Economy at Risk:
The Growing U.S. Trade Deficit

Statement by

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I have a feeling that explaining to this audience why the U.S. trade deficit is a bad thing and needs to be reversed is like preaching to the choir. So I am just going to spend a few minutes reviewing the economic problems that are associated with the trade deficit, and then I want to move on to outline a framework for thinking about the causes of the trade deficit and the options for reducing it.

I see two broad types of problems stemming from the trade deficit, which we might call the "real" and "financial" effects. The real problems include above all the loss of good-paying jobs in tradable goods industries, especially manufacturing, which has contributed to the rising inequality in American society. The real problems also include the gradual shrinkage of the U.S. industrial sector to the point where so much of our production has been "outsourced" that it would be difficult, in the short run, even to produce enough goods to replace many of our imports unless we rebuild our industrial capacity. According to my estimates, the rise in the value of the dollar since 1995 — which is a major cause of the trade deficit — has discouraged investment in U.S. manufacturing to such an extent that the capital stock of the manufacturing sector was 17% lower in 2004 and new investment in U.S. manufacturing was more than 60% lower in 2004 than they would have been if the dollar had not appreciated. Although the remaining manufacturing capacity is highly efficient, it accounts for a shrinking portion of U.S. employment. Thus, the trade deficit does not simply cause a temporary reduction in output, but also a permanent loss of manufacturing capacity that can have long-lasting negative effects on the country's future productive capabilities.

On the financial side, the trade deficit is sustained by capital inflows — essentially, borrowing from abroad — currently to the tune of about $800 billion annually. In the short run this use of a national credit card gives American consumers the appearance of a free lunch, but in the long run it creates a serious vulnerability to a financial meltdown whenever foreign lenders are no longer willing to buy up massive amounts of U.S. assets that are likely to fall in value when the dollar eventually declines further than it has already. Today, most economists are debating whether we will have a "soft" or "hard" landing when that day comes, but the necessity of an eventual and painful adjustment is becoming ever more clear.

How did we reach this situation? In part there is a long-term deterioration in U.S. competitiveness, some of which is inevitable due to the catch-up of less developed countries and former Communist nations, but some of which is due to our own neglect of our industrial base. In part, the U.S. economy is effectively more open to imports than many of its trading partners, especially in Asia, in spite of trade agreements like the WTO that create the appearance of reciprocal market opening. In some cases, other countries have been more willing to use government influence to promote domestic industrial production, rather than to encourage their own companies to move offshore as our government has. In addition, there are very important short-term macroeconomic factors that have caused the trade deficit to balloon in recent years. These factors include the persistent overvaluation of the dollar (see Figure 1) and the especially continued manipulation of exchange rates by China and other East Asian countries, as well as the slow growth in Europe and Japan that have contributed to their surpluses with the more rapidly growing U.S. economy.

One red herring that we have to dismiss is the infamous "twin deficits" argument, which blames the trade deficit on the federal budget deficit. It is true that these two deficits are linked by an accounting identity, which says that the current account balance (the broadest measure of our trade) must equal the sum of the government budget surplus *plus* the difference between private saving and investment. But this is an accounting identity, *not* a causal relationship. It does *not* mean that reducing the budget deficit will automatically improve the trade balance, because private saving and investment can adjust in ways that offset the shift in the fiscal balance. This is exactly what happened in the late 1990s, when the budget deficit shrank and turned into a surplus, but the trade deficit continued to grow as consumer spending boomed and private saving lagged behind private investment. There are good reasons to reduce the federal budget deficit and restore fiscal sanity, but no one should think that this would be sufficient by itself to solve the trade imbalance.

In fact, there is really no secret about how to solve global trade imbalances; it is not rocket science. Good old-fashioned macroeconomics teaches that there are two essential devices for reducing a trade deficit: (1) *expenditure-switching* policies and (2) *expenditure-changing* policies. Expenditure-switching policies, which induce consumers (both at home and abroad) to buy more U.S. goods and less foreign goods, include exchange rate adjustments, import tariffs, and more complicated schemes such as Warren Buffet's auction quota proposal which is designed to promote exports as well as to restrain imports. Expenditure-changing policies could include fiscal restraint and reduced consumer spending in the U.S., but these must be accompanied by more expansionary macro policies and increased consumer spending by our trading partners in order to prevent U.S. adjustment from sparking a global downturn.

