

## GETTING RID OF THE TRADE DEFICIT: A CHEAPER DOLLAR IS NOT ENOUGH

by Jeff Faux

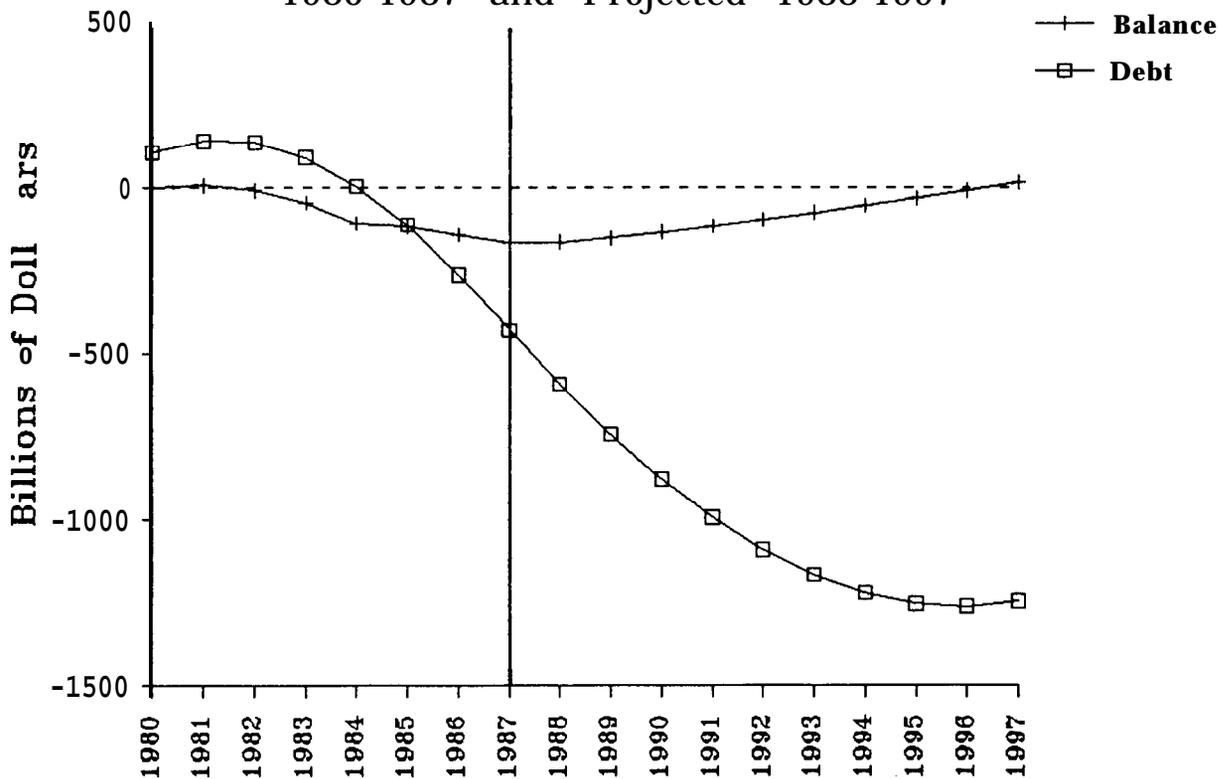
For the past three years the Administration's answer to the complex problem of the U.S. trade deficit has been currency devaluation -- lowering the value of the dollar against the currencies of our trading partners. The assumption is that increases in the dollar's exchange rate after 1981 caused imports to expand and exports to drop: therefore, bringing the dollar back to pre-1981 levels will automatically restore our trade balance. Reliance on this theory is implicit in the argument of those who oppose more direct and assertive U.S. trade policies.

Yet, since 1985, the drop in the exchange value of the U.S. dollar has yielded only a modest shrinkage of the gap between our imports and exports. Indeed, 1987 as a whole posted a record U.S. trade deficit of \$171.2 billion, up \$15 billion from 1986.

We can expect some improvement. The monthly deficit numbers in nominal dollars have declined after the record high of October 1987. And in terms of volume, the merchandise trade deficit seems to have peaked in the third quarter of 1986. But even under very optimistic assumptions it will be years before the merchandise deficit disappears, and even longer before we achieve a turnaround in our rapidly accumulating international debt.

