Democratic Commissioners' Views

Causes of the U. S. trade and current account deficits

I. Introduction

The U.S. trade deficit has soared to unprecedented heights in recent years, overtaking even the high levels reached in the late 1980s. In 1999, the merchandise deficit reached $346 billion, the goods and services deficit was $265 billion, and the current account deficit hit $331 billion, all of which were all-time records, both in terms of dollar amounts and as a percentage of U.S. GNP.[1] Moreover, these deficits have been running at even higher rates in preliminary data for the first several months of 2000. The current account deficit reached $450 billion, at an annual rate, in 2000, even with slowing in the U.S. economy and greater economic growth abroad.[2] It will approach or exceed $500 billion in 2001, according to recent forecasts.

The large and growing U.S. balance of payments deficit is a very significant threat facing the domestic economy because unless checked, it could cause a currency or financial crisis that would result in a sharp decline in output and employment—possibly reigniting inflation. Experience in both developed and developing countries has shown that large and growing trade and current account deficits do not automatically correct themselves. They almost always result in a financial crisis, leading to economic instability and rising unemployment. Federal Reserve Chairman Alan Greenspan alluded to these risks in testimony before the Senate Banking Committee. His comments, premised on the fact that trade must be financed by borrowing from the rest of the world, were that

> *[T]here has to be a limit as to how much of the world's savings our residents can borrow at close to prevailing interest and exchange rates. And a narrowing of disparities among global growth rates could induce a narrowing of rates of return here relative to those abroad that could adversely affect the propensity of foreigners to invest in the United States.*[3]

He also noted, "So long as foreigners continue to seek to hold ever-increasing quantities of dollar investments in their portfolios, as they obviously have been, the exchange rate for the dollar will remain firm." His comments clearly imply that any decline in the demand for "dollar investments" would put downward pressure on the dollar, causing interest rates to rise and increasing the risk of a financial crisis in the United States.

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[1] Bureau of Economic Analysis, June 20, 2000, release.
[2] Bureau of Economic Analysis, U.S. International Transactions Press Release. Estimate for 2000 reflects the effects of continuing growth in the U.S. trade deficit through July, U.S. Census Bureau, FT 900 – U.S. International Trade In Goods and Services (September 20, 2000).
[3] Testimony of Chairman Alan Greenspan on the Federal Reserve's Report On Monetary Policy, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 20, 2000. http://www.federalreserve.gov/boarddocs/hh/2000/July/Testimony.htm.

Historically such crises have often been caused in other countries by rapidly growing trade deficits and excessive levels of foreign debt. The United States had a balance-of-payments deficit equal to 4.3 percent of output (GDP) in the second quarter of 2000, and net foreign indebtedness worth about 15 percent of GDP.[4] Chairman Greenspan noted in the same statement that total inflows of foreign capital have increased "more than two and one-half times" since 1995.

In 1999, (then) Treasury Secretary Robert Rubin was even more explicit, when he noted that

> *[T]he United States has a large and growing trade deficit, while Europe and Japan have large and stable or growing trade surpluses. Relative growth rates undoubtedly have something to do with that, but it is almost impossible, I believe, to avoid the conclusion that the United States has simply been more open to absorbing the exports of countries seeking to recover from crisis. The international system cannot sustain indefinitely the large imbalances created by the disparities in growth and openness between the U.S. and its major industrial trading partners.*[5]

History clearly shows that rising deficits do not correct themselves automatically or painlessly. Both rich and poor countries can be hit by financial crises. Mexico, Russia, and several countries in Asia and Latin America were hard hit by such crises between 1997 and 1999. Several European countries also experienced international crises in the 1990s.

Sweden experienced an especially severe crisis that began with current account problems in the 1980s. These peaked in 1993, when the current account deficit reached 3.6 percent of GDP.[6] Interest rates were increased from 10.1 percent in 1988 to 18.4 percent in 1992 in an attempt to defend the kroner and reduce demand for imports.[7] This policy was finally abandoned in 1993 because the domestic economy was suffering. Interest rates were reduced and the currency depreciated 25 percent in that year alone, and the current account finally began to improve.[8] However, the damage had already been done. Output in Sweden declined by more than 5 percent between 1990 and 1993, and unemployment soared from 1.6 percent to 8.2 percent in the same period. The government budget, which was in surplus in 1990, was quickly turned into a deficit equal to 16 percent of GDP in 1993, as a result of rising unemployment and social welfare payments.

The United Kingdom also experienced both currency and current account crises in the early 1990s, and the facts were similar. The United Kingdom's current account deficit reached 5 percent of GDP in 1990. Interest rates were increased from 9.7 percent in 1988 to 14.6 percent in 1990, in an attempt to reduce demand for imports and defend the currency. Unemployment

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[4] Bureau of Economic Analysis, U.S. International Transactions Press Release, September 13, 2000. Estimate for 2000 reflects the effects of continuing growth in the U.S. trade deficit through July. U.S. Census Bureau, FT 900 – U.S. International Trade In Goods and Services, September 20, 2000,

[5] Treasury Secretary Robert E. Rubin, remarks before the World Economic Conference, Davos, Switzerland, January 30, 1999. http://www.ustreas.gov/press/releases/pr2920.htm.

[6] International Monetary Fund, International Financial Statistics Yearbook. All statistics in this section are from this source, unless otherwise noted, 1999.

[7] Ibid. Annual average money market interest rates are reported.

[8] Ibid. Dollar/kroner exchange rates reported.

rose from 6.3 percent in 1989 to 10.4 percent in 1993. High interest rates were initially used to keep the pound within the accepted trading bands in the European Exchange Rate mechanism, but rising unemployment forced the United Kingdom to lower interest rates and abandon the Exchange Rate mechanism in 1992. The pound declined 13.3 percent, relative to the dollar between 1989 and 1994. The United Kingdom budget also went from a surplus of 1.5 percent of GDP in 1989 to a deficit of 7.3 percent of GDP in 1993, a swing of nearly 9 percentage points. The 1992 currency runs also affected Italy and France as well as the United Kingdom. France was then the fourth largest economy in the world.

Denmark experienced a similar trade and financial crisis between 1979 and 1983. The Danish current account deficit peaked at 4.1 percent of GDP in 1982. Denmark also increased interest rates by 4.3 percentage points between 1979 and 1982, in a failed attempt to defend its currency. As a result, unemployment nearly doubled, rising from 6.0 percent in 1979 to 11.4 percent in 1983.[9] The Danish kroner depreciated 45.6 percent between 1980 and 1984, and yet the current account deficit was still 3.1 percent of GDP at the end of this traumatic period. Meanwhile, the government budget deficit soared from 2.7 percent of GDP in 1980 to 8.1 percent in 1982, before recovering somewhat in 1983 and 1984.

Some maintain that the United States is different from these countries because it can borrow in its own currency, which is also used around the world for currency reserves and for transaction purposes.[10] However, these factors are more likely to simply postpone the ultimate day of reckoning. The financial laws of gravity have not been repealed for the United States, though they may work differently. If the current account is allowed to expand further before the United States trade balance begins to improve, then the resulting disruption to the domestic economy could be even larger than the recessions that hit the European countries discussed above.

Limits of traditional policies for reducing trade deficits

There are only two macroeconomic remedies available for reducing the deficit: a permanent reduction in U.S. growth rates and a permanently falling value of the dollar. Either could cause a hard landing. This chapter will demonstrate that the United States is more open to imports than other countries and that it has a greater tendency than other countries to increase imports for any given increase in income.[11] If we accept this as the status quo, then the only macroeconomic change we can make to avoid trade deficits in the future is to reduce our growth rates below those of the rest of the world, and/or to make our goods progressively cheaper by devaluing our currency.

Neither of these approaches is acceptable. Americans will not settle for a second-class economy with lower rates of growth than other developed economies. Ultimately, a steady decline in the value of the dollar will also erode U.S. standards of living, which will be rejected by American voters.

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[9] OECD, Labour Force Statistics: 1976-1996. (Paris, France: Organization for Economic Cooperation and Development, 1997).
[10] Note, for example, that the United States is not alone in borrowing abroad in its own currency. All of Denmark's foreign debt was denominated in kroner in the early 1980s, as well.
[11] These studies of what economists call the "income elasticity of imports" are reviewed in Catherine Mann, Is the U.S. Trade Deficit Sustainable? (Washington, DC: Institute for International Economics, 1999).

In addition, either a reduction in growth rates or a steady devaluation of the currency would cause a financial crisis and a hard landing for the domestic economy and are not desirable as long-run policies designed to correct the structural causes of the deficit. If growth slowed in the United States, relative to the rest of the world, then rates of return on U.S. financial assets would also decline. A decline in profit rates in this country would make U.S. stocks, in particular, much less attractive to foreign investors, who would move their funds to more profitable markets. This would result, in turn, in a sharp decline in the stock values, accelerating the exit from the dollar, and instituting a vicious cycle of decline for consumer wealth and consumption and for the U.S. currency.

In a similar manner, if the dollar began to steadily decline, then holders of dollars and U.S. securities would attempt to rapidly sell off those assets and move into other currencies. This is likely to set off a "race for the exits" that would result in a sharp fall in the dollar. Rogoff and Obstfeld have estimated that the dollar would fall by 40 percent if the United States has a currency crisis and that the required adjustment would be much less if the adjustment were done gradually (a 25 percent decline is needed in the long run, in their model).[12] Hence, a currency crisis is likely to result in overshooting—an excessive decline in the dollar that would severely injure the domestic economy.

The European cases discussed above illustrate the dangers of these traditional remedies of deflation and devaluation, especially for workers whose jobs would be put at risk. In addition, current government budget surpluses, which have been achieved through a decade of sacrifice, could be wiped out overnight by a financial crisis.

There are better policies available for permanently reducing U.S. trade deficits. These would include market openings abroad and higher savings rates in the United States (causing a lower level of imports) as well as a recovery of U.S. manufacturing. If the United States wants to eliminate its trade deficit without reducing output and employment, then domestic manufacturing exports will have to increase by about 30 percent, just to meet the need for increased exports and for replacement of imports. This is because the manufacturing sector is responsible for the vast majority of the U.S. trade deficit, as discussed in Chapter 4. In addition, 80 percent of world trade is in goods. Balancing our accounts based on service exports alone just is not feasible.[13]

In the foreseeable future, services exports and airplanes alone (within the manufacturing sector) cannot carry the load to reduce the deficit.[14] Thus, a comprehensive set of policies designed to rebuild U.S. manufacturing and to increase its competitiveness is needed to reduce the trade

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[12] Maurice Obstfeld and Kenneth Rogoff. Perspectives on OECD Economic Integration: Implications for U.S. Current Account Adjustment," manuscript obtained from: http://www.kc.frb.org/PUBLICAT/SYMPOS/2000/2000draft.htm, 2000. Their model is based on a reverse causal relationship and on theories of incomplete markets. In this model, changes in the current account are balanced (the deficit is eliminated) by an adjustment in real exchange rates. This paper is a scaled-down version of Maurice Obstfeld and Kenneth Rogoff's, "The Six Major Puzzles in International Macroeconomics: Is There a Common Cause?" National Bureau of Economic Research Working Paper W7777, (Cambridge, MA: NBER, July 2000).

[13] WTO, 1999 (Personal Communication with Commission Staff, October, 10, 2000).

[14] The U.S. aircraft, engine, and parts sectors generated a $29 billion trade surplus in 1999. This is the largest trade surplus of any major U.S. industry, by far, yet it is less than 10 percent of the U.S. current account deficit in 1999. Source: U.S. Census Bureau, http://www.census.gov/foreign-trade/Press-Release/99_press_releases/Final_Revisions_1999/exh7.txt.

deficit without destroying the domestic economy. The United States does not need to cut output or to reduce real incomes in order to compete more effectively in the world economy. Labor costs, in particular, are not the cause of America's trade problems. Wages in Germany and Japan are equal to or above those in the United States, yet those countries run trade surpluses. What makes them different from the United States? The answers to this question will help us to understand, and develop solutions for, the competitive problems of U.S. industry.

We also need a set of contingency plans for a hard landing, even if we do something to reduce the risk of a hard landing—some "criteria to guide policymakers." To simply wait for a crisis and then decide what to do is wrong. All the European examples discussed above demonstrate that raising interest rates in order to defend the currency in the face of a substantial run on the dollar will simply compound domestic woes and cause unemployment to soar. Standby measures to rapidly expand domestic manufacturing will be needed. It will be much harder for the United States to solve its trade problems than for smaller countries in Europe, in part because those countries are much more involved in trade to begin with. Such measures could include substantial increases in training programs and investments in research and development (in cooperation with business), together with expanded assistance for small businesses and regional development.

Background

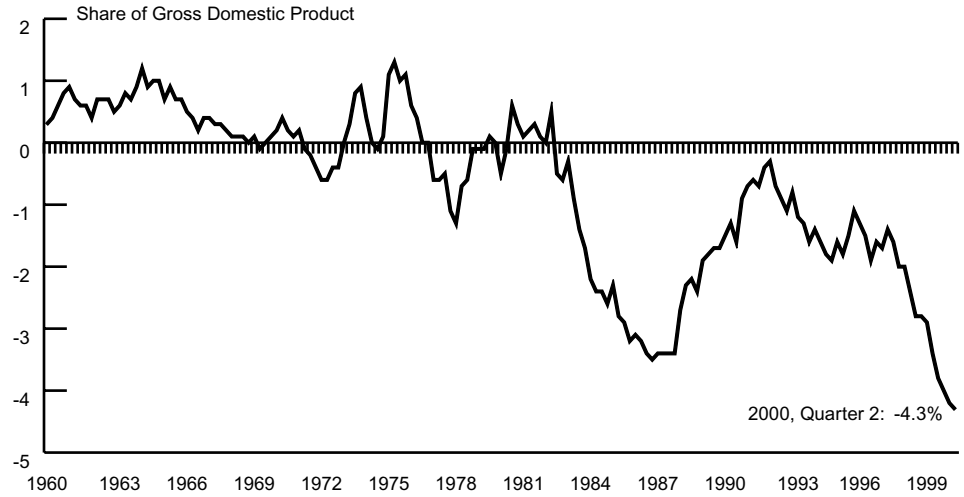
The United States has had a long-term tendency toward increasing trade deficits over several decades. Figure 2.1 shows the trend of the U.S. current account balance, the broadest measure of U.S. trade flows, since 1960. The current account fell from an average surplus of about 0.5 percent of GNP in the 1960s to an average deficit of about –0.5 percent of GNP in the 1970s, and -2.0 percent of GNP in the 1980s. In the 1990s, the U.S. trade deficit has averaged –2.7 percent of GNP. The current account deficit in 1999 reached an all-time high of –3.7 percent of GDP, surpassing the previous historical peak deficit of –3.4 percent in 1987, and this deficit reached 4.3 percent of GDP in the second quarter of 2000. As shown below, in our discussion of trade balances, savings and investment, the current account deficit shows that U.S. consumption of goods, services, and government procurement and foreign aid currently exceeds U.S. income by an amount equal to 4.3 percent of GDP.[15] If this gap is to be closed, U.S. consumption must fall and net exports must rise by an equivalent amount if the United States is going to avoid a recession.