If there were enough political leadership in the United States and the other major countries, it would be easy to formulate a deal in which these sorts of policies — that is, exchange rate realignment combined with offsetting expenditure changes — could be implemented simultaneously in a joint effort to reduce the trade imbalances that threaten global financial stability, while maintaining growth and prosperity throughout the world economy. In an even more ideal world, we would reconsider the ideas of John Maynard Keynes and others since him to create a new source of global liquidity in order to eliminate the usage of dollars as an international reserve currency, which tends to keep its value chronically above a level that is optimal for the U.S. domestic economy (as happened to the British pound in an earlier era).

Unfortunately, such leadership is lacking both at home and abroad today. In the absence of concerted efforts to create a more stable global financial system, we are left to our own devices to try to pressure countries like China to stop manipulating their currencies, and we have to consider fall-back measures such as an across-the-board tariff or a system of import quotas allocated to exporters. These sorts of measures are not ideal; especially, an import tariff helps to reduce imports but does not stimulate exports. Nevertheless, the adoption of such fall-back measures may be necessary, and their threatened adoption could potentially prod reluctant nations to make the adjustments that they have so far resisted. My own view, which I expressed in a 1992 book with the Economic Policy Institute, is that tariffs should be limited to imports from those countries that intervene heavily to keep their currencies artificially undervalued, and should be lifted if those countries abandon their currency manipulation and let their exchange rates adjust to levels consistent with more balanced trade. I realize, however, that considerations such as GATT/WTO legality and other factors may weigh in favor of other alternatives, as I'm sure will be discussed by the next panel.

It is important to note that some adjustment is already going on in the global economy, although so far it has been too little and too partial. As the blue line in Figure 2 shows, the dollar has fallen 23% in real terms relative to the major, floating rate currencies (euro, yen, pound, etc.) since its peak in February 2002, and this has begun to show fruits in terms of more rapid export growth in the past two years. This makes sense, because U.S. exports compete primarily with European and Japanese products in global markets. However, the decline in the dollar relative to the major currencies has not helped much on the import side, since most of our imports now come from other trading partners such as China and other developing and transition economies. As Figure 2 also shows (see the red line), the dollar has *not* declined over the past four years relative to the currencies of these other countries, most of which have pegged or managed exchange rates — and some of them (led by China, though China is not alone) have been amassing huge reserves of dollar assets in an effort to keep their currencies artificially low and the dollar artificially high. As a result of the continued undervaluation of so many foreign currencies, imports continue to grow just about as fast as exports (see Figure 3), thus leaving us with a persistently worsening deficit since imports are now much larger than exports as a result of a decade of persistently faster growth.[1]

It should also be noted that the Fed's interest rate increases in the past few years — which have been greater than necessary for restraining any actual inflationary threat — have helped to halt the dollar from adjusting further downward vis-à-vis the major floating rate currencies. Thus, Fed policy is currently operating the wrong direction for solving our trade problem. Meanwhile, the willingness of foreign central banks to hold large amounts of low-return U.S. official assets (such as T-bills) has helped to keep down borrowing costs for both the U.S. government and the ever-more

[1] In 2005, export growth exceeded import growth for the first time in ten years (see Figure 3), but only by a slight margin.

indebted U.S. consumers, and this helps to explain why the Bush administration has not been too eager to pressure those central banks into stopping their exchange market intervention.

