Republican Commissioners' Views

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

The recent large U.S. trade and current account deficits are fundamentally macroeconomic phenomena. They are the consequence of macroeconomic policy and performance in the United States and our trading partners and result from the strong economic performance of the United States and the relatively slower growth of our trading partners. As Paul Volcker, former Chairman of the Board of Governors of the Federal Reserve System, testified before the Commission:

> *…the growth of the United States in combination with the sluggishness elsewhere has been a key factor and the dominating factor in the rising current account deficit.*[1]

Furthermore, as Nobel Laureate Professor Milton Friedman testified before the Commission:

> *The remarkable performance of the United States economy in the past few years would have been impossible without the inflow of foreign capital, which is a mirror image of large balance of payments deficits.* [2]

Overview

The magnitude of a nation's imports and exports is largely determined by that nation's income, the incomes of its major trading partners, and the exchange rate of its national currency. Rising domestic incomes cause imports to increase. Similarly, rising incomes in trading partners will lead to increased exports to them. Changes in exchange rates—the price of a nation's currency in terms of another currency—change the relative prices of imports and exports, at least over time, which in turn affect imports and exports. These variables provide most of the explanation for the U.S. trade and current account deficits.

The United States enjoyed the longest sustained economic expansion in its history during the 1990s. The increase in U.S. income during the expansion led to rising imports. Imports, in fact, grew faster than income. This pattern has been consistently observed over the entire post-World War II period.

During the 1990s, many of our trading partners experienced much slower growth. Japan, notably, suffered economic stagnation and recession during most of the decade. The East Asian financial crisis that began in 1997 further decreased the incomes of some of our trading partners. The

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[1] Hearing of the U.S. Trade Deficit Review Commission, March 13, 2000, New York, NY.
[2] Hearing of the U.S. Trade Deficit Review Commission, November 15, 1999, Palo Alto, CA.

result of relatively slower economic growth in the nations we trade with has been slower growth of our exports.

Furthermore, the dollar was strong during the 1990s and into 2000. For example, the dollar has steadily appreciated against the euro since the latter was created in January 1999. In many cases, nations with persistent current account deficits will see their currencies' exchange rates fall. By making imports more expensive and exports less expensive, this currency depreciation can lead to lower deficits. The U.S. dollar did not depreciate, however, largely because exchange rates are determined by both capital flows and trade flows. The attractiveness of the United States as a destination for foreign investment has contributed to the dollar's continued strength, despite the large current account deficits.

When the current account deficit is looked at in the context of the national income and product accounts, the standard measures of economic activity, another important relationship becomes clear. A current account deficit will always equal the difference between a nation's saving and investment. Saving is the value of current national production that is not consumed by households or purchased by the government. It represents resources that are made available from current production for investment. Without international trade and capital flows, investment will always be limited by and equal to domestic saving. However, with international trade and capital flows, investment need not be limited to the level of domestic saving. Net inflows of foreign capital supplement domestic saving and make possible a level of investment that is greater than domestic saving. When this happens, there will always be an equal and offsetting deficit on the trade or current account as the added investment expenditures draw in imports of real goods and services.

Understanding the link between saving and investment, however, does not provide a simple "solution" to persistent deficits, if that were thought to be necessary. In testimony before the Commission, Barry Eichengreen, Professor of Economics at the University of California-Berkeley, noted that

> *[H]ard thinking about the trade deficit starts with the fact that the difference between imports and exports equals the difference between domestic investment and domestic saving. It is important to understand that this equality is not the prediction of an economic model. It is an accounting identity.*

In the short run, this accounting identity does not provide guidance on how the current account deficits could be substantially reduced. Over a longer period, however, the benefits to the nation of higher saving are clear—such saving is a sustainable way of financing the investment that is key to generating economic growth. Removing disincentives to saving, such as those created by the tax code, can help clear the way to higher saving.

Finally, the role of foreign trade barriers in determining the level of the trade deficit remains a subject of some debate. Economists generally believe that foreign trade barriers primarily affect what we export and import, to which nations we export, and from which nations we import, rather than how much we export. In this analysis, trade barriers can only affect the level of the trade deficit to the extent that they affect the economy's levels of saving and investment.

However, irrespective of one's view on the importance of trade barriers on the trade deficit, there is a widespread conviction that foreign trade barriers are harmful, both to the United States and the country erecting the barrier. Even if foreign trade barriers are not a primary cause of the recent U.S. trade deficits, businesses and workers affected by these barriers and policies lose when they cannot export the competitive goods and services they are able to produce. Because foreign trade barriers may affect how much we trade with individual trading partners, these barriers can affect bilateral trade balances with these nations, often with serious political consequences. Trade barriers are costly for the nations that erect them – its consumers are denied the ability to purchase products freely, and its businesses are not forced to compete as vigorously for their customers.

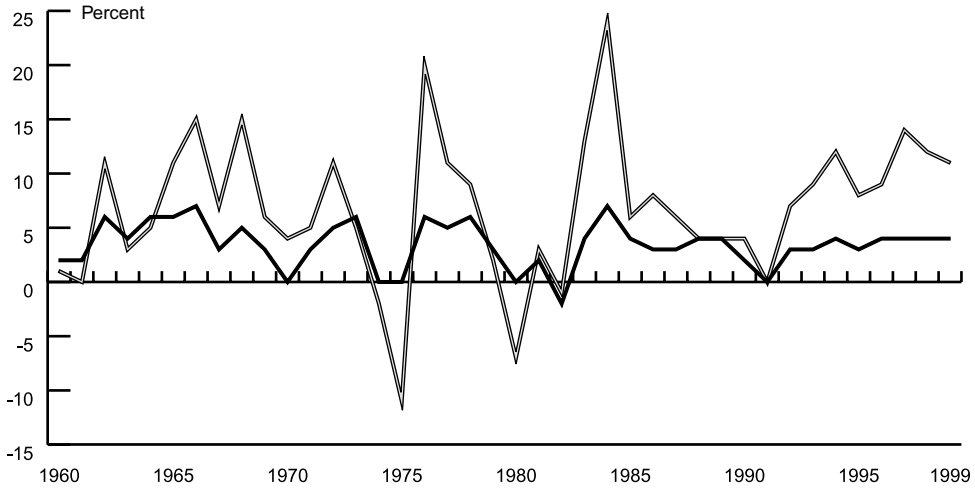
This chapter discusses each of these issues as well as other factors that contribute to the trade and current account deficits.

Economic conditions in the United States and in our trading partners' countries

Rising income in a nation sets the stage for increases in both overall expenditures and imports. Furthermore, U.S. imports tend to increase at a faster rate than incomes when incomes are increasing, perhaps even twice as fast.[3] Figure 2.1 illustrates how the growth rate of U.S. imports outpaces the growth rate of U.S. income (measured by GDP). Left unexplained, however, is why this situation occurs and why it can persist. Some analysts have suggested that intrafirm and intraindustry trade's large share of total international trade may explain why imports grow faster than income—not only does final demand for imports increase, but businesses import more intermediate goods to support their production.