[15] In technical terms, this means that U.S. absorption exceeded U.S. income by 4.3 percent GDP in the second quarter of 2000.

Figure 2.1[a]

U.S. Current Account, 1960 - 2000, Quarter 2

(Quarterly data)



[a] Data for 1991 was corrected to eliminate Gulf War payments to the U.S. government. This was done by examining the trend of U.S. government grant payments between 1990 and 1992 and interpolating the trend to estimate 1991 estimated gulf war payments.

Source: Bureau of Economic Analysis, Balance of Payments and Related Data, Table 1 of the International Transactions Accounts (as of September 13, 2000) **http://www.bea.doc.gov/bea/di1.htm**

In analyzing the causes of the growing U.S. trade deficit, it is important to distinguish between long-term trends and short-term factors. Among the major long-term trends that have caused large and increasing deficits in the U.S. trade balance are (1) unequal trading relationships with America's major trading partners, especially foreign countries that maintain structural surpluses with the United States, such as Japan and China; (2) the process of globalization and the movement by U.S. multinationals of technology and production jobs from the United States to low-wage locations; (3) the loss of competitive advantages by U.S. producers on the world market, which has been compounded by the failure of other nations to enforce their own labor and environmental standards and law and to adhere to international labor standards; and (4) changes in savings behavior in the U.S. economy. Increasing payments on U.S. foreign debt, which are a recent phenomenon, have also contributed to the steady growth of the U.S. current account deficit. Short-term factors that have acted to boost the deficit since the mid-1990s include (1) recent increases in the price of oil, (2) the rising value of the U.S. dollar, and (3) the slowdown in growth rates abroad relative to the U.S. economy.

Our views in this chapter will first address the causes of the long-term trend deterioration in the U.S. trade balance. Next, the causes of the short-term fluctuations around the downward trend, especially the recent very rapid growth of the trade deficit since the mid-1990s, will be discussed. This chapter will also address the macroeconomic accounting identity that links the trade balance to the gap between national savings and investment. In particular, this chapter questions the view of some economists that America's current account deficit can be fully

explained by a savings shortfall in the United States. It is important to address this view because, although expressed by some economists (including some witnesses who testified before the Commission), we believe this explanation leads to the mistaken conclusion that trade policies, exchange rate policies, and competitiveness policies can have no real effect on the U.S. trade balance.

It is our opinion that, although macroeconomic savings behavior is important, it is not the whole story in explaining the deteriorating U.S. trade balance over either the long or short term. For example, in the European financial crises noted above, large current account deficits were eliminated while government budget deficits soared (a decline in public savings). Private savings and investment always decline during recessions, bringing national savings and investment into balance. Thus, it is not sufficient to "get savings right"—the easiest (but most objectionable) way to accomplish this is by inducing a recession. The challenge is to restore competitiveness while ensuring that workers enjoy rising standards of living with appropriate incentives to increase domestic savings and investment. In this way, the United States can switch over from domestic consumption to increased net export demand without having to endure a deep recession during the process of adjustment.

II. The long-term trend toward growing U.S. trade deficits

A. Unequal relationships with America's major trading partners

A leading long-term cause of the trend toward growing U.S. trade deficits in the past forty years is the deep, underlying asymmetries in U.S. trade relations with our major trading partners. These unequal trading relations have caused our purchases of imports to grow faster than other countries' purchases of our exports on average in recent decades, contributing to the long-term deterioration of the U.S. trade balance seen in Figure 2.1 above. This persistently unbalanced relationship between America and its trading partners has contributed to the negative trend in the U.S. trade balance despite the fluctuations of exchange rates, oil prices, business cycles, and macroeconomic policies over the last forty years.

Economic researchers have long recognized the discrepancy between the responsiveness of U.S. demand for foreign imports and foreign demand for U.S. exports. In technical terms, economists have found that the income elasticity of U.S. demand for imports is greater than the income elasticity of foreign demand for U.S. exports. (See Box 2.1.) This means that for an equal increase in national income in the United States and in foreign countries, the United States increases its purchases of imports proportionally more than foreigners increase their purchases of U.S. exports (holding the relative prices of U.S. and foreign goods constant).[16]

There are a number of reasons why other countries are less willing to import goods than the United States for a given increase in income. These include persistent nontariff barriers, global-

[16] This result was first obtained by Hendrik Houthakker and Stephen Magee in a famous 1969 article and has been corroborated by numerous researchers many times since, including seven of the eight studies cited in Box 2.1. See Houthakker and Magee, 1969, Cline, 1989, Robert Lawrence, 1990; Blecker, 1992, and Blecker, 1996 in Box 2.1.

ization and the movement of factories to other countries by U.S. multinationals, and the loss of competitiveness by U.S. manufacturers. These and other barriers to U.S. trade are discussed in the remainder of this chapter. Together, they explain why the United States is so much more open to imports than other countries.

Box 2.1

Estimates of Income Elasticities of U.S. Export and Import Demand

Author(s)	Exports	Imports
Houthakker and Magee	0.99	1.51
Krugman and Baldwin	2.42	2.87
Heikle and Hooper	2.19	2.11
Cline	1.70	2.44
Lawrence	1.60	2.47
Blecker (1992)	1.67	2.68
Blecker (1996)	1.38	2.22
Alonso and Garcimartin	1.39	2.02

Sources:

Alonso, José A. and Garcimartin, Carlos. 1998-99. "A New Approach to Balance-of-Payments Constraint: Some Empirical Evidence." *Journal of Post Keynsian Economics*, Vol.21, No.2 (Winter), pp. 259-283.

Blecker, Robert A. 1992. "Structural Roots of U.S. Trade Problems: Income Elasticities, Time Trends and Hysteresis." *Journal of Post Keynsian Economics*, Vol. 14, No. 3 (Spring), pp.321-46.

Blecker, Robert A. 1996. Table 6.3. *U.S. Trade Policy and Global Growth*. Washington, D.C.: Economic Policy Institute. p.198.

Cline, William R. 1989. *United States External Adjustments and the World Economy*. Washington, D.C.: Institute for International Economics.

Helkie, William L., and Peter Hooper. 1998. "An Empirical Analysis of the External Deficit." In Ralph C. Bryant et al., eds. *External Deficits and the Dollar: The Pit and the Pendulum.* Washington, D.C.: The Brookings Institution.

Houthhakker, Hendrik S., and Stephen P. Magee. 1969. "Income and Price Elasticities in World Trade." *Review of Economics and Statistics*, Vol. 51 (May), pp.111-125.

Krugman, Paul R., and Richard Baldwin. 1987. "The Persistence of the U.S. Trade Deficit" *Brookings Papers on Economic Activity*, No. 1, pp.1-43.

Lawrence, Robert Z. 1990. "Efficient or Exclusionist?" The Import Behavior of Japanese Corporate Groups." *Brookings Papers on Economic Activity*, No. 1, pp. 311-41.

Openness in this context means much more than low tariffs or the absence of quotas. Many of our trading partners have tariffs that are as low as or lower than U.S. tariffs. What is different about the United States is that we do not maintain broad, exclusionary policies. Also, our institutions allow foreigners to buy their way into the American market. Companies can be bought, distributors can be acquired easily, lobbyists hired, etc.

Free market institutions here in the United States also mean that companies deal at arms length and are free to compete with one another in open markets where winners are chosen based on price, quality, and customer service. In other countries, there are many institutions that give preferences to a few, local suppliers—effectively excluding U.S. exporters, as shown below.

From a macroeconomic perspective, the discrepancy between U.S. demand for imports and foreign demand for U.S. exports means that we will continue to face increasing deficits in our trade balance unless one of two macroeconomic events occurs.[17] First, a price adjustment or other policy changes that make our goods relatively cheaper compared with foreign goods would improve the competitiveness of U.S. exports[18] and the competitiveness of U.S. produced goods with imports. This would require ongoing depreciation of the dollar in real terms, which would make our goods more price-competitive but would lead to a decline in our purchasing power over foreign goods. The second way to overcome the discrepancy between U.S. demand for imports and foreign demand for U.S. exports would be an income adjustment that would constrain our economy to grow more slowly than the economies of our trading partners.[19] Standard results from studies of the income elasticity of U.S. exports and imports suggest that U.S. income can only increase about 60 percent as fast as foreign income to keep trade deficits from continuing to grow, assuming that the value of the dollar remains constant.

Neither of these types of adjustments are desirable – continuous depreciation of the dollar erodes the U.S. standard of living, and constraining economic growth would result in high levels of unemployment and recession, otherwise known as a “hard landing.” If U.S. output levels fall and rates of return on U.S. investments decline, it could spark a flight of capital to other countries where investments are more profitable. This could cause a currency crisis and possibly a deep economic downturn, implied by Federal Reserve Board Chairman Greenspan. Likewise, any move to devalue the dollar is likely to cause investors to begin a "race for the exits," and a currency crisis. The dollar is likely to "overshoot" its new equilibrium level (or rate of decline) as a result of such capital flight.

It is essential, therefore, to find long-term policy solutions that can enable us to escape the dilemma of having to either depreciate our currency or slow our income growth. One possibility is to pursue a trade policy to make foreign markets more open to U.S. exports and to reduce the use of predatory trade practices by our trading partners; another policy is to push the governments of

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[17] Based on discussion in Robert Blecker’s book, "The Trade Deficit and U.S. Competitiveness," In Robert Blecker, ed. U.S. Trade Policy and Global Growth, (Washington, DC.: Economic Policy Institute, 1996), pp. 179-214.

[18] For example, devaluation will make U.S. exports cheaper and imports more expensive, causing consumers to switch from imported to domestic products. Such "expenditure switching" policies can also include export and manufacturing promotion programs and also measures designed to eliminate unfair trade, such as antidumping duties.

[19] Traditional methods for reducing overall expenditures include monetary policies (raising interest rates) and changes in government spending and taxation (spending cuts or tax increases). In past crises, governments have been more likely to raise interest rates, as shown in the European cases discussed above.

our trading partners and international agencies to promote higher growth rates abroad.[20] Growth rates in Europe and Japan were substantially lower than in the United States in 1999, as shown in figure 2.9 on page 81, continuing a trend that has persisted for several years.

Conclusions

It is often argued that foreign trade barriers cannot explain the worsening trend in the U.S. trade deficit because those barriers have fallen over time as trade negotiations have progressed through its various rounds. But this argument misses the point – foreign trade barriers do not have to increase in order to account for deterioration in the U.S. trade balance. All that is necessary is that other countries have policies in place that restrain the growth rate for their imports below the growth rate of their exports. The result will be growing trade surpluses with the United States for these countries over time. It is clear that many of our trading partners have managed to maintain sufficiently high trade barriers to contribute to a deteriorating trend in the U.S. trade balance over the last several decades, especially in the case of those countries with which the United States has its largest bilateral trade deficits.

B. Unequal U.S. trade relationships: Persistent differences in market openness, dumping, and industrial targeting

One fundamental factor that underlies the structural asymmetries in U.S. trade relationships is the difference in market openness. The U.S. market has consistently and effectively been much more open to imports than have foreign markets.[21] The greater openness of the U.S. market compared to foreign markets has persisted despite many rounds of trade negotiations and mutual reductions in legal trade barriers. In prior decades, trade barriers abroad often included explicit trade policies such as tariffs, quotas, and other formal trade restrictions. While trade negotiations have lowered many foreign official trade barriers to U.S. exports, other types of nonofficial barriers remain and have grown in relative importance to take their place, and they provide high levels of effective protection.[22] In addition, the United States is a much easier market to penetrate than many other countries because of our open, free-market institutions. Companies and consumers in many countries have demonstrated a strong tendency to trade more with themselves than with others for a variety of cultural, legal, and historical reasons. For example, several studies have shown that Canada's provinces are 20 times more likely to trade with each other than with comparable U.S. states, despite the fact that in many cases, Canadians are "closer to the U.S. than they are to each other." This pattern has persisted for at least eight years after the U.S.-Canada Free Trade Agreement was implemented and has not changed in the 1990s.[23]

Cultural differences also play a significant role in explaining the U.S. openness to imports, versus other countries. In many ways, American consumers are less nationalistic and more price

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[20] See Chapter 6 for a complete review of policy options for reducing the trade deficit.
[21] This helps explain why the U.S. income elasticity of demand for imports is higher than the foreign income elasticity of demand for U.S. exports, which has contributed to the growth of the trade deficit.
[22] For example, a recent study found that "import barriers in place in Japan in 1989 cost Japanese consumers $105 billion, about 3.6 percent of GDP." Yoko Sazanami, Shujiro Urata, and Hiroki Kawai, Measuring the Costs of Protection in Japan (Washington, DC: Institute of International Economics, 1995 summary (http://www.iie.com).
[23] Janet Ceglowski, "Has the Border Narrowed?" The North American Journal of Economics and Finance, 11(1) (August 2000) pp. 61-75.

and status sensitive. By contrast, Japanese consumers will often pass up a bargain on cheap imports to buy a local good. U.S. firms are also more willing to go abroad to purchase parts and assembled goods than are their foreign counterparts, as discussed below. Some part of the problem is due to American attitudes; it is not only trade barriers.