Figure 1 illustrates the effect of a steady \$25 billion per year improvement in the merchandise trade balance on both the current account (which includes services and remittances) and the net U.S. debt to foreigners. It shows that, even with such an optimistic assumption on trade, it will be 1996 or 1997 before our net foreign debt ceases to grow. At that point we would owe well over a trillion dollars, with interest payments to foreigners likely to be even larger than the conservative \$60 billion per year assumed in the projections. (See Appendix Table)

Figure 1  
**U.S. FOREIGN DEBT  
 AND CURRENT ACCOUNT BALANCE**  
 1980-1987 and Projected 1988-1997



Source: Bureau of Economic Analysis, Department of Commerce, and Appendix Table.

Had the dollar **not** fallen since early 1985 our financial position now would undoubtedly be much worse. But, as we enter the fourth year of currency devaluation, it should be clear to all serious observers that this policy does not have the capacity to haul us out of the deficit hole into which we have fallen. Indeed, logic and experience suggest that continuing to trust in the power of this single "silver bullet" to eliminate the trade deficit will result in:

- lower real income for Americans;
- a larger foreign debt burden;
- an increasing threat of recession;
- a missed opportunity to curb other nations' restrictive trade practices.

The implication for policy is not that the United States should artificially stop the dollar from falling further. it is that we should now **supplement** our **policy** arsenal with **common-sense trade management and competitiveness** strategies which can **help** shrink the trade deficit by means other than lowering **American** living standards.

## FALLING DOLLARS, FALLING DEFICITS, AND FALLING INCOMES

There is, theoretically, some exchange value of the dollar that is low enough to eliminate the trade deficit all by itself. At that level, U.S. exports would become so cheap and imports so expensive that we could hardly avoid selling more to the rest of the world than we buy from it. We do not know what that level is. But given the resistance of the trade deficit to the lower dollar thus far, we know that in order to do the job alone the dollar will have to fall much further. The result would be a major relative decline in U.S. wages and incomes. In other words, we would eliminate our trade deficit by becoming a low-wage producer.

Contrary to one widespread misconception, we cannot escape the negative consequences of a lower dollar just by reducing our fiscal deficit. There are two mechanisms through which a lower fiscal deficit can translate into a lower trade deficit. One works by lowering the dollar: less deficit financing reduces government demands on available savings which reduces pressure on interest rates. This, in turn, reduces foreign demand for dollars to invest here, reducing the dollar's value and making U.S. exports cheaper and imports more expensive.

The other mechanism works by cutting the fiscal deficit so quickly and so deeply that it causes a recession, thereby reducing imports by reducing incomes. In addition to the obvious disadvantage of recession, the possibility that the fragile world financial system would collapse, turning recession into a

depression, makes this a particularly risky strategy for trade deficit reduction.

Reducing the fiscal deficit is necessary to reduce our reliance on foreign capital. And steady moderate-paced progress toward shrinking that deficit should be a priority of economic policy. But those who claim that it is the path to a trade balance should be forced to acknowledge its consequences: lowering the fiscal deficit can affect the trade deficit only through reduction in real incomes via a lower dollar or via recession. Or both.

#### WHY THE TRADE DEFICIT IS NOT DISAPPEARING

The insensitivity of the trade deficit to the lower dollar suggests that the international marketplace is much more complex than most economists and policymakers assumed three years ago. The assumption of symmetry -- that the falling dollar would have the mirror effect of a rising one and bring us safely back to the equilibrium of a trade balance -- misreads the dynamic character of the new global economy. Robert Kuttner suggests that, rather than equilibrium, the ruling condition in a modern economy may be "hysteresis", a term borrowed from physics meaning the failure of an object to return to its previous position after a disturbance has been removed.<sup>1</sup>

Among the specific reasons for the trade deficit's failure to drop with the dollar are:

