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Introduction

1980s Redux?

Forecasters project that the US trade deficit in 1999 will reach about $200 billion, and the current account deficit will be more than $300 billion, or about 3.3 percent of GDP. The trajectory for the year 2000 and beyond exhibits further widening. The current account deficit has not been this large in percentage terms since 1987, when the trade deficit was $153 billion and the current account deficit $170 billion.

The US economy is expected to continue to outperform the rest of the world in 1999, with an expected GDP growth of at least 3.5 percent, compared to the industrial countries' average of around 2 percent. This divergence in growth rates is eerily similar to what we saw in the mid-1980s, when the United States rebounded from the 1981-82 global recession much more quickly than did its industrial-country trading partners.

The exchange value of the dollar appreciates in response to the higher actual and expected returns that come with robust growth. Accordingly, between 1981 and 1985, the exchange value of the dollar appreciated some 50 percent against the currencies of the major US trading partners. Between mid-1995 and early 1998 the dollar also appreciated, although by a more modest 25 percent.

Along with these similarities between the two periods, might there be another forthcoming? After its substantial run-up, between 1985 and 1987 the dollar depreciated about 50 percent. While it is never easy to explain the behavior of foreign exchange markets, by February 1985 investors' and policymakers' views about the dollar complemented one another.

Table 1.1 Domestic economic indicators

	1991	1999 or latest	
GDP growth (chained 1992 $, percentage)	–0.9	4.5	(1st quarter, annualized)
Unemployment rate (percentage)	6.8	4.2	(March)
Number of employed persons (millions)	118	133	(March)
Inflation rate (CPI-urban)	3.1	1.7	(March)
Dow Jones industrial average	2,929	10,813	(1 May)
30-year US Treasury bond rate (percentage)	8.14	5.58	(1 May)
3-month US Treasury bill rate (percentage)	5.42	4.34	(1 May)
Federal budget position as percentage of GDP	–4.6	0.8	(1998)

Source: Council of Economic Advisers, *Economic Indicators* (April 1999).

Foreign investors had overbought dollars and US investments and had grown concerned about the magnitude of the external deficits and what they implied about future returns on US dollar investments. Policymakers, too, were alarmed at the value of the dollar and of their own currencies, and agreed in the context of the Plaza Agreement and later the Louvre Accord to undertake joint intervention in the foreign exchange markets to encourage the dollar down and then to maintain it at what they considered a more sustainable rate.

As we consider the constellation of domestic and external economic data for the United States and the world in 1999 and 2000, does a significant depreciation of the dollar appear inevitable? Or are the external deficits more sustainable now than they were in the mid-1980s, given that the US economy is different and that the factors underlying the widening of the deficits in the 1990s are different from those of the 1980s? More generally, once such large imbalances emerge, what factors can help to right them in an orderly way?

The US Economy in the 1990s: Robust Domestic Growth and Rapid Global Integration

Through the 1990s, US economic performance strengthened, to the envy of the world (table 1.1). The United States is the undisputed technological leader. The government budget is in surplus. Some 133 million people are now employed, and the unemployment rate has fallen below 4.5 percent, the lowest in a generation. At the same time, inflation has fallen and remains under 2 percent, also the lowest in three decades. During this expansion, US corporations have generated unprecedented wealth, which is

Table 1.2 External economic indicators

	1991	1998 or latest
Exports, goods and services (billions of US dollars)	601.8	959.0
Imports, goods and services (billions of US dollars)	622.3	1,102.0
(Exports + imports)/GDP (chained 1992 $, percentage)	20	29
Capital inflows + capital outflows (billions of US dollars)	167.5	847.9[a]
Current account (billions of US dollars)	–5.7	–233.4[a]
Current account/GDP (percentage)	–0.1	–2.7
Net international investment position (current cost, billions of US dollars)	–326	–1,500[b]
Net investment receipts or payments (billions of US dollars)	21.5	–22.5[a]

a. Preliminary.

b. Estimate based on 1997 data plus 1998 current account.

Source: Council of Economic Advisers, *Economic Indicators* (April 1999).

distributed more widely across American households than ever before. Even in the face of global financial volatility and downturns in the economies of virtually all US trading partners in 1998, the US economy has continued to grow in 1999 with unprecedented robustness.