Country-specific trade barriers–Japan

Nearly 45 percent of the U.S. trade deficit today is with two countries, Japan and China, and two-thirds of the U.S. trade deficit is with the Asian countries as a group. (See Table 2.1) These countries are well known for their overt and covert trade barriers. These trade barriers have persisted despite U.S. efforts over many years to enforce trade agreements to increase market access for U.S. goods.

In testimony before the Commission, Patrick Mulloy, Assistant Secretary of the Department of Commerce, noted that, unlike U.S. trade patterns with the rest of the world, trade with Asia has not generally reflected changes in economic growth rates and other macroeconomic factors. Secretary Mulloy cited high tariff barriers as a major factor restricting U.S. exports to Asia but stressed the importance of nontariff barriers to U.S. goods in creating large, bilateral U.S. trade deficits with these countries. He stated:

> *Tariffs remain a serious problem. But in Japan, for example, where the tariffs are only three percent, the Institute for International Economics published a study in 1995 calculating the implied margin of protection that keeps imports out of Japan. They estimated that Japan's invisible protection for machinery imports was equivalent to an average tariff of 140 percent. With this amount of invisible protection in place, it is not surprising that we and many other countries have great difficulty exporting industrial products to Japan.*[24]

[24] Patrick Mulloy, Testimony to U.S. Trade Deficit Review Commission, December 10, 1999, p. 126 of the transcript. See Sazanami, Shojiro and Kawai, Measuring the Costs of Protection, op. cit.

Table 2.1

U.S. Merchandise Trade by Country and Region, 1999
(International Transactions Basis, in Billions of U.S. Dollars)

Country or Region	Exports	Imports	Balance	Percentage of Total Deficit (c)
Total World (b)	695.8	1024.60	-328.81	100%
Western Europe	166	213	-47	14.30%
European Union	151.8	195.2	-43.41	13.20%
Germany	26.8	55.2	-28.4	8.6%
United Kingdom	38.4	39.2	-0.8	0.3%
Canada	166.6	198.7	-32.1	9.8%
Mexico	86.9	109.7	-22.8	6.9%
Total North American Free Trade Agreement	253.5	308.40	-54.9	16.7%
Other Western Hemisphere (a)	55.2	58.5	-3.3	1.00%
Japan	57.5	130.9	-73.4	22.3%
China	13.1	81.8	-68.7	20.9%
Taiwan	19.1	35.2	-16.1	4.9%
Hong Kong	12.7	10.5	2.1	-0.6%
Korea	23	31.2	-8.2	2.5%
Singapore	16.2	18.2	-1.9	0.6%
Other Asia	4.7	14.8	-10.1	3.10%
Total Asia, excluding Japan	133.4	277.7	-144.3	43.9
Total Asia, including Japan	190.9	408.5	-217.7	66.2%

Notes:
(a) Excluding Canada or Mexico.
(b) Includes other countries and regions not shown separately.
(c) Negative numbers in this column indicate surpluses.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, and author's calculations.

In describing the U.S. trade relationship with Japan, Edward Lincoln of The Brookings Institution wrote in his paper submitted to the Commission:

> *Both anecdotal and statistical evidence indicates that Japan has not played its expected role in providing reciprocal access to its markets in exchange for more liberal rules of access to the United States or other countries.*[25]

[25] Edward J. Lincoln, Japan: A Continuing Dilemma for Open Trade Ideals (June 2000), Washington, D.C.: The Brookings Institution, Available from the Commission's website: http://www.ustdrc.gov.

Country-specific trade barriers–China

The size of China's trade surplus with the United States, at over $69 billion in 1999, is expected to overtake that of Japan's in the near future. As Greg Mastel noted in his paper for the Commission:

> *Despite recent steps to lower trade barriers, China remains a highly protected market. China maintains an array of barriers ranging from high tariffs to import registration requirements. Collectively, these policies are significant barriers to U.S. exports, particularly in the agricultural sector and other manufacturing sectors…in which China has pursued an aggressive industrial policy aimed at building Chinese industries.*[26]

The United States has experienced persistent problems with the Chinese government concerning Chinese compliance with trade agreements in the last decade. In 1992, the Chinese and U.S. governments signed a Memorandum of Understanding in which China agreed to provide access to its markets to U.S. goods and to enforce U.S. intellectual property rights. President George Bush hailed it as a "breakthrough" agreement. But, since then, U.S. exports to China rose by only $7 billion, while imports from China rose $56 billion.[27] Clearly, the U.S. government badly misjudged either the willingness or capability of the Chinese government to live up to the agreement.

Chinese leaders signed a promise to honor U.S. intellectual property rights involving copyrights, patents, and trademarks. But the theft of protected material continues, with the clear involvement of military enterprises, government agencies, and companies owned by friends and families of Chinese leaders. After the Clinton administration threatened unilateral trade sanctions in 1995 (which would be impossible with Permanent Normal Trade Relations), the Chinese made a show of closing down a few marginal pirate operations. But today, according to industry analysts, the situation is worse than it was in 1995.[28]

China in 1992 also signed an agreement to open up market access to a large number of U.S. goods, including autos and parts, power generation equipment, pharmaceuticals, and electronics. As some barriers were lowered, new ones were put in place. The Chinese government has even reneged on written commitments to make public the rules and regulations affecting foreign trade and investment. There is ample evidence that China has been violating textile agreements by shipping goods through Hong Kong and Macao and that it continues to use large amounts of forced prison labor to produce goods for export.

Statements made by China have brought into question the acceptance of any "concessions" in the most recent trade agreements with the United States. For example, the Clinton administration announced that China agreed to award licenses to U.S. insurance companies with fiscal prudence as the only criterion. Nevertheless the Financial Times reported that Ma Yongwei,

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[26] Greg Mastel, "U.S.-China Trade: Smooth Sailing or Choppy Waters?" Paper for U.S. Trade Deficit Review Commission, May 2000, p. 39.
[27] Robert E. Scott, The High Cost of the China-WTO Deal (Washington, DC: Economic Policy Institute, 2000). Issue Brief.
[28] Greg Mastel, "The China Trade," The Weekly Standard, March 6, 2000.

chairman of the China Insurance Regulatory Commission, said that, even after it entered the WTO, China "reserved the right to block licenses for foreign insurance companies if their approval seemed to threaten stability of economic policy."[29]

The Clinton administration also claimed that China agreed to eliminate health-related barriers to U.S. meat imports that were not based on scientific evidence. According to China trade negotiator Long Yongtu, "Diplomatic negotiations involve finding new expressions. If you find a new expression, this means you have achieved a diplomatic result. In terms of imports, we have not actually made any material concessions."[30]

Negotiator Long has publicly said that, although Beijing had agreed on paper to allow the United States to export 7.3 million tons of wheat to the mainland each year, it is a "complete misunderstanding" to expect this grain to enter the country. In its agreements with the United States, he said, Beijing only conceded a "theoretical opportunity" for the export of grain.[31]

China's trade surplus with the United States contrasts with its nearly balanced trade with the countries of the European Union. Many commentators have suggested that the trade policy of the Chinese government targets trade barriers and restrictions at U.S. exports while giving more access to EU exports in response to the political calculation that the U.S. government is less likely than European governments to retaliate.[32]

As of this writing, the final negotiations over China's protocol for joining the WTO have reached a near-impasse. As one recent press report noted, the recent bill providing permanent normal trade relations status for China when it joins the WTO

> *…won approval in Congress only after Beijing offered numerous and detailed promises of opening markets across a variety of important sectors, including autos, telecommunications, agricultural products and financial services….But in recent months, Chinese officials have given many indications that their commitment to those promises is weakening. Suspicions that China's Communist leaders are getting cold feet about global competition has stymied the final negotiations on China's WTO membership.*[33]

Several recent studies have shown that China's entry into the WTO is likely to worsen the U.S. trade deficit with that country, in several ways. For example, a report by the U.S. International Trade Commission predicted that China's WTO entry would significantly increase investment by U.S. multinationals inside China.[34] If investment by U.S. multinationals increases, China's production base for exporting goods back to the United States will continue to broaden, resulting in an

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[29] Financial Times, November 19, 1999.
[30] "China to Retain State Monopoly Over Oil Imports After WTO Entry," AFX NewsLimited, Asia, January 6, 2000.
[31] Quoted by AFL-CIO President John J. Sweeney, testimony before Senate Finance Committee on "U.S. Trade with China and China's Accession to the WTO," March 23, 2000. Federal Document Clearing House. Transcript.
[32] See Commissioner Thurow's comments and responses during U.S. Trade Deficit Review Commission testimony December 10, 1999, Washington, DC — Technical Briefing on the Trade Deficit "Causes, Impacts and Solutions Continued", Commissioner Dimitri Papadimitriou, Chair. See Commissioner Thurow's question at p. 191 in the transcript of the afternoon discussion period: "…If you look at all the trade barriers in Asia, there's always a mystery. Why do they have a much bigger effect on the United States than they do in Europe? …"
[33] Clay Chandler, "Chinese Reaffirm Desire to Join WTO," Washington Post, October 12, 2000. p. E01.
[34] U.S. International Trade Commission (USITC). Assessment of the Economic Effects on the United States of China's Accession to the WTO. Table EX-4, p. xix. Investigation No.332-403 (Washington, D.C: USITC,1999), Publication 3229.

even greater U.S. trade deficit with China. In the past decade, China has seen an explosion of foreign direct investment (FDI) by firms from the United States and other countries. In fact, between 1992 and 1999, more than $270 billion has been invested in China by thousands of foreign firms.[35]

In addition, the rapidly growing U.S. trade deficit with China is directly linked to the growth of multinational firms operating in China. Of China's more than $200 billion in exports in 1998, over 40 percent had their source in multinational firms operating in China.[36] Recent research has also demonstrated that a 10 percent increase in the level of U.S. direct investment in China is associated with a 7.3 percent increase in the volume of U.S. imports from China and a 2.1 percent decline in U.S. exports to China in that industry.[37]

Another recent study has examined the likely impacts on the United States, over the next decade, if China does enter the WTO. This study is based on the findings of the USITC study of China's entry into the WTO that was noted above. The USITC study predicted that U.S. exports to China would grow more rapidly than U.S. imports from that country if permanent normal trade relations legislation passed. However, the new study found that the absolute level of the U.S. trade deficit with China would increase by at least 80 percent between 1999 and 2010, even if these forecasts of increasing U.S. exports remain true for the next decade, and that this would result in the elimination of 872,091 jobs during this period. In addition, every state in the United States will suffer significant job losses over the next decade, as trade deficits expand. Major losses will be experienced in states such as California (91,269 jobs lost), Texas (-54,868) and Pennsylvania (-48,456). Every industry in the United States will also lose jobs due to increased trade deficits, including services (-58,391), manufacturing (-742,201, 85 percent of the total), and even including agriculture and other natural resources (5,095 jobs lost).[38]

One of the key assumptions of the USITC assessment of the impacts of China's entry into the WTO was that China does not devalue its currency. However, many other countries that have entered into trade agreements with the United States have devalued their currencies shortly after the agreement went into effect. Examples include Mexico after the North American Free Trade Agreement (NAFTA) (1994-95 currency crisis) and Canada after the U.S.-Canada Free Trade Agreement (FTA) was implemented in 1989 (between 1989 and 2000, the Canadian dollar has lost about 30 percent of its value against the U.S. dollar).[39] China is likely to follow a pattern similar that followed by Mexico after NAFTA: sometime after China enters the WTO, it will experience a currency crisis and devaluation, which will be followed by surging FDI into China and then rapidly expanding Chinese exports to and trade surpluses with the United States. China's last major devaluation occurred in 1994, and China has experienced sustained periods of double-digit inflation since then.

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[35] International Monetary Fund, International Financial Statistics (March 2000). Note that US multinationals are the third largest source of FDI into China following Hong Kong and Japan, 2000.
[36] Ministry of Foreign Trade and Economic Cooperation. Trade data. < www.moftec.cn.gov >, 2000.
[37] James Burke. "U.S. Investment In China Worsens Trade Deficit: U.S. Firms Build Export-Oriented Production Base In China's Low-Wage, Low Labor-Protection Economy." (Washington, D.C.: Economic Policy Institute, May 2000), Briefing Paper, p. 1. http://www.epinet.org/.
[38] Robert E. Scott, China and the States: Booming Trade Deficit With China Will Accelerate Job Destruction In Next Decade With Losses In Every State. (Washington DC: Economic Policy Institute, May 2000), Issue Brief, pp. 1-2. http://www.epinet.org/.
[39] Between January 1, 1990, and October 6, 2000, the Canadian dollar depreciated by 29 percent against the U.S. dollar. Federal Reserve, Foreign Exchange Rates, H.10, Historical Data. http://www.bog.frb.fed.us/releases/H10/hist/.

Any devaluation should be construed as a signal of China's nonacceptance of the broad rules of the WTO against competitive devaluations. If China devalues, the United States should take actions to limit or negate the devaluation's effect. The Chinese government must understand this behavior is anathema to the spirit of WTO accession and permanent normal trade relations, and that swift action by the United States will follow and frustrate its desired effects on their exports to the United States. For this strategy to be effective, we recommend that the United States take the lead in building a consensus among the world's leading trading nations that competitive devaluations by any country with a substantial global trade surplus destabilizes the global trading system, and common action of the leading members of the WTO might be appropriate.