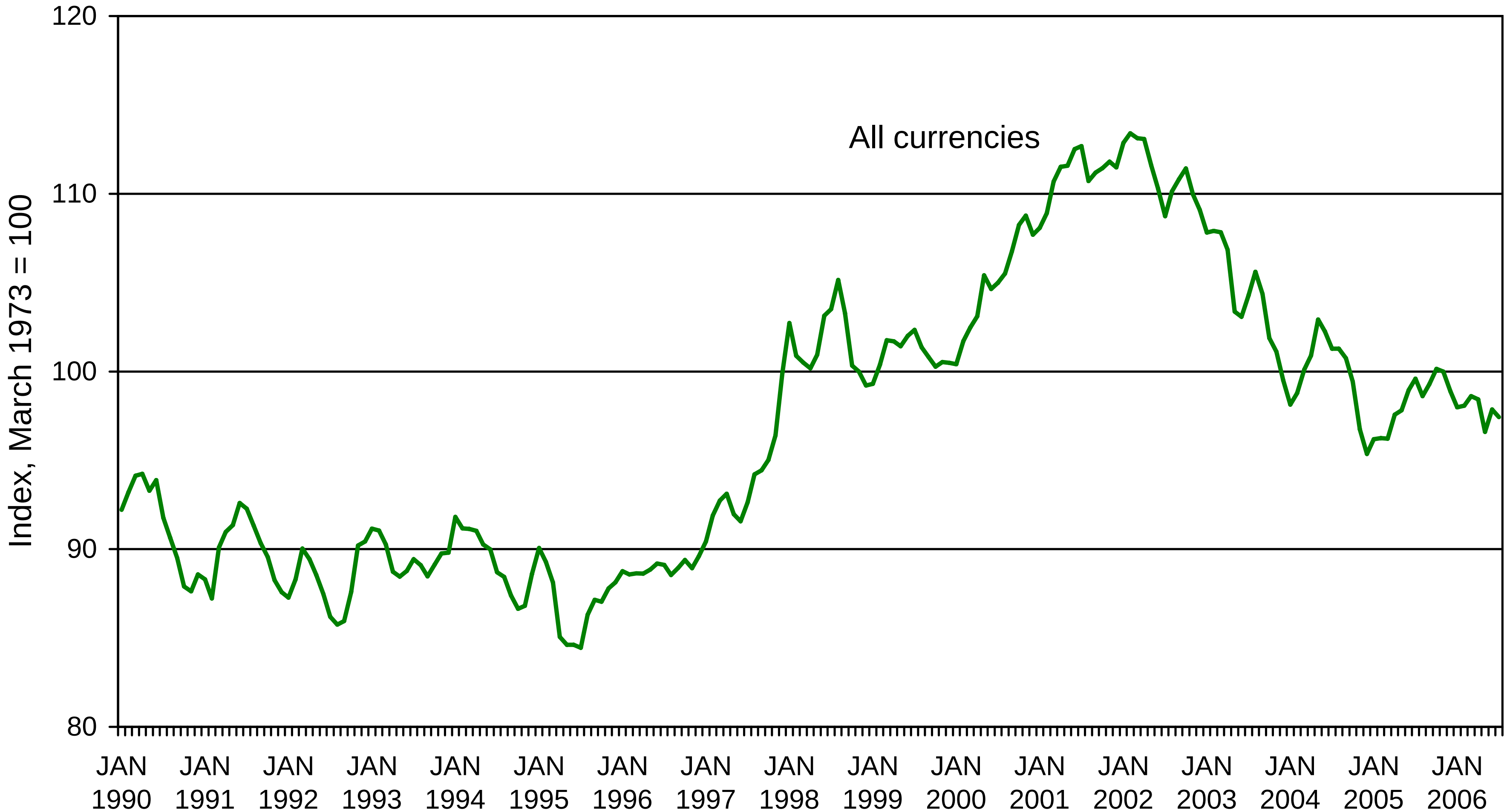
This brings me to my final point, which is that we have to recognize the political obstacles that currently prevent us from adopting a more rational policy about the trade deficit. The current situation, however dysfunctional and risky, has created powerful vested interests in maintaining the status quo. Corporations that have succeeded by outsourcing, financial institutions that benefit from large capital flows, and foreign countries that depend on exports for promoting growth and employment all have a stake in perpetuating the present currency misalignments and trade imbalances. And again, the Bush administration benefits politically from the willingness of foreign central banks to finance the growing U.S. federal debt, which relieves upward pressures on U.S. interest rates and thereby prevents American households and corporations from feeling more of a pinch from the budget deficit.

At present, this combination of economic and politically interests is blocking any concerted effort to address the trade deficit and its real and financial consequences. Accordingly, not only those who are adversely affected by the present circumstances, but all who are concerned about the country's economic future, must exert pressure on the U.S. government to abandon its ostrich-like stance and take the trade deficit problem seriously. Hopefully, our government in cooperation with the other major countries can adopt a sensible package of exchange rate and macroeconomic policies to help wean this country and the global economy as a whole away from their unsustainable co-dependency on trade imbalances before it collapses of its own weight. If a cooperative approach is not possible, then unilateral actions such as tariffs or auction quotas could be necessary either to rectify the imbalances or to induce other countries to permit the necessary adjustments in their exchange rates. Finally, it is important to remember that either a lower dollar or other expenditure-switching policies, although necessary and unavoidable, will not be effective in the long run unless we also address the underlying sources of U.S. competitive decline and work to recreate a larger industrial base in the United States. Thank you.