[3] These studies of what economists call the "income elasticity of imports" are reviewed in Catherine Mann, *Is the Trade Deficit Sustainable?* (Washington, D.C.: Institute for International Economics, 1999).

Figure 2.1
Growth Rates of GDP and Imports, 1960–99



Source: Bureau of Economic Analysis, quarterly National Income and Products Account data for real (inflation-adjusted) gross domestic product and imports

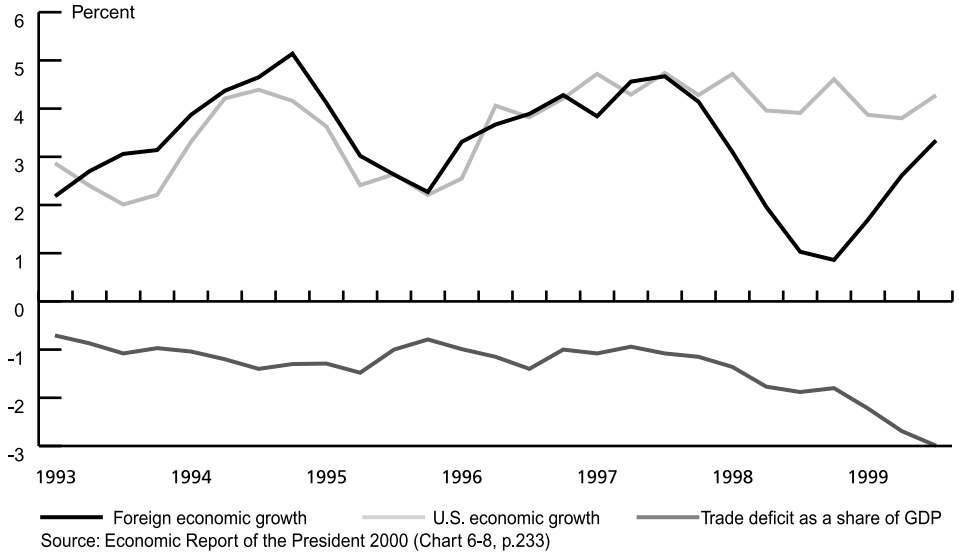
Viewed on a global basis, the growth of world trade has also far outpaced the growth of world GDP. The volume of world trade in goods increased at an annual rate of 6.5 percent from 1990 to 1998, more than three times the 2 percent annual gain in world GDP. For many nations, therefore, trade and imports grew faster than incomes. Despite this rapid growth, the U.S. marginal propensity to import out of rising income is still higher than that of other industrialized countries.

Strong U.S. economic growth relative to foreign growth has been a key factor in the growth of U.S. trade and current deficits during the late1990s. The United States has experienced the longest sustained economic expansion in its history during the 1990s. However, during the end of the decade, many of our trading partners have lagged well behind in their growth rates. As figure 2.2 shows, the U.S. economy grew at a 4.3 percent rate in 1999, while the growth of our trading partners averaged about 2 percent. The financial crisis that began in Thailand in 1997 and spread through East Asia set off severe recessions in much of the developing world and thus lowered East Asia's imports from developed nations, including the United States.[4]

[4] Indonesia, Malaysia, South Korea, and Thailand accounted for roughly $44 billion in U.S. exports (about 7.1 percent of total U.S. exports) in 1996 but only $39 billion (5.6 percent of total exports) by early 1999.

Figure 2.2

U.S. and Foreign Economic Growth and the U.S. Trade Deficit, 1993–September 1999



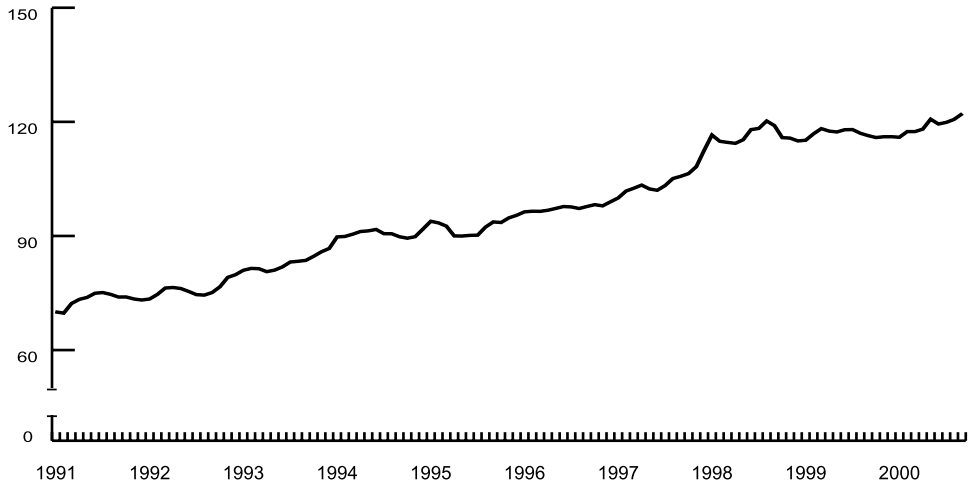
Source: Economic Report of the President 2000 (Chart 6-8, p.233)

The sustained period of faster growth in the United States than in the rest of the world, combined with the higher U.S. propensity to import, has led to large U.S. trade deficits. As Figure 2.2 shows, the trade deficits increased substantially during the 1990s. The lowest points for these deficits were in the early 1990s, as the 1990-91 recession was ending[5] and before the U.S. economy began to grow. The trade deficit grew much faster in the late 1990s, when U.S. economic growth was substantially above that of other nations, particularly those suffering from the East Asian financial crisis.

The effects of the relatively high U.S. income level were compounded by the strength of the dollar during the 1990s, as shown in Figure 2.3. If trade flows alone determined exchange rates, the trade deficits would have led to a dollar depreciation that would increase the price of imports (and decrease the price of exports), leading to a reduction in the trade deficit. Exchange rates, however, are determined by capital flows as well as trade flows and, as discussed below, capital flows have been the dominant force behind the strong dollar.

[5] The current account showed a surplus in 1991 for the first year since 1981. This surplus of $4.3 billion, however, includes onetime transfers of $42.5 billion from several Gulf War coalition partners to finance U.S. expenditures on the Gulf War. Absent these transfers, the U.S. current account would have had a deficit of $38 billion.