Conclusion

Making foreign markets more open to U.S. exports is a necessary step toward reversing the long-term deterioration of the U.S. trade balance. Many of our major trading partners maintain discriminatory trade policies that hurt the ability of U.S. industries to expand exports and to compete with imports in our home market. In addition to traditional trade barriers, these policies include nontrade barriers such as regulatory entry barriers for U.S. goods, corporate practices that favor domestic suppliers, and offset agreements that require local inputs in production or technology transfers from the United States in return for market access. Foreign governments also use subsidies and industrial policies to lower the cost of production for their domestic producers in key industries, effectively driving U.S. goods out of the market. The U.S. trade deficit is concentrated in a few countries, and a few sectors, as shown in this section, and below. In particular, the U.S. trade deficit with Asia, plus our deficit in petroleum, is 100 percent of the total U.S. trade deficit. Large U.S. imports of oil, in particular, mean that this country has to have a surplus with the rest of the world in order to balance our trade accounts.

C. Effects of predatory trade practices and industrial policies

Structural Problems in Global Steel Trade. The Asian financial crisis has created a steel industry crisis situation in the United States as country after country resorted to dumping steel in the United States when demand fell in their domestic markets. A recently released study from the U.S. Department of Commerce notes that imports of hot-rolled steel increased by 70 percent during 1998, "from the previous year's record high."[40] Domestic capacity utilization rates declined from 90 percent to 75 percent in the same period. At least six companies were driven into bankruptcy as a result of the crisis, and several more could be forced to declare bankruptcy before the end of 2000. The industry did not begin to recover until the second half of 1999, after a number of antidumping cases had been concluded and substantial duties were imposed on offending importers.

The Commerce study reports that the crisis was caused by a number of factors. In the short run, low Asian demand resulted in a surplus of steel capacity and production in Asia. Currency

[40] U.S. Department of Commerce, Report to the President: Global Steel Trade: Structural Problems and Future Solutions, (Washington, DC: U.S. Department of Commerce, July 2000), p. 1. Online version: http://www.ita.doc.gov/media/publications.htm.

devaluation in countries affected by the financial crisis (including Brazil) caused exports from these countries to have lower dollar prices.

Over the long term, there is a fundamental problem of a glut of global steelmaking capacity. The Commerce study cited a 1999 OECD study, which found that world steelmaking capacity had increased by roughly 150 million metric tons (MT) between 1985 and 1999 and that an additional 45 MT will come on line by 2001. The Commerce study also cited a study by World Steel Dynamics, the well-known industry analyst, which estimated that there are between 250 and 275 MT of excess capacity, worldwide.

The steel industry has a number of unique structural problems. Chief among these is the existence of high fixed costs and relatively low operating costs, especially in the larger, integrated steel mills. As a result, companies have an incentive to reduce prices below average costs in order to keep mills operating during downturns. Often, the only way to maintain output in such cases is by dumping steel in foreign markets (selling their products at prices below cost, or below prices in their own home markets).

These practices are aided and abetted by governments that often subsidize steelmakers in a number of ways. As the Commerce study put it:

> *One way or another, steel companies around the world benefit from government practices that forestall adjustments mandated by the market. As a result, market forces are not able to bring world capacity and supply in line with demand. Because capacity and production cuts are resisted, excess capacity tends to be maintained and more steel tends to be produced. This greater supply of steel worldwide has a dampening effect on prices in good times and bad.*[41]

One result of these policies is that the history of steel trade for the past three decades is filled with repeated unfair trade practices. This situation is complicated by the existence of a global steel cartel, involving producers from most countries other than the United States, which apportions the distribution of steel around the world. One result of this conspiracy is that excess exports are usually targeted exclusively at the U.S. market, since other countries are less willing to allow steel imports into their countries, especially during periods of crisis and economic distress.

In their comprehensive assessment of the problems facing the U.S. steel industry, the Commerce Department concluded that

> *[t]he thirty-year history of repeated unfair trade actions is symptomatic of underlying market-distorting practices in the global steel market. … Such practices enable the steel companies in the countries most involved in the 1998 crisis to set low prices for exports and forestall downsizing adjustments mandated by the market.*[42]

[41] Ibid. p. 4.
[42] Ibid.

A senior leader of the U.S. steel industry who has experienced this entire period of conflict concluded that

> *[t]his report documents 30 years of deceit, deception and exploitation of the U.S. steel industry by cartels and government subsidized steel producers who are willing to ship huge volumes of steel to this country at prices below their own costs of production.*

Aerospace and the EU: Industrial policy without end

In 1999 Airbus Industries, the European aircraft manufacturer, captured more than 56 percent of the market for large civilian aircraft. Boeing's share dropped to less than 44 percent. Since 1996, Airbus' market share has gone from less than 30 percent to more than half of the world market.[43] We would toast Airbus's dramatic success if it were the result of better management and better planes. Unfortunately, it is not. It is the result of three decades of European industrial policy and massive government subsidies.

The European Union and its member states created a civilian aerospace industry that exists only because of government support. For the past three decades, European governments have provided massive subsidies, estimated to exceed $30 billion, that funded more than 70 percent of the development cost of new aircraft, manipulated government regulations, and employed government-to-government pressure to create and expand Airbus Industries and its supplier network.[44] Despite the large market share gained by Airbus Industries, unfair European government support continues unabated.

The rise of Airbus Industries has seriously harmed Boeing, the primary U.S. producer of large civil aircraft, and the United States. Boeing, as a private sector company, has to operate profitably and meet its obligations to its shareholders. When it develops and markets new aircraft, it must put its own capital at risk. If its products are a success, it prospers. If not, it runs the same risks as any business in a capitalistic economy that fails to be profitable. The unfair subsidies and other support for Airbus Industries has created an unlevel playing field in which Boeing, a private U.S. company, is in effect in toe-to-toe competition with European governments and all of their resources. The growth of Airbus Industries' market share directly lowers Boeing's sales, employment, and profits.

The following examples are emblematic of the continued support provided by European governments to the development and marketing of Airbus aircraft.

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[43] Airclaims Limited, proprietary information source available through the Internet by subscription. Shares reflect the number of aircraft sold and not the value of shipments.

[44] Between 1970 and 1990 alone, "Airbus received government aid in the form of grants and soft loans totaling $26 billion, including unpaid interest." This estimate is based on a 1990 study commissioned by the U.S. Department of Commerce. See Randy Barber and Robert E. Scott, Jobs on the Wing (Washington, DC: Economic Policy Institute, 1995), pp. 49-55.

Massive subsidies for the development of new aircraft

Unlike its American private sector competitor, Airbus Industries does not bear the financial risk of developing new planes. European governments historically provided more than 70 percent of the funding to develop new aircraft. However, under a 1992 U.S.-EU agreement, European governments are supposed to limit their funding to one-third of the cost of developing new aircraft. The mechanism used is low-cost, success-conditional loans. That is, Airbus Industries need only begin to repay development costs if a new plane is a commercial success. Even then, if any funds are repaid, they are at a very low interest rate. If a new plane is not a commercial success, Airbus Industries does not have to repay any money to the member governments that have provided funds to develop the new aircraft.

Airbus Industries is now in the process of launching a new plane, the A3XX, which is a super-jumbo designed to carry one hundred more passengers than a Boeing 747. This new aircraft could not be developed or launched without a government subsidy estimated at $4 billion to $5 billion.[45] No matter what the commercial fate of this aircraft is, Boeing and the United States stand to lose. If the A3XX is a commercial failure, Airbus will not have to repay the cost of developing the plane. Even so, Boeing will lose sales, and the price it charges for the 747 will be cut in an effort to hold on to market share. If the A3XX is a success, Boeing loses market share and revenue, while Airbus is strengthened by the cash flow from the new aircraft.

Manipulation of regulations to support the European aviation industry

In 1999, the European Union adopted new regulations allegedly for the purpose of controlling the noise of older aircraft. However, these regulations had no direct effect on the noise level of older aircraft permitted to operate in Europe. They did, however, impose a significant cost to the U.S. aviation industry.[46]

These regulations, which were set to go into effect in May 2000, violated international understandings on how aircraft noise standards should be set. Contrary to the noise standards adopted by the International Civil Aviation Organization, the new EU regulations did not set maximum allowable noise levels. Rather, they created design standards that had no relation to the actual noise levels of the aircraft. No matter how quiet an aircraft might be, the regulations, in effect, prohibited older aircraft from being registered to operate in Europe even if they were made quieter by installing new, U.S.-made engines or if they were retrofitted with U.S.-made hushkits. The regulations disrupted the sale of billions of dollars in U.S.-made hushkits and replacement engines. And, while they also reduced the value of older aircraft in the U.S. fleet, the regulations were drawn in a highly discriminatory way that protected European airlines from any financial damage.

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[45] This estimate is based on the publicly reported cost of $12 billion to $15 billion needed to develop the A3XX jumbo jet, assuming that 30 percent of this amount is financed by the EU and member governments.

[46] Testimony by Ambassador David Aaron, Undersecretary for International Trade, U.S. Department of Commerce, September 9, 1999, before the Subcommittee on Aviation of the Committee on Transportation and Infrastructure, U.S. House of Representatives.

The United States is currently pursuing a case against the EU in the International Civil Aviation Organization in an effort to invalidate this new regulation.

No component is too small for a European subsidy

While European suppliers make up the bulk of all avionics equipment installed on Airbus Industries aircraft, a U.S. company – Honeywell – was retained as the supplier of the flight management system. In 1997, the French government, with the approval of the EU, announced that it was providing subsidized financing in the amount of 140 million French francs to a French company, Sextant Avionique. The subsidy was for the express purpose of developing a European flight management system supplier for Airbus aircraft to supplant Honeywell.[47]

In 1999, the United States began a formal WTO dispute settlement case against France under the WTO/General Agreement on Tariffs and Trade Agreement on Subsidies and Countervailing Measures. However, before the complaint could be prosecuted, Honeywell requested that the complaint be withdrawn. The reasons for this request are unclear. Meanwhile, at about the same time the dispute settlement case was begun, Honeywell announced that it was acquiring the Allied Signal Corporation. This proposed acquisition was the subject of an antitrust review by the European Union.

Conclusion

The use of government subsidies and industrial policies is a significant form of nontrade barrier that is facing U.S. producers. In efforts to promote their export sectors, many of our trading partners have subsidized domestic producers, leading to substantial overproduction of many goods on the world market by otherwise noncompetitive producers. Overcapacity abroad lowers the world price of these goods – this depresses exports by U.S. producers while leading to high levels of import penetration in the U.S. market. In the case of steel production, the dumping of subsidized Asian and European steel has greatly hurt U.S. producers despite high relative levels of efficiency in U.S. plants.

[47] Source: Letter from Ambassador Rita Hayes, Deputy U.S. Trade Representative, to Ambassador Roderick Abbott, permanent member of the Delegation of EU Commission to the WTO, May 21, 1999.

D. Globalization and the role of U.S. multinationals in moving technology, jobs, and engineering from the United States to low-wage countries

The role of intrafirm trade in manufactured goods

Manufactured goods make up the predominant share of U.S. and world trade and are the central focus in the competition among nations for world markets. The growing competition in manufactured goods has also been accompanied by intensifying competition for production locations. The spread of manufacturing has been made possible by declining transportation costs, advances in digital communications, and falling barriers to trade and investment. As a result, manufacturing now takes place in dozens of low-wage, developing countries with first-world manufacturing technology and management, that is a key part of the globalization process. The number one target of all these plants is the U.S. market. This global dispersion of manufacturing technologies and facilities has led to downward pressures on prices, costs, and wages in the United States (as we show in Chapter 3).

Multinationals from the United States, in particular, are also driving the process of globalization to new frontiers, and also new low points, roaming the globe in a relentless search to minimize their production costs. Many corporate managers are now reportedly ashamed to admit that they are involved in manufacturing at all – the goal of the corporate elite seems to be to out-source manufacturing, and also research and development, altogether.

U.S. multinationals have become almost stateless enterprises, free to move about from country to country as needed to avoid costly or undesirable regulatory constraints. They have little or no interest in maximizing the national interest of their many stakeholders (for example, workers, communities, the general public, or the government) in the United States. Their only interest lies in maximizing their firm's short-run bottom line and in furthering the massive increases in salaries, bonuses, and stock options that have accrued to corporate executives in the 1990s.

Interestingly, multinationals from other countries, especially those from Europe and Japan, are much more willing than U.S. firms to retain production, employment, and critical research and technology development activities in their home countries. For example, aerospace employment in France has reportedly increased sharply in recent years, as contrasted with the fall in aero-space employment in the United States. One difference is that French firms are expanding their supplier base at home while aerospace companies in the United States are actively attempting to move production abroad, especially to low-wage locations.

As a result of the increase in global manufacturing capabilities and the changing nature of companies, the supply chain of parts and components is also changing. Parts and components can

now be drawn from manufacturing facilities around the world. In addition, large, integrated companies that manufacture all or most of their parts and components no longer hold a cost advantage over their competitors. Global firms are divesting themselves of larger and larger portions of their manufacturing operations so that they may concentrate more on design, marketing, and other management functions and less on manufacturing operations. For example, aircraft and automobiles embody manufactured parts and components from thousands of suppliers located in virtually every part of the world.

Manufacturing firms in the United States and other developed countries have adopted various make-or-buy strategies to take advantage of global opportunities. First, they have invested in sales and production facilities in foreign countries, both to tap foreign markets and to provide lower-cost sources of supply for some parts, components, and products. Exports to and imports from these foreign affiliates are termed "intrafirm trade." In addition, there is an increasing tendency to utilize domestic or foreign contract manufacturers–that is, hiring other firms that specialize in certain kinds of manufacturing processes or product lines

Intrafirm trade–the trade between U. S. parents and their foreign affiliates and between foreign companies in the United States and their foreign parents–is a major portion of U.S. manufactures trade. U.S. multinational corporations (MNCs) generated 61.6 percent of total 1997 U.S. manufactured goods exports. (See Table 2.2, line 3). Over half (53.3 percent) of these MNCs' exports went to their foreign affiliate firms an amount equivalent to 32.8 percent of 1997 U.S. manufactures exports (line 4, share of line 3). Exports by U.S. MNCs to nonaffiliated foreign customers totaled 28.7 percent of U.S. manufactures exports (line 5).