This unrivaled good news on the domestic front has been associated with a rising interdependence of the US economy with the rest of the world through trade and financial links (table 1.2). Ongoing liberalization in trade and investment policies and deregulation in telecommunications and transport promote an increasing globalization of production and distribution of goods and services. During the 1990s, exports and imports of goods and services increased some 60 and 80 percent, respectively. About 30 percent of real GDP is directly affected by the forces of international trade, with the exposure of some sectors much higher, and others affected indirectly.

The United States and, more importantly, other countries liberalized their financial systems, and US financial intermediaries helped US and foreign investors diversify their portfolios of wealth into nondomestic stocks and bonds. Net cross-border flows of capital more than quadrupled, and gross cross-border flows of financial assets amount to trillions of dollars and continue to increase.

During the 1990s the US current account, which is the broadest measure of the net flow of trade and investment income, moved from near balance to a deficit of $233 billion dollars in 1998, representing a change from zero to 2.7 percent of GDP. The deficit comes from a large and widening deficit of trade in goods, even as trade in services increasingly is in surplus.

The flip side of a trade deficit is net capital inflows. If imports are not paid for with exports, they must be paid for through net sales of domestic assets or a buildup of liabilities to foreigners. The accumulation of the flow of net investment by foreigners constitutes the US net international investment position. Whatever measurement techniques are used, the value of foreign assets owned by the United States is less than the value of US assets held by foreigners; the negative net international investment position is some $1.5 trillion dollars, about 18 percent of GDP. Over a period of less than 10 years, the net investment earnings on this position turned from a positive $22 billion to a negative $22 billion.

Global Financial Crises Highlight the Linkages

The effects of economic turmoil in many countries around the world in 1997 and 1998 highlight the growing importance of trade and financial interrelationships between the United States and the rest of the world. As the economies of Asia collapsed, as Japan's recession worsened, and as economic activity in Latin America slowed, US export growth tumbled from about 10 percent in 1997 to zero in 1998, and exports shrank in absolute terms in the early months of 1999.

At the same time, in the volatile global investment environment, particularly after Russia defaulted on its financial obligations, US securities looked especially safe and valuable. Net purchases of US government securities surged, and the 30-year bond yield dropped from 6.6 percent in mid-1997 to about 5 percent in December 1998. (As the global crises ebbed, the rate ticked back up to 6 percent.) Home mortgage rates fell in tandem, to levels not seen since the 1960s, spurring residential investment at an unprecedented pace. The Dow Jones industrial average wobbled only slightly during the turmoil before continuing its upward march, passing the 10,000 mark by early 1999.[1]

Where To from Here? An Ever-Widening Trade Deficit?

The global financial crises will pass. Global integration will continue. Exports and imports will both increase, and investors in the United States and elsewhere will continue to diversify their financial portfolios by purchasing and selling financial assets and companies in each other's countries. National economic well-being increasingly relies on global production, distribution, consumption, and the web of international financial transactions that binds them all together.

For at least the next year or two, however, the US current account deficit will continue to grow, for two reasons: first and foremost, the trade deficit

1. The contrasting effect of the Asian financial crises on the US external sector (a deterioration) and the "nontraded" interest-sensitive sectors (a strengthening) is borne out by global econometric analysis in Noland, Robinson, Wang (1999).

itself, and second—and increasingly important as time goes on—the rising investment-service payments on the accumulation of nearly 20 years of deficits. The growth rate of exports will rise once growth resumes abroad, and the growth in imports will slow as the US economy returns to a growth path consistent with estimates of potential. But because the trade deficit is so large now, to actually narrow the gap between exports and imports will require a dramatic change in the growth differential, with import growth slowing markedly (to about one-quarter the average rate of growth in the 1990s) and export growth rising significantly (to about four times the rate of growth in the 1990s). Such a rapid change in the growth differential has occurred only rarely, and it could be associated with difficult economic adjustments in the United States. Second, the net investment payments on the US international investment position will continue to grow so long as the current account is in deficit and net foreign investment continues; these payments add to the negative net investment position. Hence, changing the direction of the US external balance is not a simple process.

The global financial crises and the widening US external deficits have precipitated fresh inquiry into a set of perennial questions about global integration and the US economy, which receive greater scrutiny as observers start to question the "sustainability" of the trade deficit. These questions can be structured thematically into four broad areas: (1) the forces that drive international trade, finance, and the external deficit; (2) the costs and benefits of increasing integration into the global economy; (3) the role of competitiveness and trade policy in the composition, level, and balance of trade in goods, services, and financial assets; and (4) the sustainability of the US imbalances.