Figure 2.3
Real Effective Exchange Rate of the Dollar, 1991-2000



Note: Effective dollar exchange rate, Federal Reserve Board Broad Index

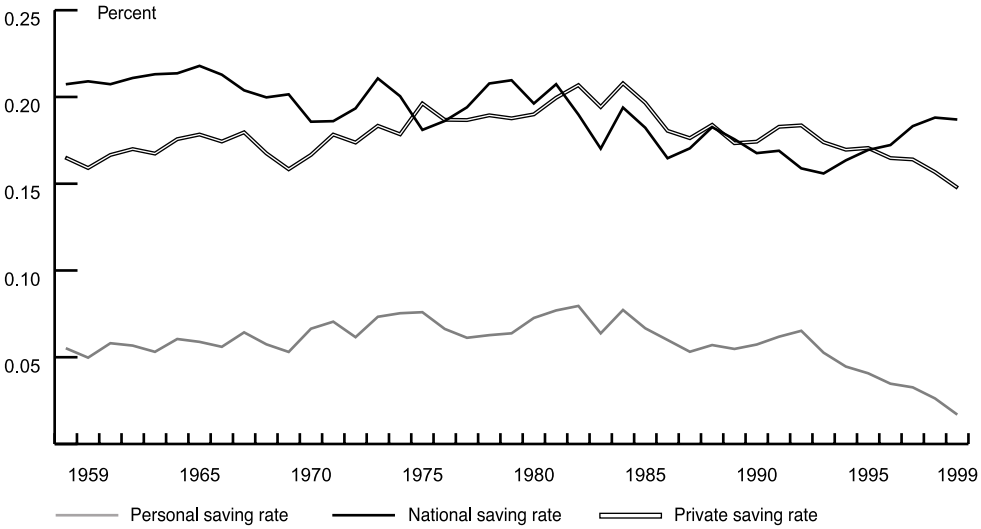
Source: International Monetary Fund World Economic Outlook, May 2000, Table 19

The last time the United States had comparably large and growing trade and current account deficits was in the mid-1980s. While the macroeconomic conditions of the 1980s and 1990s differed in many regards, one feature was common: the total level of saving in the United States was less than the total uses of saving. However, the reasons why are very different. In the 1980s, large federal budget deficits and private investment exceeded the saving of households and businesses. In the late 1990s, the federal budget moved into surplus and now contributes positively to national saving. However, at the same time, private investment grew substantially, while private saving fell.

The personal saving rate has declined continuously since 1992. In 1999, personal saving was 1.7 percent of gross national product, substantially less than the 1959 to 1999 average of 5.8 percent. The private saving rate (including corporate saving as well as personal saving) of 14.8 percent in 1999 was also below the 1959 to 1999 average of 17.8 percent. National saving (including government saving as well as private saving) was 18.7 percent, slightly below the period average of 19.0 percent. Figure 2.4 depicts changes in national, private, and personal saving rates for the 1960 to 1999 period.

Figure 2.4

National, Private, and Personal Saving Rates as a Percent of GNP, 1959-99



Note: Private saving consists of personal and corporate saving; National saving consists of private saving and government saving
Source: 2000 Economic Report of the President, Table B30, p. 342

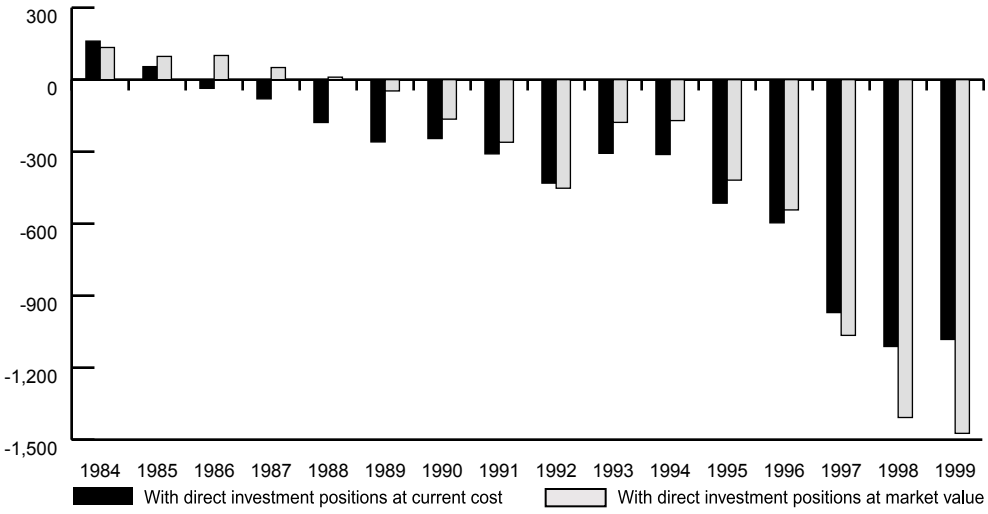
The reasons for the declining U.S. saving rate have been the source of considerable controversy. Many analysts believe that the drop in personal saving during the 1990s resulted from the increase in wealth associated with increases in the stock market and housing values. Fully analyzing this low saving rate is beyond our scope, but one thing is clear: over the long run, higher saving in the United States would be in our national interest, as would be actions to remove policies that tend to restrict saving.

The consequence of low national saving, as several Commission witnesses noted, is that the high level of investment in the United States was financed in part by foreign capital. Over the last decade, the U.S. current account deficit has been growing because of the trade deficit and rising net income payments to foreigners.[6] These net income payments are the consequence of total foreign investment in the United States exceeding total U.S. investment in foreign countries. The accumulation of net capital inflows (capital account surpluses)—or, equivalently, the accumulation of current account deficits -- has led to a negative net international investment (net debtor) position for the United States that in 1998 exceeded $1.5 trillion. (See Figure 2.5.) Current estimates are that it is now approaching $2 trillion.

[6] The Bureau of Economic Analysis' international accounts show this as a deficit in the balance on income, registering that payments of dividends and interest to foreigners exceed foreign payments to U.S. residents.

Figure 2.5

U.S. Net International Investment Position, 1984–99
(Dollars in billions)



Source: U.S. Department of Commerce, Bureau of Economic Analysis data

Many observers believe that the inflows of foreign funds are, in fact, the driving force in the system, with the high rate of return on investments in the United States. As Professor Richard Cooper of Harvard University told the Commission in his testimony:

> *…the current account [deficit] is as high as it is, and growing, because foreigners want to invest in America—in stocks, bonds, real estate, industrial plant, and other assets. Investments in America are viewed favorably around the world, and for good reason: the U.S. economy is a good, steady performer, less sluggish than Europe and Japan, less volatile than emerging markets. Inflows of investment funds push up the dollar and make foreign goods more competitive.*[7]