First, the high dollar of the early '80s, coupled with the

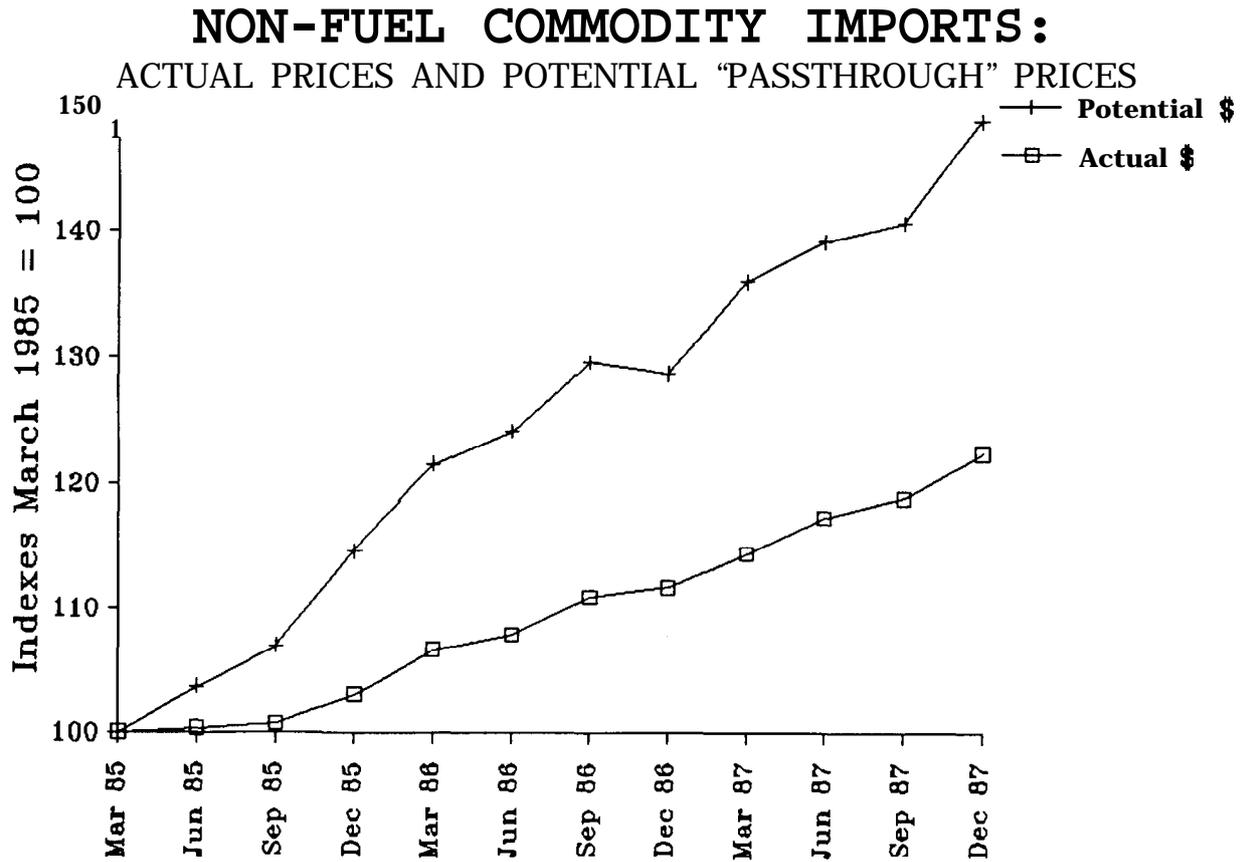
vastly increased mobility of capital and technology, created new and tougher competition for American producers. These new foreign competitors -- often nurtured by industrial policies of the home governments -- have longer time horizons than the typical American firm. They have been willing to absorb the impact of the falling dollar by taking lower profits in order to hang on to their share of the U.S. market. In contrast, there is evidence that some U.S. firms have not lowered export prices as much as the dollar has fallen and are using this **opportunity** to fatten short-term **earnings.**<sup>2</sup>

Protected home markets have helped. For example, higher profit margins from the expansion of domestic sales in Japan have enabled that country's multinationals to offset lower profit margins here. At the same time, U.S. firms seeking to take advantage of the lower dollar by reentering export markets have once again come up against the formal and informal barriers erected by the Japanese to protect and develop home-grown industries.

Figure 2 shows the difference **between the** potential increase in non-fuel import prices from a full "**passthrough**" of the lower value of the dollar and the actual increase since 1985.

Second, many of the world's raw materials, including oil, are priced in dollars. And the major surplus nations are major importers of raw materials. Thus, when the dollar falls, it lowers the cost of raw materials for our commercial rivals, helping to offset the pressures to raise dollar prices of their

Figure 2



Source: Bureau of Labor Statistics, Department of Labor. potential passthrough dollar prices calculated by EPI from BLS data.

manufactured products in the U.S. For example, compared with 1985, cost of Japanese oil imports -- relative to what the U.S. pays for its own imports in dollars -- has declined by some 40 percent, even as the world price of oil was also declining **dramatically.**<sup>3</sup>

Third, because of the need to maintain higher interest rates in the U.S. than in surplus countries (whose capital we must attract to finance our fiscal deficit), the cost of capital in those nations remains below ours. This gives a further competitive edge to their firms.