Imports by U.S. multinational firms were 31.3 percent of U.S. 1997 manufactures imports (line 6). Almost two-thirds (65.7 percent) of those imports were from their foreign affiliates, an amount equivalent to 20.5 percent of 1997 U.S. manufactures imports (line 7, share of line 6).

The United States had a $136.1 billion 1997 surplus on the manufactures trade of its MNCs, including a $44.4 billion surplus on the trade of parents with their affiliates (Table 2.3, lines 9 and 10). Thus, on average, U.S. multinationals use their foreign subsidiaries (primarily in Europe and Japan) to assemble and distribute exports from their home plants in the United States. However, intrafirm trade by multinationals in industries, such as motor vehicles and electrical machinery (including computers) where most FDI is in assembly plants in low-wage countries (e.g. Mexico, China) demonstrate a negative trade balance, as shown in Table 2.3.

Table 2.2
Manufactures Exports of and Imports by Multinational Corporations Located in the United States, 1997

Line #		$ billion	% of Total
1	Total U.S. Manufactures Exports	591.2	100
2	Total U.S. Manufactures Imports	728.6	100
	Trade of U.S. MNCs		
3	Exports: Total by parent firms	364.1	61.6
4	To foreign affiliates	194.2	32.8
5	To other foreign destinations	169.9	28.7
6	Imports: Total by parent firms	228	31.3
7	From foreign affiliates	149.8	20.5
8	From other foreign sources	78.2	10.7
9	Balance: On trade by parent firms	136.1	
10	On trade with foreign affiliates	44.1	
11	On trade with other foreign parties	91.7	
	Trade of Foreign MNCs in the United States		
12	Exports: Total by foreign affiliate in the U.S.	103.4	17.5
13	To foreign parent	45.3	7.7
14	To other foreign destinations	57.9	9.8
15	Imports: Total by foreign affiliate in the U.S.	225.4	30.9
16	From foreign parent	175.9	24.1
17	From other foreign sources	49.4	6.8
18	Balance: On total trade by foreign affiliate in U.S.	-122	
19	On trade with foreign parent	-130.6	
20	On trade with other foreign destinations	8.5	
	Summary of Intrafirm Trade		
21	U.S. Manufactures Exports	591.2	100
22	By U.S. MNCs to foreign affiliates	194.20	32.8
23	By U.S. affiliates to foreign parents	45.3	7.7
24	Total Intrafirm exports	239.5	40.5
25	U.S. Manufactures Imports	728.6	100
26	By U.S. MNCs from foreign affiliates	149.8	20.5
27	By U.S. affiliates from foreign parents	175.9	24.1
28	Total Intrafirm Imports	325.7	44.6

Sources: Related Party Trade, U.S. Census Bureau and the U.S. Trade Deficit Review Commission, September 1999.

By contrast, the United States had a $122 billion deficit in 1997 manufactures trade of the U.S. affiliates of foreign MNCs (see Table 2.2, line 18). Manufactured goods exports of foreign firms in the United States totaled $103.4 billion, 17.5 percent of the U.S. total (line 12). Less than half (43.9 percent) of these affiliates' exports went to their foreign parents (line 13, share of line 12).

Imports of these foreign affiliates, however, totaled $225.4 billion, 30.9 percent of U.S. manufactures imports (line 15). Almost four-fifths of foreign affiliate imports, $175.9 billion, an amount equal to 24.1 percent of total manufactures imports, came from the foreign parents (line 16). Thus, foreign multinationals use the U.S. subsidiaries to distribute imports from the home country in the United States.

Table 2.2 also summarizes the intrafirm portions of manufactures trade. Intrafirm trade accounted for about 40.5 percent of 1997 U.S. exports (line 24); 32.8 percent from the exports of U.S. MNCs to their foreign affiliates, and 7.7 percent from the exports of foreign firms in the United States to their foreign parents (lines 22 and 23). Exports from U.S. MNCs are primarily destined for Japan and Europe.

Intrafirm trade accounted for a somewhat higher portion of U.S. imports, with the imports of U.S. firms from their foreign affiliates representing 20.5 percent of the total and the U.S. imports of foreign firms from their foreign affiliates at 24.1 percent of the total. A significant share of imports from foreign affiliates of U.S. MNCs is produced in low-wage countries.

The role of intrafirm trade varies widely among manufactures product groups but is large in some critical areas, as shown in Table 2.3. For example, in 1999 some 59.9 percent of road vehicles and parts (SITC 78) exports were to related parties and 82.0 percent of imports were from related parties. Intrafirm trade is probably most often thought of as exchanges of parts and components as inputs to further manufacturing or assembly operations. The importing related party in some cases, however, may be simply a wholesaler operation set up to distribute finished products; for example, vehicles imported to the United States from Mexico or Asia. Similarly, while some U.S. exports to related parties in these industries could be simply to U.S.-owned foreign sales and distribution facilities, the majority is apparently dominated by flows of parts to foreign assembly plants, whose products are then exported back to the United States (so-called "tourist exports").

Foreign processors and exporters may include, but are not limited to, the foreign affiliates of U.S. firms–contract manufacturers are responsible for a growing share of imports in industries such as apparel and electronics. Thus, the intrafirm trade data in Tables 2.2 and 2.3 substantially underestimate the total impact of MNCs on U.S. trade flows because trade with contract manufacturers is excluded from these tables. The proportion of U.S. exports of parts and components that returns to the United States in finished products or larger components and assemblies cannot be precisely quantified because there are no official data available quantifying the volume of imports from contract manufacturers in foreign countries. However, it is clearly large in some product groups, as shown in Table 2.3.

Table 2.3
Intrafirm Trade by Industry in 1999
(shares of related parties in U.S. exports and imports)

SITC		Percent of Total Trade Exports	Imports
71	Power generating machinery	37.1	53.1
74	General industrial machinery	27.0	46.9
75	Office machines & ADP Equipment	42.3	67.9
76	Telecommunications equipment	31.8	70.4
77	Electrical machinery & apparatus	43.7	63.4
78	Road vehicles & parts	59.9	82.0
79	Aircraft & parts	10.4	22.5
84	Apparel	18.1	15.6
85	Footwear	18.1	6.3

Sources: Related Party Trade, U.S. Census Bureau and the U.S. Trade Deficit Review Commission, September 1999.

For example, the $22.8 billion of 1999 U.S. motor vehicle parts and accessories exports to Canada and Mexico represented over three-fourths (77.6 percent) of U.S. exports of this product group. But most of it came back to the United States included in the $44.3 billion of finished vehicle imports from those two countries. This is clearly the case, since Canadian and Mexican production for their domestic markets is quite small, and they have no major export markets other than the United States. Similarly, most of the $8.9 billion of internal combustion engine exports to Canada and Mexico, 71.8 percent of the 1999 total (industrial detail is not shown in Table 3), returned to the United States included in finished vehicles. In large measure, U.S. exports of auto parts and engines to Mexico and Canada are thus determined by U.S. imports of finished vehicles from those countries.

Large portions of U.S. exports of electrical and electronic component parts to Canada, Mexico, and Asian developing countries are also destined to return to the United States in enhanced or finished manufactured goods. To illustrate, three-fourths of the $49.4 billion of 1999 U.S. exports of transistors, semiconductor devices, and electronic microcircuit exports went to Canada, Mexico, and several Asian developing countries. Together, these countries exported $47 billion of telecom equipment to the United States, 92.1 percent of total U.S. telecom imports, and $34.1 billion of computers, 71.6 percent of total U.S. computer imports. Clearly, there is a substantial cross-trade in electrical and electronic products in which U.S. exports are, to a substantial degree, a function of U.S. imports.

Anecdotal evidence also indicates rapid increases in the role of contract manufacturers in total trade, especially with low-wage countries, and especially in the industries discussed above.

Conclusions

The Commission was unable to precisely quantify the impact of the range of practices that go under the term globalization on the overall level of the U.S. deficit nor to agree on a series of recommendations to stabilize its contribution to the deficit to reasonable levels. We recommend that such estimates be done regularly and be widely understood. Regardless of the lack of precise overall data, it is clear that the sum total of discriminatory practices in low-wage countries—including the active suppression of wages and labor rights, lax environmental and worker safety standards, compulsory technology transfers, and offset requirements—have substantially increased the pace and costs of globalization.[48] Regardless of whether measures can be put into place to somehow reduce the deficit and these practices, the combination of massive new movements of facilities and capital overseas with the accelerating global debate over the qualitative effect of such practices needs to be addressed by all who espouse the cause of freer movements of trade and investment. Clearly, the size of "globalization" practices and their impacts on developing nations, on labor in all countries, on the standard of living of major sectors of all societies, and the quality of our physical environment demands attention by policymakers and all serious analysis of the future of world trading practices. Clearly, values well beyond the support for the free movement of goods and capital need to be addressed for such freedom to remain viable. This is partly recognized by the movement among some multinationals for some codes of conduct in their operations. It was reflected in the breakdown of the preparations for a new multilateral round in Seattle and in the protests that now take place at all major conferences of international financial institutions. The future viability of the WTO is clearly at stake.

Thus, we believe that the development of new standards of equity, of fair practices, protection of rights of workers, and the environment are essential for the process of globalization to continue. Globalization faces a test of legitimacy on an urgent basis, and we believe that governments, particularly the government of the United States, must now take a far stronger leadership role in developing and enforcing standards that reach a broad consensus of the many stakeholders in the international system.

This is a major reason why we believe that no new multilateral round of negotiations in the WTO will succeed, or should be attempted, without establishing priorities in the global agenda that address such standards for workers' rights and the environment, that opens the WTO process to preserve traditional juridical rights and processes for all parties to disputes, and that demonstrates that all major players in the global trade system governed by the WTO are honestly and actively complying with the agreements already negotiated.

Unless the process of globalization is humanized and managed, the growth of world trade will be affected negatively, with negative consequences for our overall balances and for a number of bilateral relationships. Without an improvement in the adoption and enforcement of core labor

[48] Examples of these effects are presented in the next section, in the discussion of competition with developing countries, and especially in the discussion of the "pacto" agreements in Mexico. See also Chapter 3 for further discussion of the consequences of trade with low-wage, developing countries.

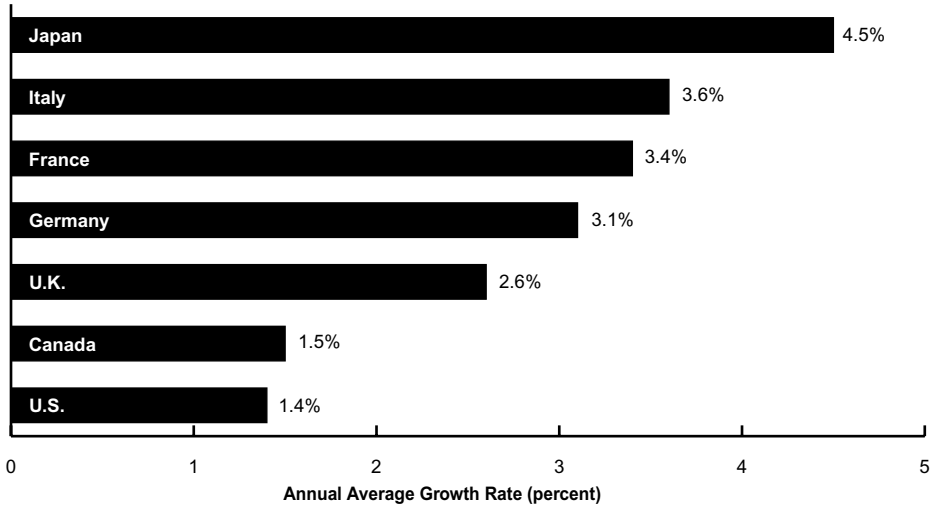
and environmental standards where these exist—which should be embodied in the WTO process and in the behavior of multinationals—dramatic downtrends in world trade are a growing possibility, with consequent effects on our trade balances not easy to predict. However, we do know that volatility in the system is likely to accelerate. All of this dramatically increases the probability of a hard landing for the U.S. economy.

E. Unequal trade relationships: Loss of competitive advantage by U.S. producers

Competition with developed countries

Another long-term cause of the trade deficit is the decline of competitive advantages by U.S. producers relative to our trading partners. From the 1960s through the 1980s, this loss of competitive advantage had its source in the technological catch-up of Western Europe and Japan, which moved toward U.S. levels of productivity. This type of catch-up by other industrialized countries has slowed down in recent years as a result of sluggish growth in Europe and Japan, a revival of productivity growth in the United States, and a renewed U.S. lead in high technology products. U.S. competitiveness problems with these countries has little or nothing to do with wages, as workers in these countries frequently earn more than their counterparts in the United States.

Figure 2.2
Productivity Growth Rates, 1960-98



Source: Lawrence Mishel, Jared Bernstein, and John Schmitt, "State of Working America: 2000-2001" (Advance Proofs). (Washington, DC: Economic Policy Institute, 2001). September 3, 2000, Figure 7A, p. 377. See also, Organization for Cooperation and Development, *Economic Outlook* (Paris, France: OECD,1999).

U.S. competitive problems with Western Europe and Japan are based, in part, on decades of poor productivity performance in the United States, as shown in Figure 2.2. The United States was among the poorest performers of the developed countries between 1960 and 1997. United States productivity grew less than one-third as rapidly in the United States as in Japan over this entire period, and less than half as rapidly as productivity growth in Germany. Productivity growth has accelerated somewhat in the past few years, averaging 2.6 percent per year in 1997, 2.9 percent in 1999, and nearly 4 percent per year through the first two quarters of 2000. However, many years of high productivity growth in the United States will be required to restore the competitiveness of domestic manufacturing facilities.[49] To address the loss of competitive advantage of U.S. producers, it is essential that trade-related policy should focus on productivity growth. The stronger the productivity growth in the U.S. economy, the more favorable will be the overall impact on the trade balance.