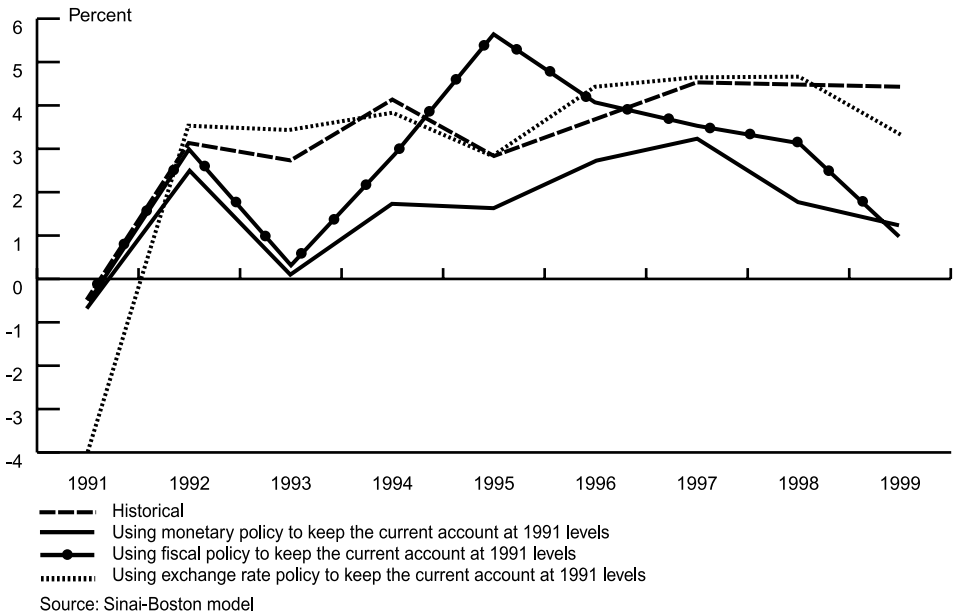
The current economic expansion has not been accompanied by increased inflation rates. This is so even though unemployment, at a thirty-year low, is at a level that was once thought to create inflationary pressures. Many analysts believe that this price stability stems from changes in the U.S. economy, particularly growing import levels, economic deregulation, and technological change. Easy availability of imports can limit price increases either by expanding available supply or reducing the ability of businesses to raise prices in order to pass on increases in their costs. With economic deregulation, major industries, including banking and finance, telecommunications, transportation, and energy, that had been subject to stringent government regulation now operate in a substantially deregulated environment, where competition limits the ability of businesses to raise prices. Rapid technological change has provided businesses with the means by which they can reduce their operating or production costs and meet increasingly intense international competition. Strong U.S. economic performance has made the United States a particularly attractive place for investors to place their funds.

[7] Hearing of the U.S. Trade Deficit Review Commission, December 10, 1999, Washington, DC.

This economic expansion might not have happened if economic policy had been conducted to ensure a balance on the current account or a lower current account deficit. The Commission used two econometric models to assess the consequences that might have resulted were economic policies used to keep the current account deficit during the 1990s at the level of 1991 (roughly 0.9 percent of GDP). At the Commission's request, these policies were simulated using two well-known econometric models of the United States, the Federal Reserve Board-U.S. quarterly model (FRB-US) and the Sinai-Boston model. These models were selected because their different modeling approaches would provide some assurance that the results are not simply peculiarities of the models.

Despite differences between the two models, the results were consistent on several key points. First, a monetary policy directed at holding the U.S. current account deficit at the 1991 level would have imposed substantial costs on the U.S. economy. The Sinai-Boston model estimated that such a policy would have resulted in interest rates above 20 percent. Second, a fiscal policy with the same target would have reduced U.S. growth for most years in the past decade. The least damage to the economy resulted when the foreign exchange value of the dollar was the policy instrument tested. However, while the federal government has control over monetary and fiscal policy, it does not have similar power over exchange rates. Figures 2.6, 2.7, and 2.8 contrast the actual (historical) values of GDP growth, unemployment, and interest rates with the simulated values under the three alternate policy scenarios. Results from the Federal Reserve model were comparable.

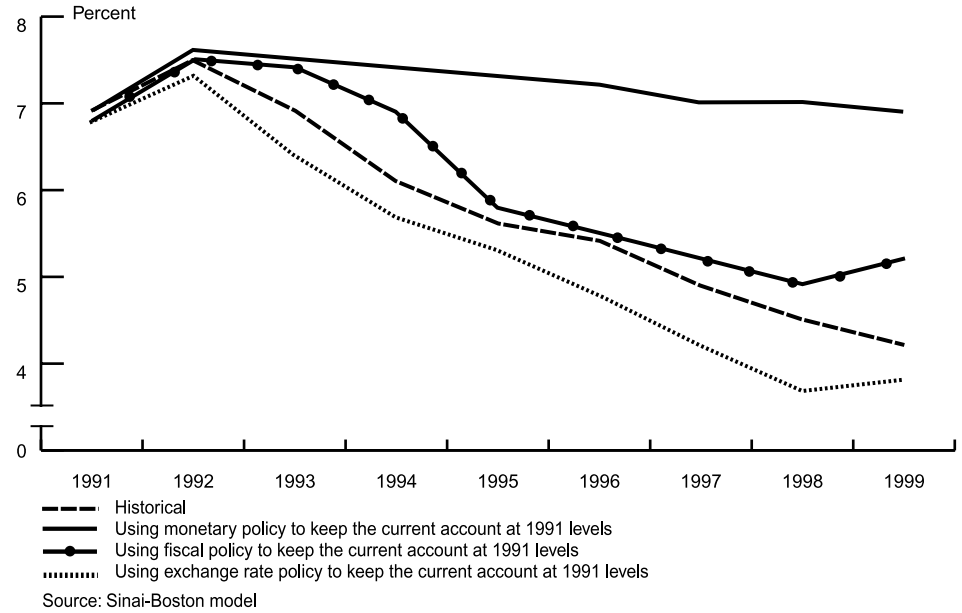
Figure 2.6
Historical and Simulated GDP Growth Rates, 1991- 99