Fourth, depressed domestic production and high interest rates restrained private capital investment in the U.S. during the 1980s. This restricted -- and in many cases shrank -- actual

capacity, making it more difficult now for American producers to expand to take advantage of the lower dollar. In a number of product lines there are simply no longer any U.S. producers.

Fifth, although the dollar has fallen dramatically against the yen and the mark, it has not fallen very much against currencies of the new competitor nations in Asia and Latin America. For example, Korea, Hong Kong, Singapore, Taiwan, Mexico, and Brazil have dramatically expanded their exports to the U.S. in the 1980s. Against the currencies of this group of countries the value of the dollar actually increased by 6 percent between the first quarter of 1985 and the fourth quarter of 1987, having already risen some 30 percent between 1980 and 1985. While some Asian nations have finally begun to allow their **"pegged"** dollar exchange rates to fall, Table 1 shows that the dollar continues to rise sharply (and our trade deficit worsened in 1987) against important Latin American **currencies.**<sup>4</sup>

Finally, the rise in the exchange rate of the dollar in the early 1980s is simply not a satisfactory explanation for all of the deterioration of the U.S. balance of trade. The trade deficit with Japan, for example, now represents 36 percent of the total U.S. trade imbalance. As Table 1 and Figure 3 show, the dollar appreciation against the yen reached its high point in 1982 -- only 10 percent above the 1980 level. Between 1982 and 1987 the yen-dollar ratio dropped 42 percent. During the same period the U.S. trade deficit with Japan rose from \$17 billion to \$58 billion.

Table 1

EPI Trade-Weighted Value of the Dollar  
[1980 = 100)

	Aggregate Index: 38 Countries*	OECD Europe	Canada	Japan	Other Asia	Latin America [Real Value]**	Six Newly Indust. Countries***
1980	100.0	100.0	<b>100.0</b>	100.0	100.0	100.0	100.0
1981	107.1	123.4	<b>102.5</b>	97.3	<b>107.8</b>	95.4	99.4
1982	121.3	141.2	<b>105.5</b>	<b>109.9</b>	<b>114.8</b>	<b>125.2</b>	122.2
1983	128.5	158.8	<b>105.4</b>	<b>104.7</b>	<b>122.5</b>	<b>137.7</b>	135.0
1984	137.4	180.2	<b>110.8</b>	<b>104.8</b>	<b>131.4</b>	<b>142.6</b>	131.4
1985	144.0	188.3	116.8	<b>105.2</b>	<b>140.0</b>	<b>149.5</b>	134.3
1986	131.1	149.1	118.8	<b>74.3</b>	<b>142.1</b>	<b>165.2</b>	146.9
1987	121.2	128.6	113.4	<b>63.8</b>	<b>135.5</b>	<b>170.5</b>	140.2
<b>1985:I</b>	147.7	208.3	115.8	113.6	139.0	139.5	127.6
1985:IV	116.4	122.2	112.1	59.9	132.2	162.2	135.1
<b>Percent Change:</b>							
<b>1985:I-</b>							
1987:IV	-21.2	-41.3	- 3.1	-47.3	- 4.9	<b>+16.2</b>	+ 5.9

