

Barry Eichengreen

Barry Eichengreen is the George C. Pardee and Helen N. Pardee Professor of Economics and Professor of Political Science at the University of California, Berkeley, where he has taught since 1987. He is also Research Associate of the National Bureau of Economic Research (Cambridge, Massachusetts) and Research Fellow of the Centre for Economic Policy Research (London, England). In 1997-8 he was Senior Policy Advisor at the International Monetary Fund. He is a fellow of the American Academy of Arts and Sciences (class of 1997). He is a member of the ABellagio Group@ of academics and high-level economic officials. Professor Eichengreen has published widely on the history and current operation of the international monetary and financial system. His books include *Toward a New International Financial Architecture* (Institute for International Economics, 1999), *Globalizing Capital: A History of the International Monetary System* (Princeton University Press, 1997), and *European Monetary Unification* (MIT Press, 1997).

Whither the U.S. Trade Deficit?

Barry Eichengreen
University of California, Berkeley
November 1999

As we speak, the U.S. trade deficit is exploding. The consensus estimate of the current account deficit for 1999 is \$325 billion, up from \$225 billion in 1998. Next year the deficit could reach \$375 billion or even \$400 billion, depending on how rapidly growth slows in America and picks up in the rest of the world. These are large numbers, on the order of 4 per cent of US GNP.

How worried should we be? Most Americans have adopted the attitude of the *Mad Magazine* character, Alfred E. Newman, who is famous for the immortal phrase, "What, me worry?" Unfortunately, the outcome may more closely resemble another of that magazine's comic strips, "Spy Versus Spy," whose principal character is typically seen juggling a time bomb about to explode.

Hard thinking about the trade deficit starts with the fact that the difference between imports and exports of goods and services equals the difference between domestic investment and domestic saving. It is important to understand that this equality is not the prediction of an economic model. It is an accounting identity. It must hold in every economy, at every time, in every place. If the facts seem to contradict this identity, then the data are wrong. This relationship is one of the few iron laws of economics.

¹Testimony before the U.S. Trade Deficit Review Commission, Palo Alto, 15 November 1999.

Looking at the deficit this way suggests that it exists for both good and bad reasons. The good reason is that investing in the U.S. is attractive. Because the U.S. economy is dynamic, investment here is high, and consequently the deficit is large. Foreign direct investment is entering the country at an annualized rate of \$300 billion, which is sufficient for the time being to finance the current account deficit. And much of that FDI is going into the high tech sector, where the United States has an indisputable lead. Of the major industrial countries, the United States has the heaviest concentration of internet connections. It has a substantial head start in the production of internet-related goods and services. Of the 46 companies Morgan Stanley Dean Witter identifies as being in the forefront of information-technology industry, 31 are American. No other country can boast a collection of info-tech companies with the size, range and dynamism of Microsoft, Intel, Cisco, IBM, Dell, Compaq and America Online, not to mention their "dot.com" progeny. To a large extent, those seeking to invest in this sector have no choice but to invest in the United States.

That's the good news. The bad news is that U.S. savings rates are low, which also widens the country's external deficit. Inadequate savings have been an American weakness for some time, but the problem now is aggravated by the high level of the stock market, which encourages households, who feel wealthier as a result of their capital gains, to consume an even larger fraction of their wage and salary income. A significant share of U.S. investment therefore has to be financed by foreigners. This inflow of capital into the United States is the flip side of the trade deficit.

How long can this continue? The optimists would say indefinitely. Because economic growth is robust and the United States has a formidable lead in information technology, U.S.

investment rates will remain high indefinitely. Foreigners will continue investing here indefinitely. The U.S. current account deficit can be financed indefinitely. And **because** growth and corporate profits will remain robust, the high level of the stock market will be sustainable. Moreover, the country's low measured savings rates, which reflect the consumption fueled by American households' growing stock market wealth, are really not a problem. Saving properly measured -- not just wage and salary income not consumed but also the increase in stock market wealth -- is not that low. And the trade deficit, relative to the expected future size of the U.S. economy, is really not that high. These, then, are simply many different ways of saying the same reassuring thing.

This brings me to my central point. Everything about this rosy scenario — the rapid growth of the U.S. economy, the attractiveness of investment, the high level of the stock market, the willingness of foreigners to pour more money into the United States -hinges on the solution to the productivity puzzle. That puzzle, of course, is whether the increase in productivity growth, which allows the U.S. economy to continue growing robustly despite being at full employment, is a temporary blip or a permanent shift.

If the acceleration is permanent, Alfred E. Newman's attitude of benign neglect is entirely justified. Alan Greenspan can similarly adopt a "What, me worry?" attitude and let the monetary reins hang loose. But if the productivity surge is only temporary, then eventually the rate of economic growth will slow. Investment in the United States will become less attractive.

