current account deficit is rationalized on spurious analysis about foreign borrowing leading to incremental productive investment. In January 1999, Secretary of the Treasury Robert Rubin, for the first time, stated that the deficit was not sustainable, but he, and his successor, have not elaborated as to what the United States should do to ensure a relatively soft landing when the point of unsustainability is reached. Meanwhile, major trading partners, in the G-7 and the IMF, are more than happy to keep the question of how to reduce the U.S. trade deficit off the agenda, since a reduction in the U.S. deficit also means a reduction in their trade surpluses.

What needs to be done is obvious and straightforward, related to the causes of the deficit. If there is a structural savings gap within a high investment U.S. economy, fiscal and other measures should be taken to increase savings. If other countries pursue mercantilist-oriented exchange rate policies, new disciplines should be adopted to curtail or end such practices. Sustained global economic growth is a mutual interest and some mutual steps can be taken to help achieve this, such as a further reduction in trade barriers and improved regulation of national banking sectors. However, as long as the U.S. current account deficit is officially viewed with benign neglect, not much will happen, a hard landing for the dollar will become more likely year by year, and I will continue to worry.