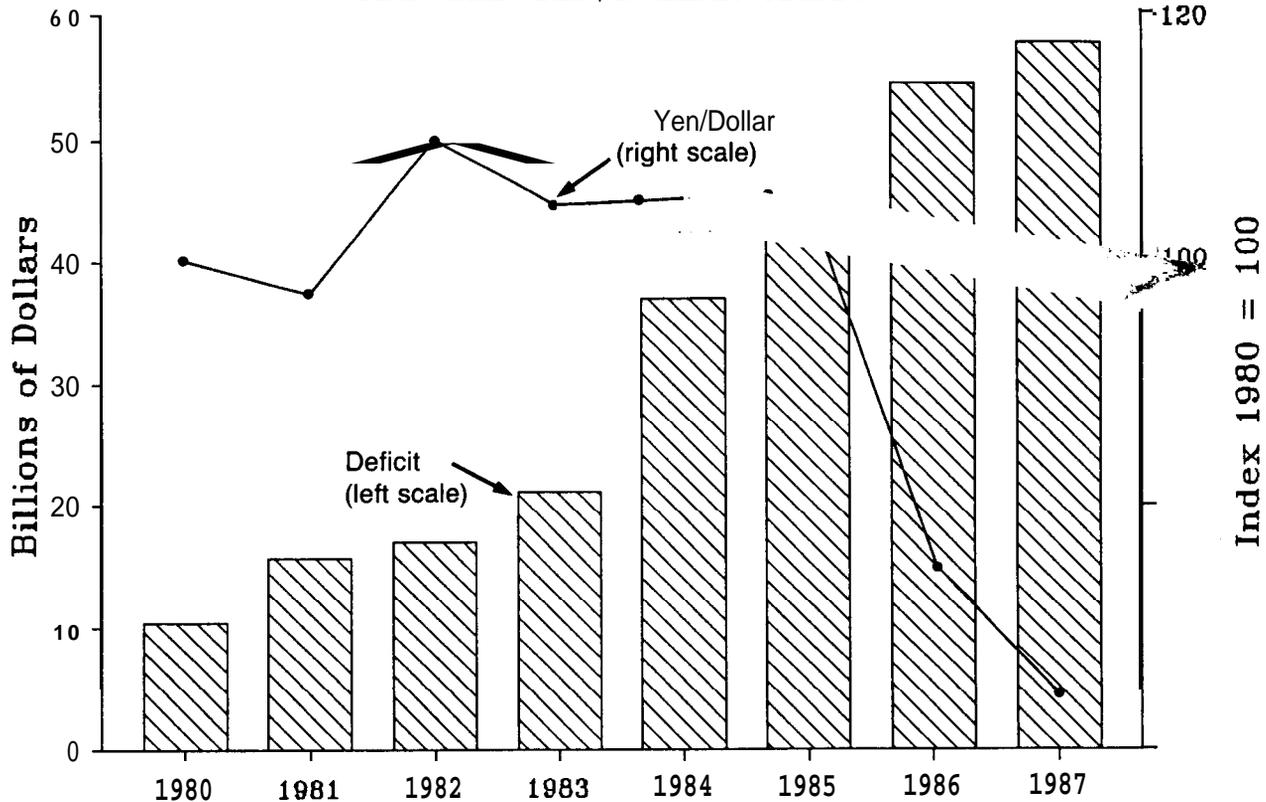
\* The aggregate index is based on the value of the dollar with respect to the currencies of 38 countries, weighted by the bilateral trade shares (exports plus imports) of each country with the U.S. in 1980.

\*\* Because severe inflation significantly distorts nominal exchange rates, the Latin American indices are corrected for relative price change and thus represent "**real**" values of the dollar.

\*\*\* Hong Kong, Taiwan, South Korea, Singapore, Mexico and Brazil.

Figure 3

## U.S. TRADE DEFICIT WITH JAPAN AND THE YEN/DOLLAR RATIO



Sources: Bureau of Economic Analysis, Department of Commerce; and International Monetary Fund, International Financial Statistics.

### EXCHANGE RATE PROTECTIONISM

In the current debate, the shibboleth of "protectionism" has been used to attack any proposal that contemplates restricting access to the U.S. market even as a means of pressuring other nations to lower their trade barriers. According to this argument, such policies hurt American consumers by raising prices of imports and they invite retaliation -- which could reduce world trade and repeat the history of the Smoot-Hawley tariff of the 1930s.

This contention is a misstatement of present reality and a distortion of the historical record.

For example, missing in the discussion of trade policy has been any recognition that the economic effect of the current alternative -- sole reliance on **currency** devaluation -- is even more "**protectionist**" than **anything proposed** in the Omnibus trade bills being considered in either House of Congress.

Harvard economist Larry Summers recently observed: "**A** ten percent decline in the dollar exchange rate is equivalent to a ten percent tariff on all imported goods and a ten percent subsidy for all exported **goods.**"<sup>5</sup> In this sense, the potential impact of the falling exchange rate has already been larger than any tariff imposed by the United States in modern times. The drop in the dollar's value so far, reflected by the EPI index, is the equivalent of an across-the-board tariff of 27 percent. By comparison, the Smoot-Hawley tariff of 1930 raised duties an average of only 6 percent on the prices of imported **products.**<sup>6</sup>

As we have seen, the exchange rate tariff has not yet been fully passed through to consumers. But if a lower dollar is to affect the trade deficit, it must be passed through. If it is not, the dollar must fall further.