This is one way of solving the deficit problem. Capital inflows will decline as foreigners perceive the reduced attractiveness of investment in the United States. The dollar will weaken. That weaker dollar will mean higher import prices, which will work to reduce U.S. purchases of

foreign goods. Thus, the deficit problem will solve itself. Unfortunately, we don't know whether this solution will occur gradually, or all at once with a crash. The latter is the dreaded "hard-landing" scenario for the dollar.

In any case, Mr. Greenspan may not be willing to wait. He may worry that the decline in the dollar will mean not just higher import prices but also higher inflation. If he believes that the acceleration in U.S. productivity growth is only temporary, he will raise interest rates to head off inflation. This will solve the deficit problem by cooling investment and cooling growth. The hope, of course, is that they do not cool so rapidly as to cause a hard landing for the economy and not just the dollar.

Chairman Greenspan appears to be uncertain whether the surge in U.S. productivity growth is temporary or permanent (though recent statements suggest that he may be swinging in a more optimistic direction). His staff appears to be uncertain. The academic community is uncertain (I speak with first-hand knowledge). Economic science has simply not advanced to the point where it can be used to reliably predict something as complex as the rate of productivity growth.

My hunch, and it is only a hunch, is that much of the acceleration in U.S. productivity growth is permanent, or at least sufficiently permanent to last for 10 or 15 years. I would guess that we are now finally beginning to reap the benefits of the information-technology revolution. For many years, the returns to our high-tech investment were missing. The efficiency with which the United States produced computers and related products increased immensely, but the sale and installation of those same computers failed to enhance the efficiency with which we produced other goods and services. This is what we meant in the first half of the 1990s when we referred

to the productivity puzzle. I would wager that the recent increase in productivity signals that the benefits of computerization for the U.S. economy as a whole are **finally** beginning to show **up** in the data.

I base this **hunch** largely on anecdotal evidence. Every day we hear stories of firms using **data-base** management systems to control their inventories more tightly, to deploy their sales people **more** efficiently, and to monitor the buying habits of their customers more closely. **Mid-**level corporate executives who no longer even have an office but work out of a hotel room with a laptop and a cell phone may not be entirely happy about their nomadic existence, but they are the productivity revolution personified.

This is also my hunch because historical analogies with our current position are so striking. In particular, we saw the same pattern a hundred years ago when the American economy was first electrified. Then, too, there was a sustained rise in productivity as a result of the diffusion of a new technology, but only after some time had passed. To capitalize on electrification, we first had to build the capacity (dams, power plants, and delivery grids). We next had to develop a new generation of machines suitable for being powered by electricity. We finally had to install a base of such machinery and learn how to use it. The result was two decades of slow productivity growth at the end of the 19th century, when we were still **sinking** these development costs, followed by two decades of rapid productivity growth as the returns rolled in.

Most likely, we are now living through another such cycle, only on “Internet time” — the cycle has been compressed, in other words, with the productivity slump and surge packed into ten instead of twenty years. Even so, my hunch is that the productivity miracle still has some

years to run.

But, to repeat, the only honest answer to the question “Is the increase in U.S. productivity growth permanent?” is “we don’t know.” Prudence therefore dictates that we insure ourselves against the possibility that it is temporary and that the house of cards may come tumbling down. Because I live on the Hayward fault, I buy earthquake insurance. This leads me to believe that the United States should similarly insure itself against the possibility that its trade deficit is unsustainable.

What is to be done? The country should take steps to begin gradually narrowing the trade deficit now, rather than waiting for the markets to do so abruptly. Because the deficit is nothing more or less than the difference between investment and savings, there are two ways to go. We can encourage saving, or we can discourage investment. The latter, all sensible people would agree, is undesirable. But it is the direct implication of the present policy of inaction, which places the problem in the hands of the Fed, whose only available instrument is higher interest rates. Higher interest rates make investment more expensive. They create the danger of recession if overdone, which should drive home the fact that this is a suboptimal way of proceeding.

Better would be to boost household, corporate and government saving. There are two obvious avenues here. One, we can tax consumption rather than income. I am not an expert in this area, but I will say that I find the other, fairly standard theoretical arguments for why a consumption tax is preferable to an income tax all the more attractive given the uncertainty surrounding the trade deficit. Two, we can save the federal government budget surplus, rather than frittering it away on new spending programs or returning it to the public via a mega-tax cut.

Prudence, it seems to me, recommends in favor of these options.

Barry Eichengreen is George C. **Pardee** and Helen N. **Pardee** Professor of Economics and Political Science at the University of California, Berkeley.