Source: Sinai-Boston model

Figure 2.7

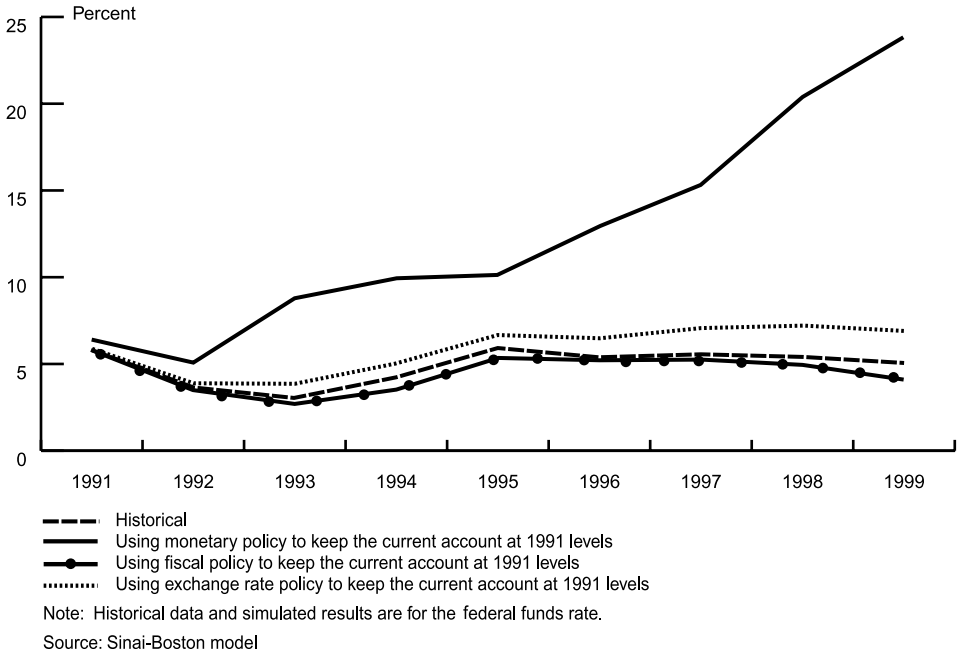
Historical and Simulated Unemployment Rates, 1991-99



Source: Sinai-Boston model

Figure 2.8

Historical and Simulated Interest Rates, 1991-99



Note: Historical data and simulated results are for the federal funds rate.

Source: Sinai-Boston model

Foreign exchange effects on U.S. trade and current account deficits

Exchange rates depend on total demand for and supply of currencies and thus reflect the factors underlying the flows of goods, services, and capital measured in the capital and current accounts. The continued strength of the U.S. dollar during a period of persistent current account deficits is a sign that capital movements into the United States, attracted by the higher rates of return here than those in many other nations, were sufficient to cover the current account deficits at existing levels of interest rates and dollar values. If the net capital inflows to the United States were not sufficient, we would expect to see the dollar depreciate and/or U.S. interest rates rise.

At times, countries have tried to set and maintain exchange rate targets to influence their exports and imports. For example, if a country succeeds in forcing its currency down against other currencies, the cost of its exports to foreign buyers should decrease, and the cost of its imports to its domestic buyers would increase. As a result, the nation's exports would rise and its imports fall. As this happens, the cost of this currency move is "paid for" by the country's consumers, who now face higher prices for imported goods and services, and by foreign businesses and workers, who lose market and job opportunities. Monetary policy is generally thought to be the most effective way to target exchange rates, although there are unavoidable domestic consequences of doing so.

Major industrial nations, including the United States, have all briefly intervened in exchange markets at times to counter disorderly markets. However, sustained intervention over a period raises a different set of questions. In particular, some analysts see increases in Japan's official reserves as an attempt to administratively set exchange rates. Japanese reserves have grown substantially over the 1990s. Japan started the decade with $77 billion in reserves. The reserve level now exceeds $344 billion. During the same period, reserves held by other industrial countries have remained basically unchanged. Some analysts suggest that Japanese government officials welcomed a weak yen as a mechanism to help exports stimulate the Japanese economy, which suffered economic stagnation for virtually the entire decade of the 1990s. As Edward Lincoln of The Brookings Institution noted in a paper prepared for the Commission:

> *…the Japanese government has continued to express dismay over the concept of floating exchange rates. Officially its concern has been over the negative impact of exchange rate volatility on international business transactions. Many analysts, however, believe that the real motive has been to keep the yen weaker than would be the case in a freely moving foreign exchange market…. From late 1994 though April 1995, for example, the yen rose to a peak of only 79 per dollar, and the Bank of Japan foreign exchange reserves rose by $2-$4 billion a month as it tried to offset the trend. More*

recently, reserves have risen very rapidly because the government was worried that renewed yen appreciation would choke off economic recovery by damaging exports…. [8]

Other analysts do not see Japanese reserve accumulation as evidence of any efforts to curtail the appreciation of the yen. The yen-dollar exchange rate can vary with differences between U.S. and Japanese prices, interest rates, relative growth rates of the two economies, and other variables, as well as market expectations of the future directions of these variables. However, the yen-dollar rate has also reflected, to some extent, the Japanese preference of relying on exports to boost Japan's lagging economy rather than making structural reforms to raise domestic demand. As such, to the extent that the Japanese government is successful in keeping the yen weaker than it would be otherwise, there is reduced pressure to make the difficult restructuring needed to resolve Japan's current economic difficulties.

Foreign trade barriers and U.S. trade and current account deficits

There is a popular perception that foreign trade barriers are an important cause of U.S. trade deficits. While foreign trade barriers can affect U.S. exports, these barriers are not an important cause of trade and current account deficits. Foreign trade barriers do not have a direct effect on the U.S. trade deficit except to the extent that they affect saving and investment decisions and the overall level of economic activity (here and in other countries).

Nevertheless, there is no disagreement that trade barriers are harmful and that trade policy must forcefully and consistently work to remove these barriers. Foreign trade barriers can affect what and how much we trade with a particular nation and thus can affect bilateral trade deficits, often with substantial political costs. Likewise, our trade barriers also impose costs.

Caution needs to be exercised when looking at bilateral trade balances without reference to a deeper analysis of the data. Bilateral trade imbalances may exist between any two countries for many benign reasons, including the relative size of the two trading partners, their per capita incomes, different consumer tastes, their stages of development, and the differing factors that make them competitive in particular industries. Consequently, there is no reason for any two countries to have balanced trade between them. In the complete absence of trade barriers, it would be perfectly normal and expected for the United States to have bilateral trade deficits or surpluses with most of its trading partners. This was well understood even in the 18th and 19th centuries.

When bilateral trade deficits are understood in the broader context, they may or may not take on significance. If the United States has a bilateral trade deficit with a country that does not have significant trade and investment barriers, the bilateral trade deficit warrants little attention.

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[8] Edward J. Lincoln, "Japan: A Continuing Dilemma for Open Trade Ideals," June 2000. Available from the Commission's web site: http://www.ustdrc.gov or on the CD-ROM that accompanies this report.

However, there is cause for concern when the United States has sustained bilateral trade deficits with countries that

- maintain well-identified trade and investment barriers, including government-directed industrial policies;
- maintain global trade surpluses irrespective of whether they are growing faster or slower than the rest of the world; and
- intervene in foreign exchange markets to keep their currencies undervalued.

When sustained bilateral trade deficits exist under those circumstances, they justifiably serve as a reason for a vigorous U.S. effort to eliminate the foreign trade barriers. Foreign barriers impose costs on affected U.S. industries and workers as well as on the nation imposing the barrier. They do lower our standard of living. They may also affect business decisions to invest in targeted lines of business. In addition, they raise questions about the inherent fairness and effectiveness of the trading system rules and institutions.