The cumulative result of almost four decades of low productivity growth is that the relative level of productivity in the United States is now below that in five countries in Western Europe: the former West Germany, France, Belgium, the Netherlands, and Norway, as shown in Table 2.4. Productivity levels are the ultimate driving force behind wage growth in most economies. Thus, low productivity levels in the United States are at least partially responsible for the low level of wages in the United States, relative to wages in many EU countries. Low productivity is a significant threat to both the competitiveness of U.S. firms and to the living standards of most Americans. Achieving a sustained boost in productivity will require major national investments in education, training, and apprentice programs for non-college-educated workers (such as those now in place in Germany); in public and privately funded research and development; and in support infrastructure for small businesses and regional development activities. These and other policies designed to increase manufacturing competitiveness will be discussed in Chapter 6.

[49] Although the United States has experienced very high rates of productivity growth in manufacturing in the 1990s, these growth rates apply only to that portion of output (value added) that is generated within that sector. Manufactured goods embody a growing share of services content, where productivity growth has been much slower (negligible or negative in some periods). Thus, the economy wide rate of productivity growth is a better indicator of the competitiveness of U.S. manufactured products, since the price of those products includes both manufacturing and service components.

Table 2.4
Relative productivity levels, 1960-97 (U.S. = 100)

Country	1960	1973	1987	1997
United States	**100**	**100**	**100**	**100**
Japan	21	45	58	68
Germany	—	—	—	88
West Germany*	52	69	84	101
France	54	73	96	102
Italy	40	64	78	88
United Kingdom	58	66	79	83
Canada	79	79	86	81
Australia	73	70	77	80
Austria	44	64	79	85
Belgium	49	68	89	107
Denmark	48	63	68	77
Finland	37	55	64	78
Ireland	31	42	59	90
Netherlands	58	77	95	101
New Zealand	—	—	—	58
Norway	48	56	76	106
Portugal	22	37	40	47
Spain	23	44	57	70
Sweden	58	73	78	78
Switzerland	71	76	76	78
Average excl U.S.	47	61	73	82

*Figure in column for 1997 refers to 1995.

Source: Lawrence Mishel, Jared Bernstein and John Schmitt, State of Working America: 2000-01 (Advance Proofs). (Washington, DC: Economic Policy Institute, September 3, 2000), Table 7.3, p. 375. See also, Conference Board, "Perspectives on a Global Economy: The Euro's Impact on European Labor Markets," Report Number 1236-99-RR (New York: The Conference Board, 1999).

Competition with developing countries

In recent years, our trade posture has faced competition on another front: the rise of newly industrializing countries such as Korea, China, and Mexico. These newly industrialized countries, while not yet near U.S. levels of productivity, have become capable of producing a wide range of increasingly sophisticated manufactured products using workers paid much lower wages than U.S. workers. The combination of rising productivity and low wages in these countries has resulted in considerably lower unit labor costs (that is, labor cost per unit of production) that have undermined the competitiveness of U.S. producers.

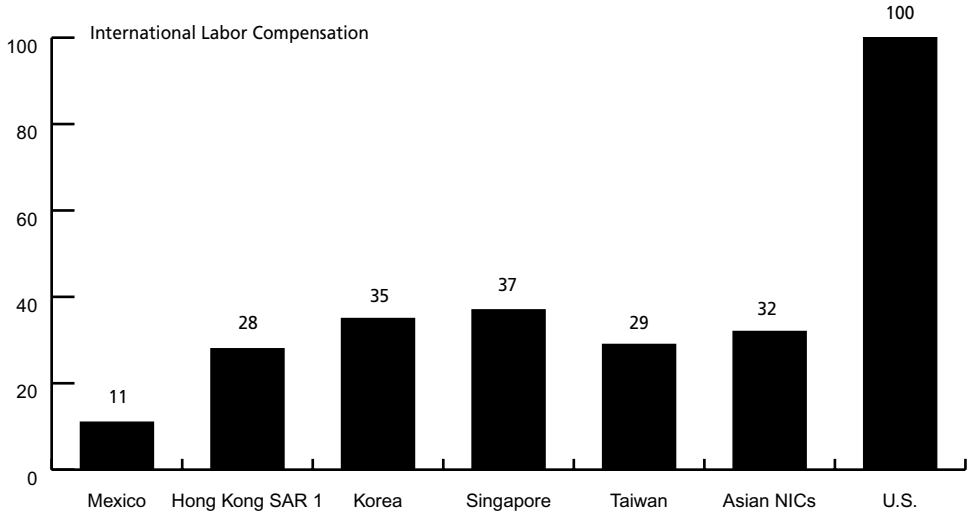
In 1999, hourly wages and benefits were 11 percent of the U.S. level in Mexico and 32 percent of the U.S. level in the East Asian newly industrializing countries for which data were available (Hong Kong, Korea, Singapore, and Taiwan), according to the U.S. Bureau of Labor Statistics (see Figure 2.3). Wages and benefits were undoubtedly even lower in this period and for the past several decades in poorer countries for which data are not available, such as China, Malaysia, and the Dominican Republic.

Foreign direct investment by U.S. MNCs in developing countries allows them to utilize cheap labor and to directly combine it with U.S. technology, U.S. engineers, and U.S. managers. The plants are often identical with those in the United States except for wages and foreign direct labor. U.S. health and safety standards are often ignored, as well, lowering costs for MNCs, often with terrible consequences for workers in these countries.

Domestic wages are held down in countries like Mexico, China, and the East Asian newly industrializing countries by a variety of factors. These include the backwardness of the rest of the economy, a lack of effective labor rights and standards, the outright repression of labor organizing efforts in some cases, and the use by export sector employers of young women workers who often possess low bargaining power in these societies.

These countries often fail to enforce their labor and environmental laws and observe internationally recognized labor standards. Problems in the enforcement of labor rights are illustrated by the following case study of Mexico's experiences under the “pacto” system. Mexico also has a number of terrible environmental problems, particularly in the maquiladora export-processing zone along its border with the United States.[50]

Figure 2.3
Wages and Benefits in U.S. and Trading Partner Economies in 1999



Source: OECD Economic Outlook. http://www.imf.org/external/pubs/ft/weo/2000/02/index.htm.

[50] Confirmed by Commissioner Wessel, based on observances during his visits to numerous communities and manufacturing plants in this region.

Mexico case: The pacto experience

In a free society, wages reflect the value of what workers produce. An important element in assuring fair wages is the right of workers to associate in free and independent unions and bargain collectively. Without the freedom to associate in unions and bargain collectively, wages of workers can be, and often are, unfairly suppressed. In the case of Mexico, the historically authoritarian Mexican government has used its power over the past decade and a half to lower dramatically the real wages of Mexican workers in an effort to reduce inflation and attract foreign investment in search of low-wage workers. This fall in real Mexican wages has taken place despite the presence of a large national labor union and federal laws that nominally provide extensive legal protections to workers.

Beginning in 1987, when inflation hit 160 percent, the Mexican government instituted the Pact of Economic Solidarity ("pacto"). Through a series of "pactos," annual wage and price agreements were worked out between representatives of government, labor, and the private sector. The result of both this government intervention and the financial crisis of 1994-95 was a dramatic decline in inflation-adjusted Mexican wages over much of the past two decades. According to a December 1997 study by the National Autonomous University of Mexico, in the decade 1987 to 1997, workers' real wages fell more than 73 percent. That same study reported that a worker in 1987 needed to work eight and a half hours to buy the weekly basic food basket. By 1997, a worker needed to work 32-1/2 hours to buy the same amount of food. This plunge in real wages took place despite large foreign investment and rising productivity.[51]

Another indication of the suppression of Mexican wages is the share of national income going to worker wages and benefits. In the United States, compensation of employees, including wages and benefits, comes to around 72 percent of national income. In Mexico, the comparable figure for returns to labor is less than 30 percent. The rest goes to returns to capital, depreciation, and indirect taxes.[52]

The Mexican government strategy has been a success if measured by Mexico's ability to attract foreign investment. Low wages have made Mexico an attractive destination for manufacturing production. Billions of dollars of foreign investment have flowed into Mexico. And there is no reason to expect the trend to stop soon. This past year, the pressures and the attraction of Mexico were pointed out in a Business Week article.

> *In a new, super aggressive round of cost-cutting, the company (GE) is now demanding deep price cuts from its suppliers. To help them meet the stiff goals, several of GE's business units – including aircraft engines, power systems, and industrial systems – have been prodding suppliers to move to low-cost Mexico, where the industrial giant already employs 30,000 people. GE even puts on "supplier migration" conferences to help them make the leap.*[53]

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[51] Bierma Paige, "Work in Progress: Mexican Labor Marches into a New Millennium," Business Mexico, American Chamber of Commerce of Mexico (February 1998).
[52] Sidney Weintraub, "Time to Rethink Who Does the Sacrificing in Mexico," Houston Chronicle, January 13, 1998.
[53] Aaron Bernstein, "Welch's March to the South," Business Week, December 6, 1999.

A supplier to GE Aircraft Engines summed up GE's message to the companies attending a supplier meeting.

> *"Migrate or be out of business; not a matter of if, just when. This is not a seminar just to provide information. We expect you to move and move quickly."* [54]

The deliberate suppression of Mexican wages has hurt U.S. workers in two important ways. First, the low Mexican wages orchestrated by government intervention have made Mexico a magnet for U.S. manufacturing jobs. Simply put, Mexico has been able to steal hundreds of thousands of good U.S. manufacturing jobs because of the ability of U.S. companies to move production to Mexico and combine modern capital, technology, and management with artificially low-wage workers. Second, the impoverishment of Mexico's workers means that the Mexican working class has not been able to achieve the middle-class income level that would have enabled it to become a significant market for U.S. exports.

Currency manipulation: Beggar-thy-neighbor policies

Some of the largest U.S. trading partners have consistently used exchange rate policies to keep the value of the dollar high in international markets. By carrying out large-scale, official purchases of dollars, the drop in the dollar's value that should generally occur to make U.S. exports cheaper and imports to the United States more expensive does not happen.

Exchange rate manipulations by the monetary authorities in many countries have often been used to undervalue the local currency, which makes labor costs artificially low in dollar terms. In Asia, where this problem is most severe, the Asian NICs (i.e., Asia excluding Japan) combined accounted for 43.9 percent of the U.S. trade deficit in 1999 [as shown in Table 2.1, p. 52]. China alone was responsible for more than one-fifth of the U.S. trade deficit. In addition, Japan, which has also frequently intervened to manage the value of its currency, was responsible alone for more than 22.3 percent of the total U.S. trade deficit in 1999.

Simple evidence of persistent intervention by Japan and China can be obtained by comparing trends in their reserve holdings with those of the United States. Between 1989 and 1997, Japan's holdings of international reserves (excluding gold) increased by 162 percent, while its real GDP grew only 18 percent (in total). Thus, its ratio of reserves to GDP increased by 122 percent, more than double. China's reserve holdings exploded in this period, increasing almost seven-fold (695 percent), while its real GDP expanded by 118 percent. Thus, its reserve/GDP ratio increased by a factor of more than two and a half (269 percent). In the same period U.S. reserves actually fell, and the reserve/GDP ratio declined by more than one-fifth (22 percent) in this country.[55] In an era when the proliferation of electronic transfers and transactions has exploded and private currency markets have deepened, the need for advanced countries like the United States and China to hold currency reserves has declined significantly. Given these

[54] Ibid.
[55] International Monetary Fund, International Financial Statistics, (Washington, DC: IMF, 1998).

facts, it is clear that both China and Japan have acquired excess national currency reserves. This is obvious evidence of efforts to manipulate their currencies for competitive advantage.

In order to address these problems, it is essential that the United States should enforce the provisions of the 1988 Trade Act by pursuing negotiations where there is evidence of exchange rate intervention, especially when countries purchase excessive amounts of dollars in attempts to keep the value of the dollar high, which helps to artificially depress the relative dollar value of the wages of their workers.[56] On at least three occasions between 1988 and 1992, the U.S. Department of the Treasury used its authority to identify countries that had developed global current account surpluses by artificially depressing the value of their currency. In two of these three cases (involving Korea and Taiwan), the Treasury Department successfully negotiated with these countries, and they subsequently allowed their currencies to appreciate.

For example, in October 1988, the Treasury noted in its biannual report to Congress that "Taiwan's external position has been the most distorted of the four NIEs" (newly industrializing economies). "In addition, its foreign exchange reserves climbed by 66 percent from 1986 to 1987." Furthermore, Taiwan had accumulated a global trade surplus of $20.7 billion, of which $17.4 billion was with the United States, alone." The Treasury stated that it would enter into expedited negotiations with Taiwan "for the purpose of ensuring that Taiwan regularly and promptly adjusts the rate of exchange between the NT dollar and the U.S. dollar" in order to reduce the trade deficit and "eliminate the unfair trade advantage."[57]

The Treasury continued to negotiate with Taiwan for the next two years and finally downgraded its warning from a "negotiation status" to a posture in which the Treasury would "monitor and encourage authorities to liberalize exchange controls." Taiwan's trade surplus did begin to decline in this period, and there was "no evidence of direct exchange rate 'manipulation'."[58] Thus, the negotiations were at least partially successful in the case of Taiwan.

The Treasury Department also initiated negotiations about currency manipulation with Korea in 1988 and with China in May 1992.[59] The negotiations with Korea ultimately resulted in the elimination of capital controls by that country. While this ultimately resulted in a substantial appreciation of the Korean won, it also undermined the stability of the Korean financial system.[60] Negotiations with China were unsuccessful, as China ultimately carried out a major devaluation of its currency in 1994, as noted above.

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[56] 1998 Trade Act: Public Law 100-418 test—August 23, 1988, Title III—International Financial Policy, Subtitle A—Exchange Rates and International Economic Coordination. This measure requires the Secretary of the Treasury to "analyze on an annual basis the exchange rate policies of foreign countries…and consider whether countries manipulate" their exchange rates. If manipulation is found, the Secretary is required to enter into negotiations with countries that are intervening if they have global current account surpluses and significant bilateral surpluses with the United States.

[57] Department of the Treasury, "Report to the Congress on International Economic and Exchange Rate Policy," (Washington, D.C.: Department of The Treasury, October 15, 1988), pp. 16-17.