Moreover, currency depreciation is a cruder and blunter protectionist tool than either raising tariffs on specific goods or bilateral trade negotiations. Currency depreciation hurts all nations with whom we trade, not just those who are running large surpluses against us. It forces the U.S. to have the same trade policy toward impoverished nations in Africa as it does toward Japan and Germany. It is inflexible and therefore cannot be

altered in exchange for opening up foreign markets. And it makes no distinction between imports that are necessities and those that are luxuries.

Like a tariff, lower exchange rates are also subject to a form of retaliation. Indeed, many countries already peg their nations' currencies to the dollar, thereby automatically retaliating against our lower exchange rate. Economic history is replete with attempts by countries (Great Britain in the **1930s**, for example) to solve their trade problem by devaluation, only to have their trading partners respond by depreciating their own currencies.

Plunging into a "currency **war**" in order to avoid the risk of a trade war is hardly a promising way to expand world trade. It may, in fact, add to the uncertainty facing private investors and producers, and thereby be even more destabilizing than formal trade barriers. Currently, for example, the dollar is being propped up by the willingness of the German and Japanese governments to finance the U.S. deficit in order to keep an even lower dollar from undercutting their exports to the U.S. This has added to the burden of international trade by forcing exporters and importers to guess what currency speculators are guessing about what governments are guessing about what currency speculators are guessing, etc.

While ignoring the protectionist implications of currency depreciation, the present debate on trade policy seems obsessed with analogies to the Smoot-Hawley tariff and its alleged

contribution to the Depression. Such analogies do not withstand scrutiny.

Smoot-Hawley was enacted when the U.S. was running a surplus, not a massive deficit, as is now the case. Moreover, Smoot-Hawley could not have been the cause of the worldwide contraction of trade since imports into the United States had already declined 24 percent from the first half of 1929 to the first half of 1930. (Smoot-Hawley was enacted in June 1930.) Ironically, in 1922, the **Fordney-McCumber** Act imposed even larger increases in tariffs on U.S. imports than did Smoot-Hawley, and was followed by an expansion of world trade and **prosperity.**<sup>7</sup>

Moreover, there is at least some evidence that the net effect of Smoot-Hawley was actually positive, in counteracting falling U.S. prices and in helping to stimulate production. In a recent working paper to the National Bureau of Economic Research, economist Barry Eichengreen concluded: **"Rather** than worsening the Great Depression by reducing foreign demands for U.S. exports, the direct macroeconomic effect of the tariff is likely to have been expansionary. This **remains** true even when feedbacks to the United States and foreign retaliation are **analyzed.**"<sup>8</sup>

Whatever the actual impact Smoot-Hawley had in the **1930s**, the analogy with the current trade bills in either the Senate or the House is false. Indeed, much of the Omnibus Trade Bill has to do with overhauling the process of setting trade policy. Provisions include: speeding up approval of trade agreements, defining violations of workers rights as unfair trade practices,

and requiring the Administration to defend exchange rate policy. An extremely important provision mandates advance notice of plant shutdowns and finances retraining and job placement services for displaced workers.

Buried in the bill there undoubtedly lurks some special treatment of specific commodities included to gather in the votes necessary for passage in Congress. This has always been the legislative price of progress. The current collection of "sweeteners" seems little different from, for example, the Tax Reform Bill of 1986.

Yet that part of the House bill that has drawn fire as the most protectionist is not special interest log-rolling, but rather the so-called Gephardt Amendment, which imposes no specific tariffs or quotas at all. It requires the Administration to negotiate with any country that has an excessive trade surplus with the United States resulting from a clear pattern of unfair trade practices. If, after 6 months, negotiations fail, the President can use a variety of tools to reduce the surplus by ten percent per year. The President also has the power to decline to act if he decides that enforcing the amendment would not be in the national economic interest.

To argue that such a provision is "protectionist" makes a parody out of the notion of free trade. In fact, it denies the U.S. the only practical leverage it has to open up the markets of its trading partners -- access to the U.S. consumer.

As is usually the case with legislative debate, the rhetoric

("free trade" versus "protectionism") hides the underlying struggle between those economic interests who benefit from imports and those who benefit from expanded production in the U.S. It also hides the political conflict between those in government who have for decades bartered access to the U.S. market as a means of furthering military and diplomatic goals and those who believe that the U.S. economy is the bedrock of national security.