Figure 1

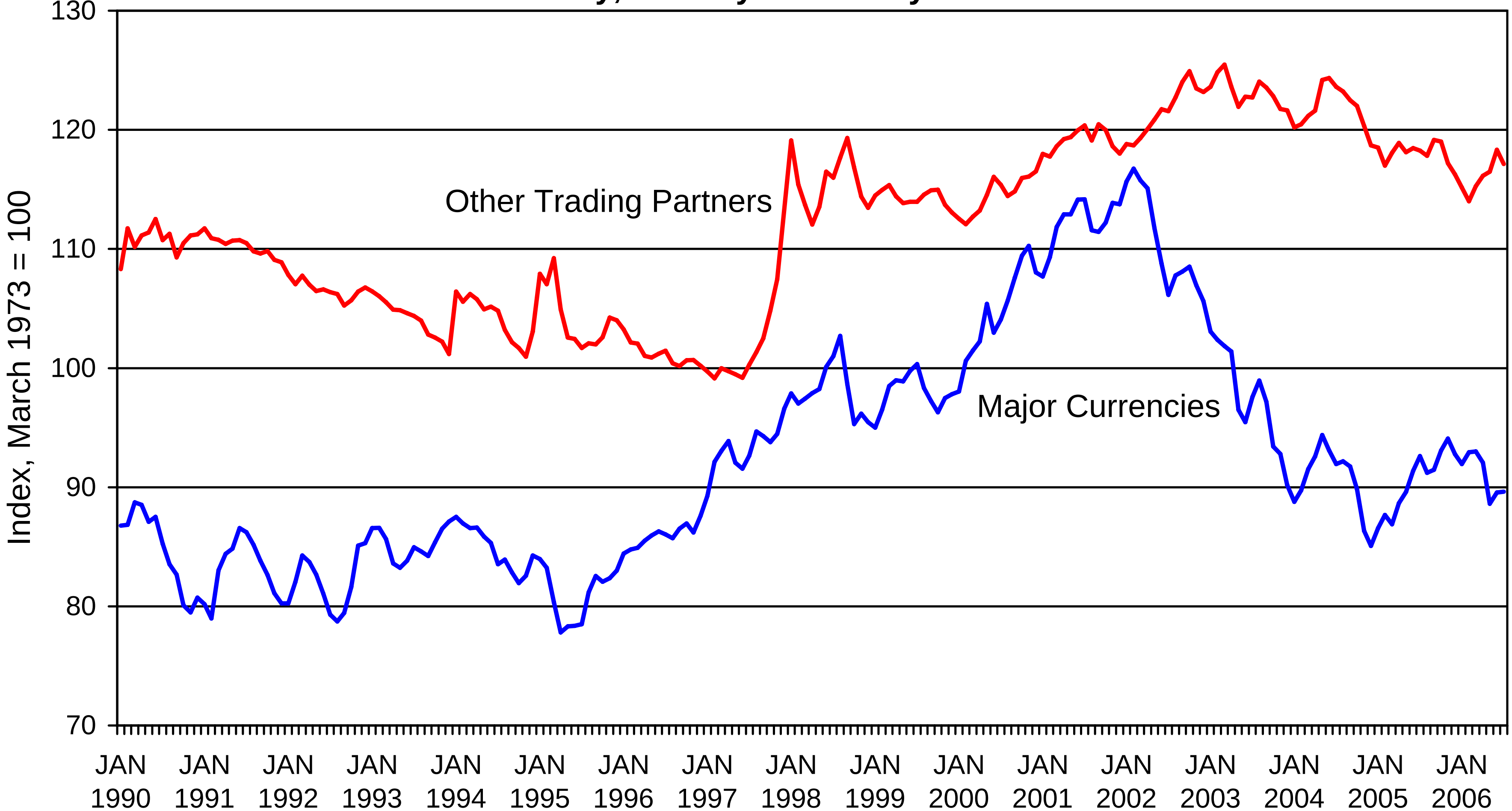
Fed's Broad Index of the Real Value of the U.S. Dollar