Ultimately, foreign trade barriers represent an effort by foreign governments to avoid the costs of adjustment that come with economic change. While these barriers often inflict the greatest damage on the nations that impose them, they also inflict costs on other nations, including the United States. While the ability of U.S. industry to adapt in different ways to the barriers may limit the damage to the United States, U.S. trade law and policy must vigorously and consistently strive to reduce foreign trade barriers, both at home and abroad, in the context of multilateral negotiations with reciprocal reductions of U.S. trade barriers.

High bilateral deficits with Japan, in particular, have persisted over the 1990s. While differences in the relative levels of economic growth have influenced the size of the bilateral deficits, the deficits have occurred through periods when U.S. economic growth lagged well behind Japan's growth as well as when U.S. economic growth surpassed Japan's. In addition, the deficits occurred when the Japanese yen, relative to the dollar, was both weak and strong. During this period, we witnessed an array of U.S.-Japanese trade agreements and Japanese government initiatives to open Japanese markets.

Similarly, the growth in bilateral deficits with China and the barriers that limit U.S. exports to China were frequently cited issues in the congressional debate over granting permanent normal trade relations to China and Chinese accession to World Trade Organization membership.

Japan

Japan's sustained trade barriers impose several kinds of costs:

- Japan's restrictive activities create dislocations for U.S. businesses and workers who face competition from Japanese exports that benefit from a protected home market.
- Japan's protection of specific industries, such as agriculture, deprives specific U.S. industries of export sales.
- The inefficiency of the Japanese economy has lowered Japan's growth rate compared to what it might have been otherwise. Japanese government support of inefficient industries has exacerbated the inefficiency of the economy. The lost potential growth, in turn, has both reduced potential U.S. exports to Japan and restrained Japanese competitiveness.
- The persistence of Japan's trade barriers is seen as a challenge to the credibility and effectiveness of the world trading system and has reduced public support for that system.
- Support for individual industries by the Japanese government has had adverse impacts on the counterpart U.S. industries.

The high priority placed by several administrations on trade negotiations with Japan through the mid-1990s met with only mixed success, as have the quieter bilateral negotiations of the second term of the Clinton administration. Many American businesses are frustrated by their inability to make progress on specific market access issues. The statistical indicators of market penetration by foreign firms reinforce the independent conclusion that Japan remains less accessible than the markets of the United States or other large industrial nations. While the disparity between market penetration in Japan and the rest of the world has diminished somewhat over the past decade, it remains distinctive.

Most nations have experienced an increase in the extent of intra-industry trade as their trade barriers have decreased and as their economies have matured (with more sophisticated manufacturing firms capable of specializing in niche markets). An analysis of intra-industry international trade patterns gives some insight into the extent to which any country's market is open to international trade.

Japan's trade patterns showed an increase in intra-industry trade as its formal trade barriers were being lowered from the 1970s through the mid-1980s. Intra-industry trade rose from the mid-1980s to the mid-1990s. But even with an increase, the extent to which this type of trade occurs remains well below that of other nations.[9]

Foreign direct investment has become a crucial factor for determining trade patterns, with the

[9] For a more detailed presentation and analysis of data concerning intra-industry trade, see Edward J. Lincoln, *Japan's Unequal Trade*, (Washington, D.C.: The Brookings Institution, 1990), pp. 39-60; and Lincoln, *Troubled Times: U.S. –Japanese Trade Relations in the 1990s* (Washington, D.C.: The Brookings Institution, 1999), pp. 31-52.

growth of intrafirm and intra-industry trade. Foreign-owned firms tend to import at higher rates than domestically owned firms. And, as the Organization for Economic Cooperation and Development (OECD) has reported, Japan has had less inward foreign direct investment than either the United States or the European Union:

> *…the stock of inward investment is much lower in Japan than in the other two regions, at just under 1/2 percent [of gross domestic product]. This compares with 3 1/2 percent and 4 percent in the United States and the European Union, respectively. This disparity in FDI [foreign direct investment] flows is also evidenced in the share of foreign affiliates in Japanese manufacturing production, which is between six to ten times lower than in any other major [Group of] Seven country and has declined since the early 1980s.* [10]

Over the past two years, however, some changes within Japan have given indications that it may be more receptive to foreign goods and services. These changes should be viewed within the context of broader Japanese efforts to deregulate its economy. Although only time will tell if these efforts represent fundamental shifts, broad deregulation of the Japanese economy would bring substantial benefits to Japan and the rest of the world.

The principal change has been a significant rise in foreign direct investment into Japan, driven by the availability of some troubled or effectively bankrupt Japanese corporations for acquisition by foreign firms. The results of the rise in foreign direct investment into Japan have been quite dramatic, with a handful of large Japanese corporations being acquired.

Direct investment into Japan had been so low in earlier years, however, that the recent increase –even with the widely reported, large-scale minority investments in major Japanese automobile companies–means that the overall level of investment is still below the level in other developed nations. Thus, while opening Japanese markets has not been the focus of much political attention in Washington during the past several years, the problems of market access remain.

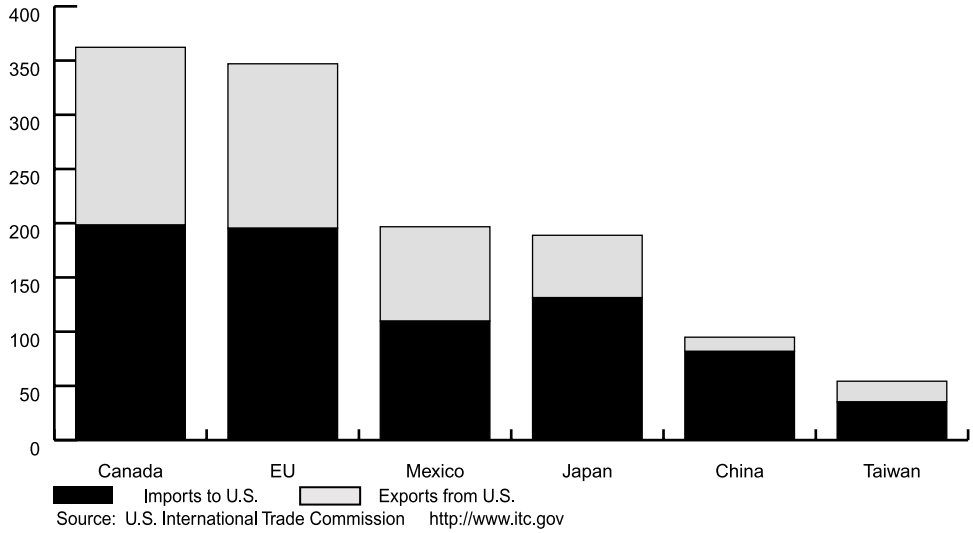
China

The establishment of improved ties between Washington and Beijing in 1972 and China's decision to begin reforming its economy and expanding economic ties with the West in 1978 set off a tremendous surge of growth in trade and investment in China. In 2000, total trade between the United States and China is likely to top $100 billion. China has become one of the U.S.' top five trading partners, and the United States is by far the largest market for Chinese exports, as seen in Figures 2.9 and 2.10.