#### THE BILATERAL OPTION

Elements in the trade bill have also been criticized on the grounds that they encourage bilateral, as opposed to multilateral, negotiation. Yet having a bilateral trade option among our policy tools permits the U.S. to adjust its trade strategy to the wide variety of trade regimes that exist in the real world. As Pat Choate and Juyne Linger have recently pointed **out**, one can identify at least five **quite** different policies and regulations under which the nations of the world regulate their **trade**.<sup>9</sup> Choate and Linger estimate that **only** one-quarter of the world's trade occurs under that Anglo-American system we call **"free trade"**. (Even this free trade system is, of course, studded with a variety of formal and informal tariffs, quotas and subsidies.)

A policy that cannot distinguish between trade with a "plan-driven" market-oriented economy such as Japan's, a developing mixed economy such as Mexico's, and a centrally planned economy

such as the Soviet Union's is ill-equipped to steer a sensible course through the new competitive world in which we find ourselves.

Bilateral negotiations have long been a major part of the global **economy**. The Reagan Administration itself has been in **continuous negotiations with our trading partners over a wide variety of products** regardless of whether these nations practice free or managed trade. Decisions are often arbitrary and sudden. For example, because the **"four tigers"** of Asia -- South Korea, Taiwan, Hong Kong, and Singapore -- had been letting their currencies fall with the dollar, the Administration in late January retaliated by removing from them the special benefits given to developing nations. By setting out the criteria for bilateral action, the trade bill could reduce some of the uncertainty and arbitrariness from the current process and give foreign and domestic firms a more stable environment in which to make their decisions.

Bilateral approaches to trade negotiations have their limitations. Ideally, we need a new set of global arrangements to take the place of the outmoded General Agreement on Tariffs and Trade (GATT) which can no longer accommodate the scope or character of today's world trade in goods and services. But GATT discussions will take years to resolve. Meanwhile, each month's trade deficit adds billions more to our foreign debt, mortgaging our future and limiting our international autonomy.

Another argument against legislative efforts to force down

trading barriers is that restrictions on sales of American goods overseas are only one cause of the trade deficit. Good point. The trade deficit is a case of "**death** by a thousand **cuts.**" The fiscal deficit, low productivity, obsolete management practices, the American obsession with paper entrepreneurship, targeted industrial policies of other nations, Third World indebtedness, lack of minimal labor and environmental standards in the Third World, an inadequately trained U.S. labor force, and the unwillingness of our trading partners to grow **faster** have all contributed. But the fact that one is bleeding from several wounds is hardly reason not to put a tourniquet on one of them.

Nor should it be an excuse to avoid addressing the fundamental questions of productivity and innovation in American industry. Over the long haul we can avoid lower incomes and the other negative consequences of a continually dropping dollar only if we raise our levels of productivity. We will be in this new era of international competition for as long into the future as we can see. In order to keep up with the competition, much less get ahead of it, we will need large and sustained private and public investments in critical economic inputs -- plant and equipment, education and training, public infrastructure, the commercialization of research and development -- as well as the evolution of new partnerships between government, business, labor, and universities.

The stakes in this new global competition are high -- ultimately they involve our sovereignty and the industrial

foundation of our national security. So far we have gambled that we can win this protracted struggle with the cheap dollar alone. It is now obvious that we need to add a few more policies to our arsenal.

March 1988

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Appendix Table

The Foreign Debt and the US Current Account Balance  
1980 - 1987, and Projection to 1997  
[Billions of Dollars]