My objective in this book is to provide facts and analyses in these areas and to focus attention on what should be and what should not be policy concerns, and on what actions policymakers can take, and what actions they should avoid.

Among my main points are that the trade deficit represents mostly good news—for both the United States and the rest of the world. It can continue on its current trajectory for two or three more years. Indeed, increased productivity growth associated with the globalization of production and distribution makes it possible for the imbalances to grow larger and to be sustained for a longer time than was the case in the 1980s. Moreover, the liberalization and globalization of international financial markets and institutions makes it easier and more attractive for investors to diversify their wealth portfolios to include high-return, relatively safe US investments. But the United States cannot forever consume beyond its long-term means; nor will its financial investments always be so favored.

There are some structural issues that US policymakers should face—particularly now, when the economic climate is so good. Household savings rates are too low given reasonable expectations for future income and wealth. Current and future worker preparedness for current and future jobs is inadequate and worsening. Trade negotiations must resume and should focus on multilateral liberalization of services. These structural issues facing the United States are not new, but they become more salient as the United States increasingly engages in a globalized and technology-driven marketplace.

A most important concern is the continued cyclical economic doldrums of the rest of the world. The lost decade in Japan, the tepid growth in most of Europe's economies, the tentative rebound in Asia, and the teetering of Latin America could be setting the stage for a rerun of the 1980s. If sustained growth around the world is delayed for several more years, US investments will continue to yield expected returns higher than those abroad and the dollar will continue to strengthen and the trade deficit to worsen, until a replay of 1985 for policymakers and the exchange value of the dollar becomes inevitable.

Overview and Organization of the Book

This book is designed to answer questions that policymakers often ask about US trade and foreign investment. Ten specific questions are collected around four themes.

The chapters in Part 1 address the forces that drive international trade, finance, and the external deficit. These chapters provide the framework for answering the question of what happened to the twin deficits of 1985 and of how the composition of trade and finance has changed over time. This information is important for understanding why policymakers should focus on policies to increase household savings and to promote service-sector negotiations. It also lays the groundwork for discussions on why capital flows are important when considering the sustainability of "the" deficit.

The chapters in Part 2 cover how the increasing integration into the global economy should affect policymakers' response to the external deficit. They address whether and how trade deficits hurt US workers and firms as well as how globalization is associated with increased productivity and lower inflation in the US economy. These chapters are designed in part to help policymakers counter the protectionist demands that inevitably accompany growing trade deficits, making clear that a policy partnership between government, business, unions, schools, and individuals to help firms and workers grasp new employment opportunities is required to obtain the full benefits of globalization and productivity growth. In addition, the fact that globalization and productivity growth are related implies that a larger current account deficit can be absorbed for longer now than in 1985, because the wherewithal to make good on commitments is growing.

The chapters in Part 3 consider how competitiveness and trade policy might affect the deficit and how policymakers should respond. These chapters explore the tensions between the microeconomic concept of relative price competitiveness and the macroeconomic concept of competitiveness as measured by share of global trade or by the external balance. The discussions in these chapters can help policymakers understand the long-run effects of labor quality and labor productivity on price competitiveness as well as the short- and medium-run effects of exchange rate misalignments on relative price competitiveness and trade balance. Part 3 also addresses whether and through what channels market-access negotiations with particular countries or unfair trade practices of individual countries can affect external balance. This information is designed to arm policymakers with an understanding of what bilateral deficits mean and what they do not mean, and it can help focus attention on what sorts of trade negotiations might yield the greatest improvement in external balance.

The chapters in Part 4, finally, address the question of whether the imbalances are sustainable from both the internal and external perspectives. These chapters discuss cyclical vs. structural trade deficits as well as the question of whether some trade deficits are nonproblematic in the sense that they have within them the means to finance repayment of borrowed funds or make good on expectations to return equity value. This analysis can clarify for policymakers how much of the widening of the trade deficit is associated with good US economic performance combined with poor economic performance in Japan and Europe, as well as with the fallout from the global financial crises. But it also points out that the composition of the external deficit and domestic spending (between consumption and investment) are important for ensuring that the deficit can continue to be financed. These chapters also address the relationship between capital flows and the current account.

The final chapter in Part 4 addresses the question of whether the United States is "special" and as such unlikely to suffer the fate of, say, the United Kingdom, Italy, Mexico, Russia, Brazil, or the Asian economies when investor sentiment changes. This chapter responds directly to the question of whether the trade deficit is sustainable, assessing the issue both from the standpoint of the ratio of current account to GDP and from that of capital flows as a share of global wealth.