[58] Department of the Treasury, "Report to the Congress on International Economic and Exchange Rate Policy," (Washington, D.C.: Department of The Treasury, November 1990), p. 27.

[59] Korea's currency manipulation was noted in the Department of the Treasury's report of October 15, 1988, (op cit.) p. 19. The May 1992 Treasury report stated that China was also manipulating its currency in order to build up "external payments surpluses" and noted that negotiations with China on this issue were launched in the summer of 1991. Department of the Treasury, "Report to the Congress on International Economic and Exchange Rate Policy," (Washington, D.C.: Department of the Treasury, May 1992), pp. 32-33.

[60] See Robert A. Blecker, Taming Global Finance (Washington, D.C.: Economic Policy Institute, 1999).

Since 1992, the Treasury Department has not found a single country guilty of "manipulating its exchange rate." We believe that it is essential for the Treasury to rejuvenate the use of its bi-annual reports to the Congress on International Economic and Exchange Rate Policies to actively identify, and to initiate negotiations with, countries that are engaging in currency manipulation.

F. The macroeconomic accounting identity as an explanation of the trade deficit

Some economists have argued that trade barriers and competitiveness problems cannot possibly account for the long-term trend toward trade deficits, because the trade balance will always be equal to the gap between a nation's savings and investment (Exports – Imports = National Savings – Domestic Investment) as implied by the national income accounts. In the extreme version of this argument, it is always a shortfall of national savings relative to domestic investment that is to blame for trade deficits. (See Box 2.2 for a brief analysis of the national income account identity, including the trade/savings-investment gap relationship.) It is important to address this view, because we believe this explanation leads to the mistaken conclusion that trade, exchange rate, and competitiveness policies can have no effect on the size of the U.S. trade deficit.

The macroeconomic accounting identity between the trade balance and the savings-investment gap is merely an identity that is true by definition–it does not prove anything about the direction of causation. The "savings shortfall" arguments falsely presume that causality has to flow from the savings variable to the trade balance. In fact, there are a number of other possibilities.

Causality may flow from the trade deficit to a lower level of savings. For example, as persistent and large trade deficits depress earnings for workers and firms in the United States, saving falls along with household incomes and corporate revenues. It is important to note in this context that, in the spring of 2000, the corporate sector was generating almost all private savings, since household savings were insignificant.[61]

[61] In the second quarter of 2000, personal savings were 0.3 percent of personal income. BEA, Gross Domestic Product News Release (BEA 00-29), Table 9. http://www.bea.doc.gov/bea/newsrel/gdp200f.htm.

Box 2.2

The Balance of Payments Deficit as Deficient National Savings

The Gross National Product (Y) is defined as personal consumption (C) plus government consumption (G) plus investment (I) plus the current balance of payments (BP)–that is, exports of goods and services less imports of goods and plus net interest and other property income paid abroad*

1) $Y = C + G + I + BP$

This equation may usefully turned around so as to make it a definition of the balance of payments

2) $BP = Y - [C + G + I]$

Equation 2) says that the current balance of payments is equal by definition to the difference between national income and national expenditure–the nation's "absorption" of goods and services. If income exceeds absorption, there is a balance of payments surplus; if absorption exceeds income, then there is a balance of payments deficit.

This way of looking at the balance of payments has some interest and importance. It tells us that the present deficit, which is equal to 4.3% of GNP, means that U.S. residents are absorbing goods and services that are 4.3% larger than their collective incomes. It also partly explains the current mood of euphoria, because the recent growth in consumption and investment has substantially exceeded the growth of output, which has itself been unusually large.

But the equation gives no useful guidance about what could be done to reduce the deficit because a reduction in domestic expenditure will have its main effect on domestic output Y in the equation and only a secondary effect on the balance of payments. To eliminate a deficit equal to 4.5% of GDP by reducing income would probably require a 15% reduction in domestic output and a rise of perhaps 7 percentage points in unemployment.

There is little to be gained–since nothing of any significance at all is changed—by simply ordering the brackets in equation 2) in a different way, namely:

3) $BP = [Y - C - G] - I$

Since the expression in brackets in equation 3) is equal to national saving (since it describes national income less national consumption), equation 3) enables us to say, if we must, that the current balance of payments is equal to saving less investment. But this rearrangement doesn't advance our knowledge or understanding much, if at all. In particular we cannot infer, any more than we could from equation 2), that an increase in the nation's saving will improve the balance of payments other than by reducing total demand and output.

For certain purposes, there is some insight to be gained from separating government's operations from those of the private sector. This can be done, starting with equation 2), by subtracting taxes net of government transfers (T) from the private sector, and simultaneously including them as government receipts.

4) $BP = (Y - T - C - I) + (T - G)$

The first bracketed term on the right hand side of equation 4) describes the financial surplus of the private sector as a whole, that is, the excess of private disposable income over total private expenditure; the second term on the right hand side describes the government's overall surplus or deficit. Equation 4) emphasizes that if the private sector is in surplus or balanced, a payments deficit can only occur if there is a budget deficit–as happened during the twin deficits period of the 1980s. The equation in this form implies that if the external deficit were to go on rising, the budget would eventually move toward a deficit unless the net savings of the private sector–already at historic lows continues to fall indefinitely.

To improve the U.S. balance of payments without cutting output, some way must be found either to increase exports or to reduce the proportion of domestic income taken by imports.

* This statement is true to a high level of approximation. In fact, the balance of payments also includes small unilateral, international transfers (net) that are not part of the national income, and net income from abroad also includes small sums for compensation of employees, which are not "income from investments."

If, for example, U.S. exports were to increase through a reduction of trade barriers in other countries or an increase in the competitiveness of U.S. producers, the improvement in the trade balance would boost incomes of U.S. exporters and generate higher national savings. Thus, trade barriers and competitiveness problems can affect the trade balance, precisely because they can also influence national savings.

There could also be common factors causing both an improvement in the trade balance and a rise in national savings to occur together. For instance, a rise in the productivity of U.S. industries will make U.S. goods more competitive at home and abroad (improving the trade balance) while raising corporate profits that will generate more corporate savings.

There is another aspect of the national accounting identity that has often been ignored in discussions of the trade balance but that is key to recent U.S. experience. The trade balance is not only equal to the saving-investment gap according to the accounting identity, but it is also equal to net foreign investment (the increase in U.S. ownership of foreign assets minus the increase in foreign ownership of U.S. assets). This aspect of the accounting identity is shown below:

Exports - Imports = National Saving – National Investment
Exports - Imports = Net Foreign Investment (net capital outflows or inflows)

This relationship suggests that net foreign investment (that is, international capital flows) could be the dominant causal factor affecting the trade balance and the saving-investment gap. In recent years, a massive inflow of private capital into the United States from abroad has accompanied the steep rise in the U.S. trade deficit. These capital inflows have led to an appreciation of the dollar, which expanded the trade deficit by depressing exports and encouraging imports.[62] At the same time, large capital inflows financed higher levels of national investment than could be financed just by national savings, causing the national saving – national investment gap to widen. This inflow of foreign capital also fueled a boom in consumer spending, which depressed personal savings. The stock market boom, which has been financed in part by huge inflows of foreign funds, has boosted consumer spending in recent years and depressed personal savings. While a rising stock market is good for investors and for the economy, excessive swings in stock prices increase the risk of a catastrophic collapse in equity values. For example, a massive bubble in land and stock prices built up in the Japanese economy in the late 1980s, when many thought that country was about to dominate the world economy. Land and stock prices in Japan fell 50 percent in the early 1990s and have not recovered. That country remains mired in stagnation and recession that has eliminated growth for the past decade.

The role of international financial flows in causing the trade deficit is discussed further in the section on short-term causes below. While a low rate of savings plays a role in the U.S. trade deficit, it is certainly not the whole story. In fact, trade barriers and competitiveness problems are major causes of the trade deficit as well as key influences on national savings for the United States. Policies to address these two problems are needed to reverse the long-term trend of increasing

[62] There are many causes of the recent appreciation in the U.S. dollar. Furthermore, the U.S. currency experience is different from the history of crises in many ways. However, most countries that experience a currency crisis enter it with a significantly overvalued currency.

trade deficits for the United States. Additional views on the relationship between corporate investment and retained earnings are discussed in Chapter 4 (Sustainability of the U.S. Trade Deficit).

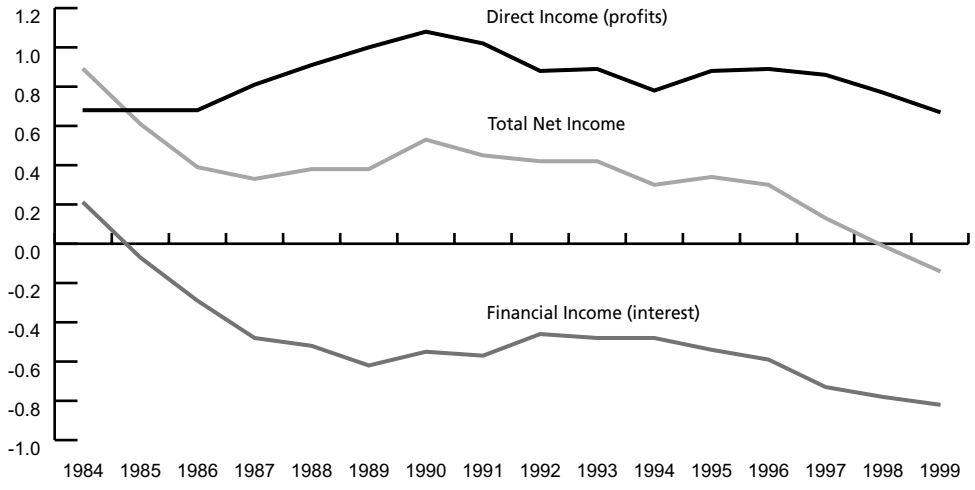
In conclusion, inducing a recession in the United States or devaluing the dollar could close the gap between savings and investment, but each such action could likely result in a hard landing for both the U.S. economy and the dollar. Additionally, these policies would reduce incomes, raise unemployment, and have their greatest impacts on the poor and production workers; those who can least afford such disruptions to their lives.

What is needed, instead, is a set of policies designed to rebuild the U.S. manufacturing base and restore its competitiveness in the global economy. Policies that can be used to achieve this worthy goal are outlined in Chapter 6.

G. Increasing foreign debt and the current account deficit

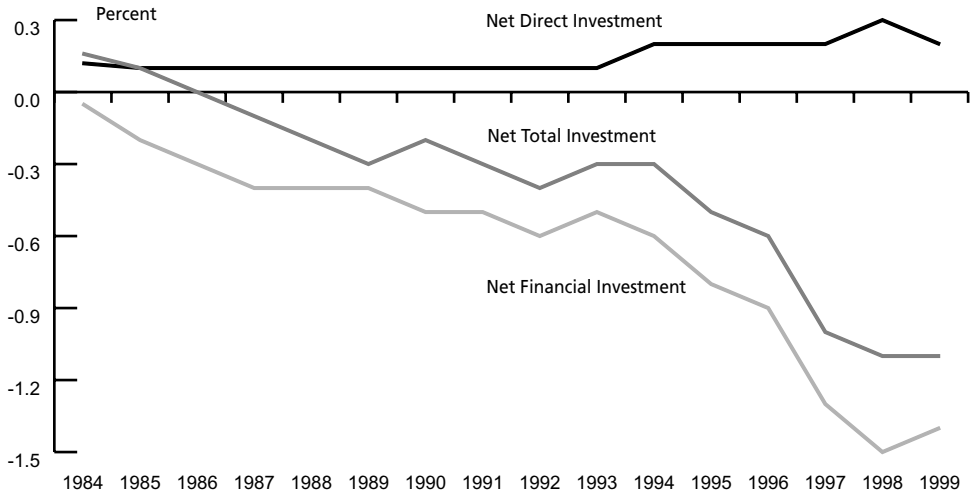
The U.S. net international debt reached a record of nearly 16 percent of U.S. GDP ($1.5 trillion) in 1999 as a result of years of large trade deficits financed by foreign lending (see Figure 2.5). The net outflow of interest payments required to service the growing U.S. international debt adds to the current account deficit. This net outflow of interest payments to service our net international debt added an amount equal to 0.8 percent of GDP ($76 billion) to the U.S. current account deficit in 1999 (see Figure 2.4) This was partially offset by U.S. Direct Income from FDI and other forms of property (see Figure 2.4, direct income and total net income). However, the U.S. deficit in net interest payments will rapidly outstrip direct income in the future, as shown in Chapter 4.

Figure 2.4
U.S. Net International Investment Income, 1984-99
(as a share of GDP)*



* Total net income = Direct income (profits) + Financial income (interest)
Source: Economic Policy Institute calculations and U.S. Department of Commerce, Bureau of Economic Analysis
http://www.bea.doc.gov/

Figure 2.5
U.S. Net International Investment Position, 1984-99
(as a share of GDP)*



* Total investment = Net direct investment + Net financial investment
Source: Economic Policy Institute calculations and U.S. Department of Commerce, Bureau of Economic Analysis
http://www.bea.doc.gov/

U.S. international debt has now risen to a point where the net outflow of interest payments is likely to become a significant (and rapidly growing) addition to the current account deficit for the foreseeable future. The net outflow of interest payments is projected to reach $150 billion to $200 billion a year by 2005. (See Chapter 4—Democratic Commissioner's Views.)

Since a current account deficit has to be financed by international borrowing that adds to net foreign debt and so to increased outflows of interest payments, a vicious cycle of self-perpetuating, worsening current account deficits can develop. Measures to reduce our trade deficit and contain the increase in our foreign debt are necessary to avoid this vicious cycle of larger deficits and growing debts.