	Merchandise Trade Balance	Net Income on Foreign Investment	Net Other Services Trade	Unilateral Transfers	Balance on Current Account	U.S. Net Investment Position End of Year
	[+ = surplus / - = deficit]					[+ = credit - = debt]
1980	- 25.5	+30.4	+4.6	- 7.6	+ 1.9	+ 106.3
1981	- 28.0	+34.1	+8.2	- 7.5	+ 6.9	+ 141.1
1982	- 36.4	+28.7	+8.1	- 9.0	- 8.7	+ 137.0
1983	- 67.1	+24.9	+5.4	- 9.5	- 46.2	+ 89.6
1984	-112.5	+18.5	-0.8	-12.2	-107.0	+ 3.6
1985	-122.1	+25.4	-4.3	-15.3	-116.4	- 111.9
1986	-144.3	+20.8	-2.2	-15.7	-141.4	- 263.6
<b>1987*</b>	-159.2	+ 5.9	-1.2	-12.2	-166.7	- 430.3
<u>Projection with Merchandise Deficit Assumed to Decline by \$25B/Yr **</u>						
1988	-134	-18	0	-12	-164	- 594
1989	-109	-30	0	-12	-151	- 745
1990	- 84	-37	0	-12	-133	- 878
1991	- 59	-44	0	-12	-115	- 993
1992	- 34	-50	0	-12	- 96	-1089
1993	- 9	-54	0	-12	- 75	-1164
1994	+ 16	-58	0	-12	- 54	-1218
1995	+ 41	-61	0	-12	- 32	-1250
1996	+ 66	-63	0	-12	- 9	-1259
1997	+ 91	-63	0	-12	+ 16	-1243

Source: Bureau of Economic Analysis, Department of Commerce.

\* The 1987 merchandise deficit (balance of payments basis) is the preliminary BEA estimate. Other current account components in 1987 are estimated from BEA data for the first 3 quarters.

\*\* The merchandise balance improves by the assumed \$25 billion per year. The net outflow of foreign investment income in 1988 is projected from recent trends. Thereafter, net outflows of such income are calculated as 5% of the net foreign debt-at the end of the preceding year. The debt itself increases each year (to 1996) by the amount of the current account deficit. Other items in the current account are assumed constant at the indicated levels.

## Endnotes

1. Robert Kuttner, "**The** Theory Gap on the Trade **Gap**," New York Times, 17 January, 1988.

2. Susan Chira, "Weaker Dollar Fails to Bring a Jump in U.S. Sales In Japan," New York Times, 3 March, 1988.

3. Estimated from Table 1.

4. The most commonly used index of U.S. foreign exchange rate movements is the Federal Reserve Board's "**Multilateral** Trade Weighted Index," which dropped 41 percent between the first quarter of 1985 and the fourth quarter of 1987. This index is weighted by the shares of total multilateral **world trade for** selected major trading partners of the U.S. in 1972-76 -- well before the shift in trade patterns caused by the high dollar itself. Moreover, the Federal Reserve Index only includes the currencies of 10 highly industrialized countries -- the so-called G-10 countries less the U.S. and plus Switzerland. By contrast, the index in Table 1, calculated by Milton Lower of the Economic Policy Institute, is weighted by U.S.. bilateral trade with 38 countries in 1980 and shows a smaller decline in the dollar. The EPI index also shows a lesser appreciation of the dollar during 1980-85 than does the Fed's index. But, whichever measure one prefers, neither has yet returned to its 1980 level.

5. Lawrence Summers, "**Time** for Inaction," The New Republic. 25 January, 1988, p. 14.

The arithmetic is actually a bit more complicated. While the subsidy effect of a declining dollar is equal to the percentage decline, the tariff effect is measured by the inverse rise in the value of other currencies against the dollar. Thus the 21% decline in the EPI Index (Table 1) works out to a 27% tariff equivalent. The further the exchange rate drops the more the tariff equivalent is magnified (a 50% drop in the exchange rate translates into 100% tariff equivalent).

6. Barry Eichengreen, "**The** Political Economy of the Smoot-Hawley Tariff," Working Paper #2001. National Bureau of Economic Research (August 1986. Table 3).

Tariffs in the Smoot-Hawley Bill were imposed on only one-third of U.S. imports. Moreover, according to Eichengreen, the tariff increases attributed to Smoot-Hawley are overstated because of falling prices. Because the tariffs were imposed in the form of specific dollars or cents per unit, the 32 percent price decline between 1929 and 1932 had the effect of raising the percentage of the sales price represented by the tariff. Thus, the price of peanut oil fell from 12 to 4 cents per pound,

**"raising"** the four cent-per-pound tariff from 33 to 100 percent.

7. Mark W. Love, **"The** Real Lessons of the Smoot-Hawley **Act,"** Journal of Commerce, 8 October, 1985.

8. Eichengreen. op. cit. Also see Gus Tyler, **"The** Long Shadow of Smoot-Hawley, **"** The New Leader, 11-25 January, 1988.

9. Pat Choate and Juyne Linger, **"Tailored** Trade: Dealing With the World As It **Is,"** Harvard Business Review. Jan - Feb 1988.