Conclusions and Policy Recommendations

The conclusions and policy recommendations in this book are derived from complex and in-depth economic analysis of data and assessment of internal and external forces. Yet they can be summarized rather briefly. A key theme is that the globalization of the US economy blurs the traditional distinction between "trade" policy and "domestic" policy. Good policy reflects the marriage of both external and domestic needs and objectives.

- International forces are allowing the current robust expansion to continue and are enhancing the long-term ability of the United States to grow without generating inflation. Lower inflation rates benefit all people, especially those who consume a large fraction of their income. Faster productivity growth is the foundation for higher wages and allows monetary policymakers to keep interest rates low for longer periods without having to be concerned about higher inflation rates. Hence restricting trade would negatively affect both the short-run and the long-run performance of the US economy.

- As a general proposition, we need to describe and better quantify the benefits of globalization, since these have not been wholly understood by the population at large nor widely embraced by their elected representatives. Yet concerns over globalization are also justified, because adjustment by firms and workers to economic dynamics can be difficult and costly. The policy approach that must emerge places emphasis squarely on education and skill-training and on the creativity and flexibility of workers and management so that they can take advantage of business and job opportunities in the expanding sectors. Only a policy partnership between government, business, unions, schools, and the individual will create the kind of environment in which everyone can benefit from globalization.

- The global financial crises and the robust US economy in combination dramatically widened the US external account deficits in 1998 and 1999. Yet, because the United States is both special and a critical participant in the international markets, the external situation is not yet unsustainable. Robust domestic demand in the United States can continue to support the resumption of global growth for two or three more years. But, because of structural asymmetries in the components of the US internal and external balance as well as political and market sensitivities to ever-increasing trade deficits, the economic forces that underpin a sustainability episode will build throughout that time frame. The key issue is how best to keep these forces at bay.

- A significant depreciation of the dollar would keep the external accounts in sustainable territory for the near and medium terms, but would not put them on a sustainable trajectory for the long term. Without structural changes (such as raising the household savings rate, improving education for the future, and liberalizing global trade in services), a once-and-for-all depreciation of the dollar continues the cycle whereby a depreciation narrows the trade deficit initially but is followed by a widening current account deficit as structural instabilities and net investment payments take hold of the dynamics. Moreover, in the current robust economic environment, it would be difficult for the US economy to produce the additional goods and services without raising the risk of inflation and a monetary policy response that would slow the economy. Nevertheless, because an exchange rate change has a dramatic impact in the near term, it could serve to bolster political sustainability while longer-term structural initiatives pan out.

- On the agenda for structural change, the United States should push hard in the multilateral and broad-based trade negotiating round for liberalizing services. The United States has global comparative advantage in services, and services remain highly protected abroad. As economies grow, they tend to consume more services, and as income in a foreign economy grows, its imports of US services tend to rise disproportionately. Successful broad-based negotiations on trade in services will likely increase US exports of services even further, with a positive effect on the trade deficit. The long-term trajectory of the US external balances could be altered significantly by the combination of successful service-sector negotiations and broad-based liberalization and deregulation at home and especially abroad. These together would unleash higher productivity and faster growth at home and abroad, which would narrow the US current account deficit.

- An important structural link between the external balance and the internal balance is the household savings rate. The current rate of household consumption is not sustainable, and the high import intensity of US consumption is contributing to the trend deterioration of the external deficit. Current rates of household savings (even if underestimated for various reasons) have been trending downward for some time, even before the stock market began its rapid rise. When the stock market boom ebbs and when a domestic slowdown occurs, consumers are likely to increase debt burdens in order to maintain the higher consumption levels to which they have become accustomed. To the extent that today's consumption and savings profiles are driven substantially by volatile capital gains, they are not sustainable.

- For a whole host of reasons, the economies of the rest of the world need to grow more rapidly. But simply from the narrow objective of the sustainability of the current constellation of US growth and value of the dollar, if other countries grew, the rate of return to their investments would rise and the US dollar would depreciate as investors mix their portfolio of international assets instead of overweighting toward US and dollar-denominated securities. Faster growth abroad and a drifting down of the dollar would naturally help to close the US current account gap. But the longer the growth of the rest of the world stagnates or remains slow, the longer foreign investors will choose US dollar-denominated assets and keep the dollar high, and the greater the chances that an unpleasant change in investor sentiment will affect the dollar, the United States, and the world.