[10] *OECD Economic Outlook.* (Paris, France: Organization for Economic Cooperation and Development, June 1999), p. 217.

Figure 2.9

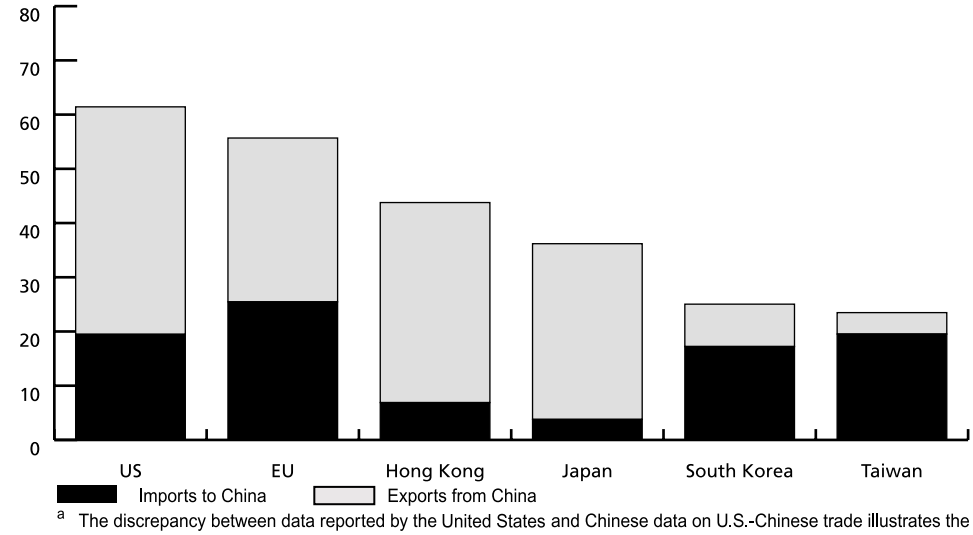
Top U.S. Trading Partners, 1999
(Dollars in billions)



Source: U.S. International Trade Commission http://www.itc.gov

Figure 2.10[a]

Top Chinese Trading Partners, 1999
(Dollars in billions)



[a] The discrepancy between data reported by the United States and Chinese data on U.S.-Chinese trade illustrates the difficulty in finding accurate data on the growing levels of world trade. This is discussed further in Chapter 7.

Source: "China's Customs Statistics," PRC General Administration of Customs, 1999

China has been gradually emerging from economic isolation since the late 1970s. In 1978, the government began to dismantle a trade bureaucracy that had given ten national import and export corporations the sole authority to sign import and export contracts. In the mid-1980s, individual province and municipal governments, industrial ministries, and enterprises began receiving permission to engage in import and export transactions. Chinese import restrictions have continued to decrease in the 1990s and, in some respects, China is more open than many developing countries.

The United States has pressed China to undertake economic reforms to protect intellectual property, open its market to imports, stop exports of goods made with prison labor, and undertake other trade reforms. At several junctures, the United States was close to imposing trade sanctions over intellectual property piracy and market access disputes.

China has undertaken some economic reforms partly in its efforts to modernize its economy and partly in response to pressure from western governments, notably the United States. The government has liberalized imports of many products, particularly components for products produced for export at western-owned factories. Further, Chinese companies that compete with western companies have sought and received increased opportunities to engage in commerce with the outside world.

Nevertheless, China maintains significant trade barriers, many of which should be removed if China joins the WTO. Imports may be blocked by a combination of tariffs, quotas, and import license requirements. In sectors such as agriculture and automobiles, all these barriers may exist. Thus, eliminating just one or even several barriers may not guarantee meaningful market access. These import controls are generally set through consultations with those ministries charged with managing sectors of the economy, and the Ministry of Foreign Trade and Economic Cooperation.

The U.S. experience with Chinese import licenses demonstrates a persistent trade problem. In a 1992 agreement with the United States, China agreed, among other things, to eliminate import licenses. Shortly thereafter, however, China announced a new series of import registration requirements that covered many of the same products. Functionally, import registration requirements are identical to import licenses; the similarity is so marked that the Clinton administration did not distinguish between the two import controls in its latest listing of foreign trade barriers.[11]

Upon accession to the WTO, China will take on a legal commitment to terminate most import quotas, licenses, and registration requirements.[12] Further, China will commit to lower tariff levels and provide substantially greater access and rights to distribute products in China and allow access by a wide range of foreign services providers. Ultimately, China and its people will gain with these economic reforms.

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[11] Office of the U.S. Trade Representative, 2000 National Trade Estimate, (Washington, DC: Office of the U.S. Trade Representative, 2000).
[12] China Trade Relations Working Group, Summary of U.S.-China Bilateral WTO Agreement (www.chinapntr.gov/bilatsumm.htm: Feb 2, 2000).

Overlaid on developments in the economy, China has been accumulating large official holdings of dollar reserves. As of September 2000, China's foreign exchange reserves were reported to exceed $158 billion, more than five times the level of a decade earlier. Foreign exchange reserves are held for international trade and finance purposes. However, the large buildup of reserves by China calls for some special justification, especially for a capital-scarce, developing country. Nevertheless, we do note that after the Asian financial crisis, there is a consensus that larger international reserves are needed than had previously been thought required.

Other foreign trade practices

The critics of low labor standards in developing countries or of lax enforcement of such standards believe that they have an impact on U.S. imports, exports, and wage rates. U.S. imports of products from such countries may be greater than otherwise, because their production costs and prices are lower abroad.

People concerned about weak social regulation see an impact on our bilateral trade balances from inadequate environmental standards or the inadequate enforcement of existing statutory and regulatory provisions. Most economists are critical of this analysis, pointing out that pollution control is viewed as desirable in most countries. However, the level of resources a country is able to devote to pollution control depends on its income. Poor countries typically have more pressing basic needs to attend to before they can afford to devote significant resources to protecting the environment. Experience has shown that, as incomes rise, countries devote a larger share of income to protecting the environment. Therefore, these analysts consider that the most effective way, in the long run, to help developing countries improve their environmental protection is to trade with and invest in them; this will assist in the development of their economies and in raising their living standards. Furthermore, economic studies have found that the savings from avoiding the costs of pollution abatement in developed countries are too small to offset the costs attendant to relocating to a developing country. Hence, environmental factors in practice are not important influences on business decisions to locate production facilities.