III. Short-run factors behind the sharp rise in the trade deficit in recent years

A. Higher oil prices in 2000

The worldwide increase in the price of crude oil has significantly increased the U.S. trade deficit in 2000. Between January and July 1999, the average cost of crude petroleum imported into the United States was $12.57 per barrel. In the first seven months of 2000, this figure jumped to $25.43/ per barrel (an increase of 102 percent), and reached $27.76 per barrel in July.[63]

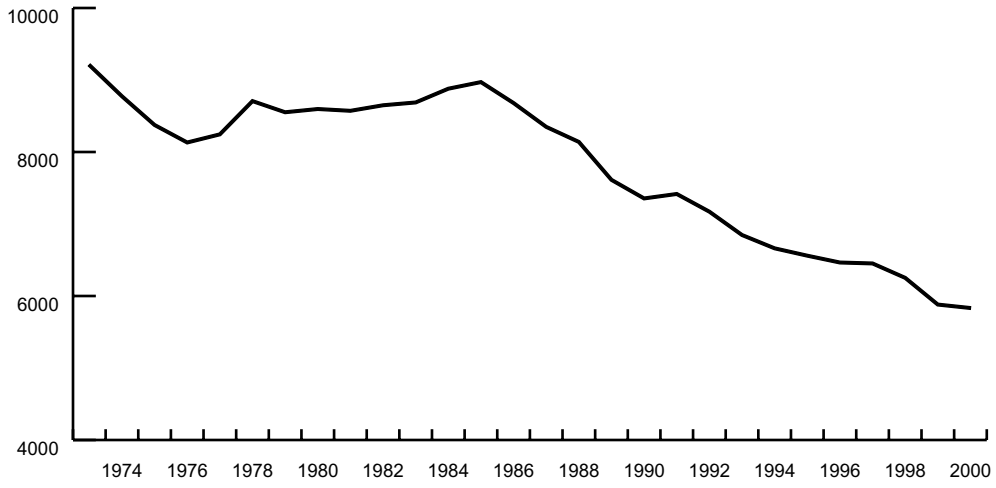
The U.S. trade deficit in petroleum products was $59.2 billion in 1999 (full year). In 2000, the

[63] Bureau of the Census, Foreign Trade Division, Report FT900 (CB-00-149), (July 2000), exhibit 17. http://www.census.gov/foreign-trade/www/press.html.

U.S. deficit in this sector could reach $122 billion, if present trends continue.[64] The total U.S. goods trade deficit was $345.6 billion in 1999 and is expected to reach $467.7 billion in 2000 at the present rate.[65] If these forecasts are correct, then higher oil prices will be responsible for about 56 percent of the increase in the trade deficit in 2000. The non-oil deficit in goods trade is also expected to increase by an additional $54 billion.

U.S. oil production has declined steadily for the past 27 years, as shown in Figure 2.6. No matter what happens to oil prices in the future, U.S. production in barrels is expected to decline, and this part of the deficit is going to get larger. This means that the United States needs to develop a growing surplus in some other sector, probably in manufactured goods.[66]

Figure 2.6
U.S. Crude Oil Production, 1973-2000*
(thousand barrels per day)



* Preliminary estimate, eight-month average
Source: U.S. Department of energy, Energy Information administration, "U.S. Crude Oil Exploration and Production"
http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/petroleum_supply_monthly/currrent/txt/table_s02_a.txt

B. The rising value of the dollar

The real appreciation of the dollar explains why U.S. products suddenly became so uncompetitive in price terms both at home and abroad beginning in the mid-1990s. After trending downward from 1990 to mid-1995, the dollar began to rise in value between mid-1995 and mid-1997 and then accelerated its ascent following the Asian crisis in mid-1997 (see Figure 2.7). The real dollar has appreciated 23 percent since 1995. Although the dollar has shown signs of stabilizing in 2000, it has not returned to the levels of the mid-1990s at which U.S. products were more price-competitive.

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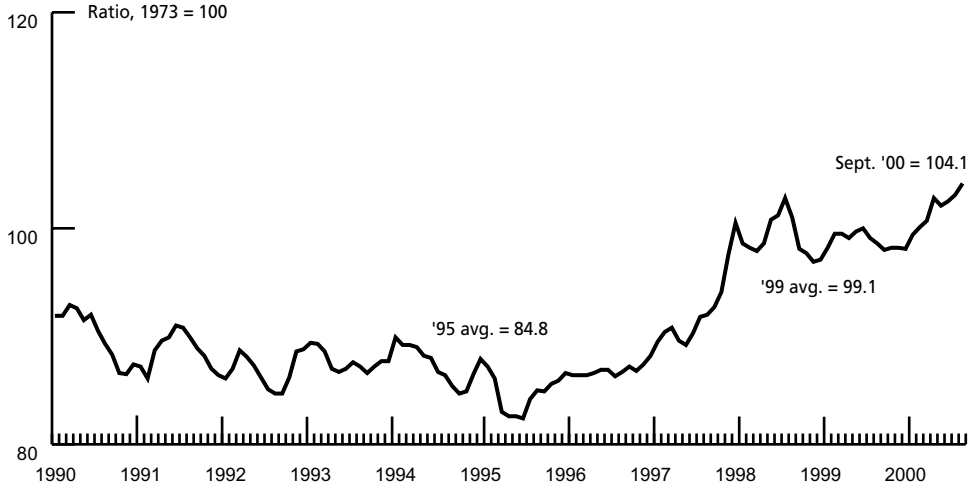
[64] Bureau of the Census, Foreign Trade Division, Report FT900 (CB-00-149), (July 2000), exhibit 9. http://www.census.gov/foreign-trade/www/press.html.
[65] Sources: Bureau of the Census, Foreign Trade Division, Report FT900 (CB-00-149), (July 2000), exhibit 1. http://www.census.gov/foreign-trade/www/press.html. And Economic Policy Institute calculations.
[66] The relationship between oil, manufactures, and other traded goods is discussed in Chapter 3. See Figure 3.3 and related text.

Figure 2.7
U.S. Real Exchange Rate Federal Reserve Board's Broad Dollar Index, 1990 to September 2000



Source: Federal Reserve Board, Summary Measures of the Foreign Exchange Value of the Dollar, http://www.bog.frb.fed.us/releases/H10/Summary/indexbc_m.txt

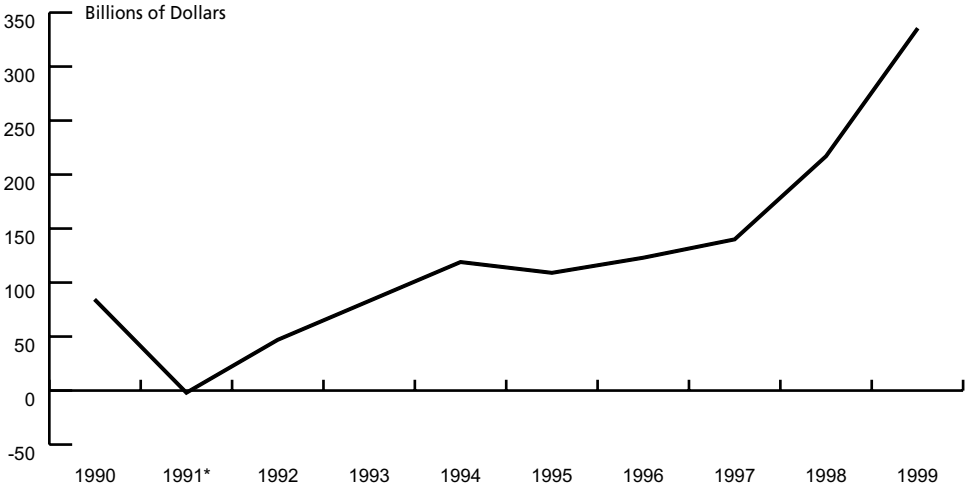
The result is that U.S. producers find it very hard to compete, no matter how advanced their technology or how productive their labor, when the dollar's rise has made their products 23 percent more expensive relative to other countries' products over the past four years.

Enormous capital inflows (foreign investment in the United States) were largely responsible for pushing up the value of the dollar and causing sharply rising current account deficits between 1995 and 1999. Annual net capital inflows soared from $100 billion to $150 billion per year in the period 1993-96 to more than $300 billion in 1999 (see Figure 2.8). Financial and economic instability abroad following the Asian crisis in 1997 motivated much of the flight of foreign investors to the U.S. economy in the 1997-99 period.

C. Slowdown in other countries' growth rates relative to the U.S. economy

The third short-term factor in causing the recent rise in the U.S. trade deficit is the slowdown in other countries' growth rates combined with the continued robust expansion in the United States.

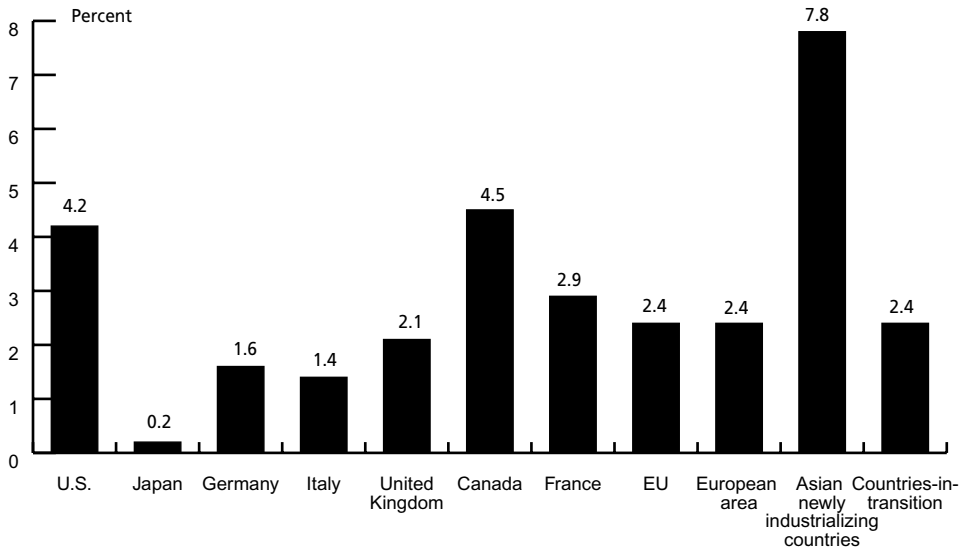
Figure 2.8
U.S. Net Capital Inflows, 1990-1999 (Net Capital Account)



* Affected by Gulf War payments
Source: Bureau of Economic Analysis, "Balance of Payments (BOP) and Related Data," Table 1 of the International Transactions Accounts (as of September 13, 2000)." http://www.bea.doc.gov/bea/di1.htm

Most major U.S. export markets are growing sluggishly at best in most developing and industrialized countries (see Figure 2.9). The rise in the U.S. trade deficit in the last two years has been driven more by sluggish export growth than by accelerated imports, suggesting that slow growth and recessions abroad are playing a key role in the most recent worsening of the trade balance.

Figure 2.9
Growth Rates of Real GDP in U.S. and Trading Partner Economies, 1999



Source: OECD 2000, *OECD Economic Outlook*, http://www.imf.org/external/pubs/ft/weo/2000/02/index.htm

With slow growth and recession in the economies of our trading partners, there is an incentive for some producers in these countries to dump goods in the U.S. market that cannot be sold in their countries, where demand is depressed. This is especially true for foreign producers in industries with capital-intensive production, such as steel, that depend on running plants at full capacity to maintain profitability.

By pushing unnecessarily harsh austerity policies on developing countries that had currency crises (such as Brazil and Korea), the U.S. Treasury and the International Monetary Fund have contributed to the shrinkage of our export markets.

By failing to stimulate their own economies, both the Europeans and the Japanese have contributed to the massive global trade imbalances. These failures in economic policy have been the result of sacrificing domestic growth in the name of fiscal rectitude and the unwillingness to carry out politically difficult but necessary structural reforms.

IV. Summary

U.S. trade and current account deficits have grown, and at an increasing rate, since the late 1960s and early 1970s. The secular growth of these deficits is the cumulative result of long-run, underlying structural problems in the U.S. economy and the world trading system. One of the most important of these structural problems is the persistence of unequal relationships, which causes U.S. imports to grow more rapidly than U.S. exports when U.S. growth is the same as our trade partners. These unequal relationships reflect, in turn, persistent differences in market openness in many countries, especially Japan, China, and to some extent the EU. The process of globalization and especially the movement of manufacturing plants to low-wage locations in developing countries have also steadily increased the U.S. trade deficit. In addition, U.S. manufacturers have become less competitive with the rest of the world due to low levels of U.S. productivity growth, and to the repression of labor rights and wages in developing countries. Finally, the rapid growth of U.S. net foreign debt, needed to finance cumulative U.S. trade deficits, is itself adding to the current account deficit, as interest payments and profits are returned to foreign lenders and investors. The costs of carrying foreign debt will be a much more important contributor to the deficit in the future. In analyzing the causes of the trade deficit, the imbalance between saving and investment is the least useful explanatory factor, because all of the factors discussed above contribute to the deficit, and because the savings investment discussion contains little useful policy content beyond the desirable general goal of increasing U.S. savings. The question that remains is how can we increase savings in ways that help reduce the trade deficit.

There is also a cyclical component to the deficit. The current account deficit tends to grow during U.S. booms (e.g., 1987 and 1999) and to shrink during recessions (e.g., 1981 and 1991), as shown in Figure 2.1. The important causes of the most recent cyclical surge included increases

in oil prices, a 23 percent appreciation in the real value of the U.S. dollar, and slow rates of growth in our major trading partners.

Policies designed to address the structural and cyclical causes of U.S. trade deficits will be proposed in Chapter 6. Most of these will focus on the need to address the long-run causes of the trade deficit. The most important are policies designed to rebuild the U.S. manufacturing base and address its fundamental competitive problems. U.S. multinationals will not bring production back to this country, even if the dollar falls and growth accelerates abroad, unless the competitiveness of domestic manufacturers is increased and their productive capacity is substantially expanded. There is little that can be done about short-run problems, such as the recent rise in oil prices, or slow growth in other economies. Chapter 6 will spell out a series of measures that can be taken to reduce chronic U.S. trade deficits and their destructive impacts on the economy.