Monthly, January 1990 - July 2006



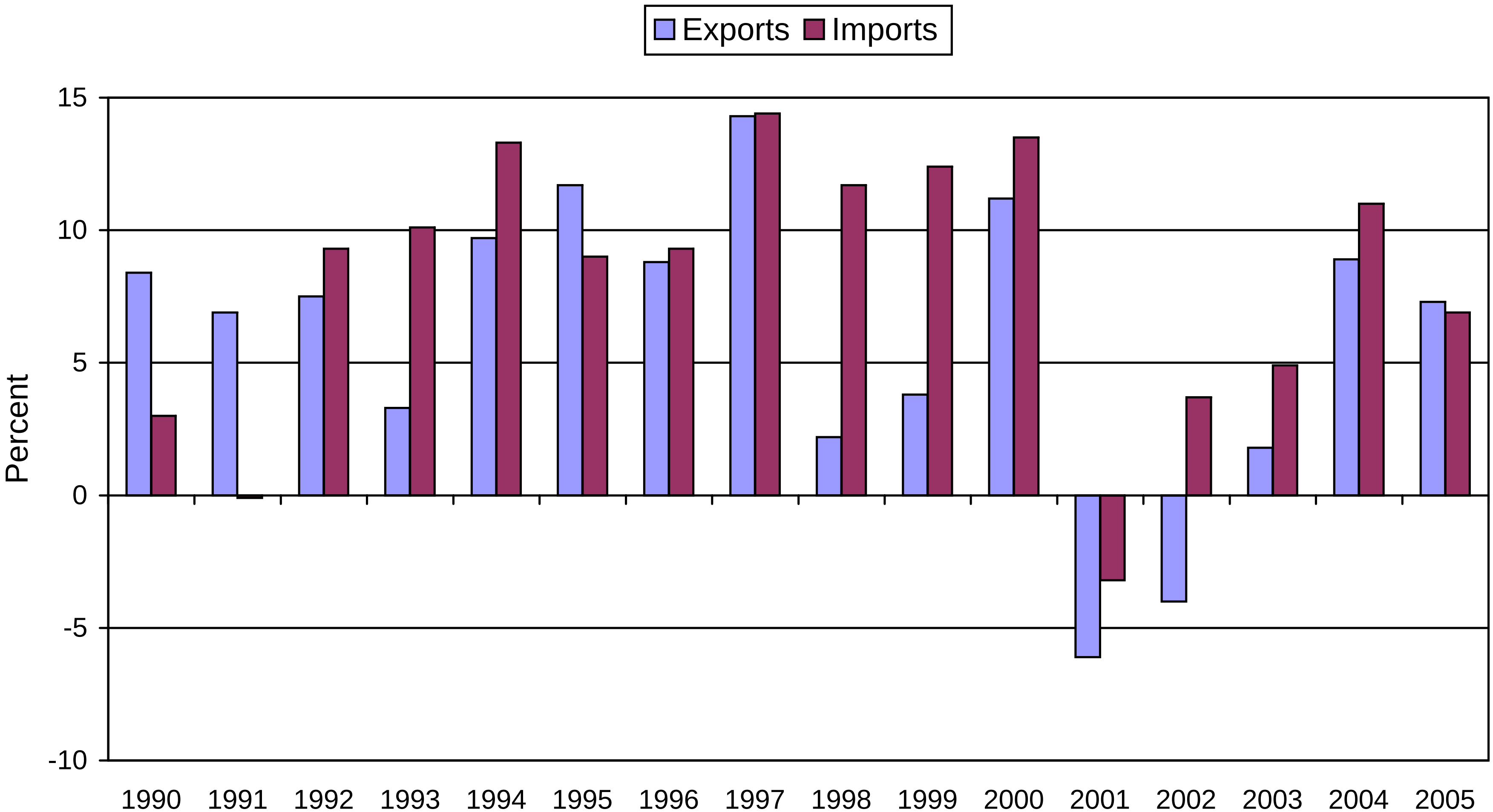
Source: U.S. Federal Reserve Board of Governors, Statistical Release H.10, available at http://www.federalreserve.gov/releases/h10/Summary/.

Figure 2
Fed's Indexes of the Real Value of the U.S. Dollar,
Major Currencies versus Other Trading Partners
Monthly, January 1990 - July 2006



Source: U.S. Federal Reserve Board of Governors, Statistical Release H.10, available at http://www.federalreserve.gov/releases/h10/Summary/.

Figure 3
Growth Rates of Real U.S. Exports and Imports of Goods
Annually, 1990-2005



Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product (Gross Domestic Product) Accounts, Table 4.2.1, www.bea.gov.