Efforts to use the trading system to impose more costly social regulation on developing countries would be counterproductive. Imposing further restrictions on these countries, in fact, will hurt their efforts to grow and thus improve their labor and environmental standards. Moreover, some of the focus on these standards is seen as primarily motivated by the desire to protect the American market from low-cost imports. Such an approach is misguided. Over time, wage rates generally reflect the productivity of labor. While the adjustment is not instantaneous, wages will ultimately rise to reflect the demand for and supply of labor and rising labor productivity. More trade with the developing countries will lead naturally to rising incomes and wages, whereas less trade will leave them in greater poverty and less ability to deal with social needs. As regards the impact on U.S. income and wages, imports from lower-wage countries can encourage U.S. workers to qualify for higher-productivity jobs that require higher skills and justify higher wages.

To address the issues raised by national differences in labor standards, we believe that the United States should use existing institutions more effectively. As we discuss later in Chapter 6, the United States should make more effective use of the International Labor Organization (ILO), and the WTO should improve its collaboration with other international organizations, including the ILO.

U.S. policies that affect international trade and the U.S. trade deficit

Some U.S. policies limit the ability of U.S. businesses to export. Trade sanctions and export controls, principally, are tools that limit U.S. exports in order to achieve national security or foreign policy goals.

- The U.S. government has often imposed trade sanctions on other nations, seeking to punish or compel them to change their practices or policies. In some cases, the United States has acted in concert with other nations, but in most instances we acted unilaterally. Unilateral sanctions may be a stronger statement against another nation's policies than diplomatic protests, but there is little evidence that unilateral sanctions are an effective tool to induce another nation to change its policies or actions. Sanctions often can be evaded, for instance, with goods shipped through third countries to disguise the ultimate recipient in the sanctioned nation. As a result, U.S. business, labor, and agriculture may be harmed for what is a symbolic gesture. In some cases, widely supported multilateral sanctions have been an effective method of inducing a change in a nation's policies or behavior. In other cases, however, even sanctions applied by a broad, multinational coalition have not been successful in changing the behavior of the targeted nation, although they may weaken it or restrict its military capacity. However, we do note that assessing the success of sanctions is complicated by the fact that sanctions may have multiple objectives, and not all of the objectives are always publicly revealed.

- During the Cold War, the United States, along with our major allies, sought to prevent the sale or transfer of weapon systems and militarily useful civilian technology (known as "dual-use" technology) to the former Soviet Union or its allies. Multilateral controls were placed on military and dual-use items throughout the Cold War. While considerably relaxed in recent years, elements of the export control system remain in place today. Export controls begin with a clear premise that an adversary (or potential adversary) can use American technology against the United States and/or our friends and allies. A weapon system may be reverse engineered, so that another nation can produce a similar system. Even short of reverse engineering, access to the weapon system or its underlying technology could

provide the adversary with insight into the system's strengths and weaknesses and allow the development of countermeasures. Ultimately, the decision to apply and enforce export controls weighs the protection of critical technologies against the feasibility and cost of enforcement with regard to possible effects on the U.S. economy. When U.S. producers do not have a monopoly on a particular technology, producers in other nations can deliver the same technology or product as a U.S. producer without being subject to similar export controls. In such circumstances, the effect of U.S. export controls is to handicap U.S. producers rather than to achieve the intended objectives.

Both sanctions and export controls involve national security and foreign policy considerations as well as trade consequences. The trade consequences have not always gotten appropriate recognition. This has been particularly true in the case of unilaterally imposed trade sanctions involving widely available products. In such circumstances, exports from other nations can easily replace U.S. products that had previously been sold to the sanctioned nation.

U.S. import barriers

The United States is the most open major economy in the world. Foreign producers and foreign investors generally have an easier time accessing the U.S. market than the market of any other major developed country. However, in ending this discussion of the causes of the U.S. trade deficit, we note that the United States maintains some import barriers that distort trading patterns. Just as foreign trade barriers do not cause the U.S. trade deficit, the U.S. import barriers do not reduce the overall U.S. trade deficit. However, they do influence to some extent what the United States does and does not import and what is produced here. The presence of these import barriers gives other nations an excuse to maintain their much larger restrictions on trade.

Contrary to widespread belief, the United States is not an island of free trade in a world of protectionism. The federal government—and at times states and localities as well–imposes numerous obstacles to imports. Five major types of such trade barriers have been identified:

- Buy-American statutes, which give preference in government procurement to domestic producers. Many states and localities maintain comparable restrictions; notably, New York State requires all state agencies to buy American steel.
- The Jones Act, which prevents foreign ships from engaging in waterborne commerce between U.S. ports. Also American-flagged vessels must be used to transport at least 50 percent of all commodities financed with U.S. foreign aid funds.
- Statutes that limit the import of specific agricultural products (such as peanuts, cotton, dairy, orange juice, and sugar) and manufactured products (including gloves, brassieres, and pillow cases).
- Selective high tariffs on specific items, notably clothing.

- Regulatory barriers aimed at protecting domestic producers. These range from state and local building codes to limits on foreign ownership of transportation and communications companies.[13]

Conclusions

The growth of the U.S. trade and current account deficits primarily stems from the relative strength of the U.S. economy, particularly during a time when the performance of other national economies lagged. Sustained economic growth accentuated two factors that contribute to the trade and current account deficits. The first is a long-standing pattern in the U.S. economy wherein imports grow with income increases and expand at a much faster rate than income. While the reasons for this pattern are not understood, its implication for the deficits is clear—higher levels of income growth in the United States lead to increased imports, while slower growth in our trading partners lead to slower growth in U.S. exports. Second, sustained economic growth makes the United States an attractive destination for foreign investment. Increased capital inflows are, in essence, the mirror image of growing current account deficits. These large net capital inflows have led to a high dollar exchange rate, even though we also had large trade deficits. The high dollar exchange rate encourages imports and inhibits U.S. export competitiveness. Finally, the current accounts are equal to the difference between saving and investment. While this accounting definition does not tell us to force saving to increase to end or reduce persistent current account deficits, it does tell us that policies that ignore this accounting definition will have little or no effect. It also points to the importance of long-run efforts to remove disincentives to saving.

The trade and current account deficits, however, are the outcomes of our nation's economic performance, not targets of economic policy. Nor should they be. The price that we would pay, in terms of lost output and high unemployment, would be devastatingly high if we had subordinated other policy goals to achieve a trade balance.

Trade barriers—be they foreign or domestic—are not a primary cause of the trade deficit. Whatever effect they may have on the deficit is indirect. There is no disagreement, however, that foreign barriers do impose costs on U.S. businesses and workers. Further, there is no disagreement that a trade barrier is most injurious to the nation that imposes the barrier. Trade policies that vigorously confront these barriers and lead to their removal are essential. Finally, some U.S. policies limit our exports, including export controls and economic sanctions; although experience suggests that while these policies limit exports, they are not always effective ways to advance U.S. interests.

[13] For details, see Murray L. Weidenbaum, *Business and Government in the Global Marketplace*, Sixth Edition (Upper Saddle River, N.J.: Prentice-Hall, 1999), pp.223-228.