Climbing Out: How To Reduce the Trade Deficit

It will be difficult to stop living beyond our means. It will not be painless. But some ways will be more painful than others.

First, the United States could reduce its Federal budget deficit. Some deficit reduction was achieved in 1987: the deficit fell to $150.4 billion, down from $221.2 billion in 1986.[137] The Council on Economic Advisers forecasts further reductions to less than $130 se billion in 1989.[138] To reduce the deficit substantially requires either reduced outlays or higher Federal revenues, and either might also reverse some other trends, including the rising share of consumption in GNP. Higher taxes would also tend to restrict private investment (with harmful repercussions on the performance of manufacturers). Despite some success in cutting the Federal deficit in 1987, the deficit remains very large; further budget cuts will be more difficult to accomplish and raising taxes is unpopular. If there is an economic recession – which some analysts are predicting for 1989 – it is likely that the budget deficit will quickly balloon.[139]

Curtailing the growth of consumption and increasing personal saving (which has fallen to record low levels)[140] means living less well, for most Americans. If investment were dampened, efforts to improve competitiveness could be thwarted. Moreover, some foreign governments have been reluctant to spur economic growth and risk inflation, and their disinclination is magnified by America's failure to make more progress in deficit reduction. In short, even reversing the reversible could prove elusive.

Added to this is the fact that there are some things that the United States cannot affect directly, if at all. The prime example is the improved manufacturing and export performance of other nations. The improved performance of many nations results both from improved manufacturing productivity and quality, and from national industrial policies and a world trade regime designed to stimulate development. It would be foolish to expect foreign companies to stop learning how to improve productivity and quality in manufacturing; it is foolish to expect foreign governments to stop promoting their own economic development and exports. We might be able to impose barriers to the continued access of foreign producers to the U.S. market, but we can hardly expect our trading partners to accept such handicaps willingly. Moreover, while there may be cases where such barriers are prudent, a wholesale resort to trade barriers to improve our trade performance could be ruinous, and

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138 An excellent discussion of some of the choices confronting the United States and its trading partners can be found in Lester C. Thurow and Laura D'Andrea Tyson, "The Economic Black Hole, "Foreign Policy, Summer 1987; and in Marris, op. cit.

137 Economic Report of the President, Transmitted to the Congress February 1988 (Washington, D. C.: U. S. Government Printing Office, February 1988), p. 337.

138 This, of course, assumes that there will be no recession through 1989.

139 For example, the Federal budget deficit more than doubled during the 1982-3 recession, increasing from $79 billion in 1981 to $208 billion in 1983. Source, Economic Report of the President, op. cit.

140 The personal saving rate, which fluctuated between 6 and 10 percent throughout the 1960s and 1970s (dipping below 6 percent in only 5 quarters since 1%2) fell, by 1987, to between 3 and 4 percent. Source: U.S. Department of Commerce, Bureau of Economic Analysis, Business Conditions Digest, January 1988, p. 83.

could undo the progress made in the postwar period toward more open international trading.

The path of relying on further currency adjustments to achieve trade balance could cause considerable pain. It is already apparent, both from research and from the performance of U.S. imports and exports, that the dollar is far from low enough to bring the current account back to historical levels (within a range of $10 billion or so, deficit or surplus). The dollar's value, as of February 1988, had fallen nearly 37 percent from its peak in the second quarter of 1985, on a trade-weighted basis.[141] This has helped to bring U.S. monthly merchandise trade deficits down to $10-14 billion in the first four months of 1988, largely by stimulating exports. It has only recently begun to reduce manufactured imports, although some products — notably, Japanese motor vehicles — have begun to show lagging sales and rising inventoried, a result of price increases induced by the change in dollar-yen values.

Bringing the dollar down further would mean that more imports would move beyond the means of more Americans. By the end of 1987, the unit value index for all U.S. manufactured imports had risen 12 percent from its 1985 level (table 20).[142] Items that are major purchases for most households – notably, motor vehicles — have become much more expensive, rising 30 percent in price above 1985 levels by 1987 (figure 29). While consumers might be expected to switch to domestically produced vehicles, they apparently have not: imported automobiles were expected to account for nearly 30 percent of American sales in 1987, up from 28 percent in 1986.[143] In part, this is because domestic automakers raised prices too, sometimes in response to the rising costs of imported vehicles. Less costly items like VCRs, televisions, and CDs have also become more expensive, although many of these items come from countries like Taiwan and Korea whose currencies have not risen very much relative to the dollar (although there is a great deal of pressure on these nations to raise their currency values). The prices of imported office machines and automatic data processing equipment increased 45 percent between the first quarter of 1985 and the last quarter of 1987, and imported telecommunications equipment prices rose 8 percent. Imported sound and image tape recorders and players (including VCRs) went up by 16 percent. Interestingly, the prices of imported television receivers dropped 2.5 percent. This shows the effects of substituting imports from Korea, and from other nations whose currencies have risen less against the dollar, for more expensive exports from Japan.

Consumers are not the only ones to suffer "as import prices rise. Imported capital goods have become more expensive too, and many producers are finding it more difficult to afford imported machinery and equipment as a result. Imported capital goods cost almost 9 percent more in 1987 than in 1985. The price of imported textile industry machinery

141 International Monetary Fund, International Financial Statistics, April 1988, country pages.
142 Unit Value Index numbers are from the Department of Commerce, Office of Trade and Investment Analysis.
143 U.S. Department of Commerce, 1988 U.S. Industrial Outlook, (Washington, D. C.: U.S. Government Printing Office, January 1988), p. 38-3.
144 Import price data for office and ADP machines, telecommunications equipment, televisions, and sound and image tape recorders and players are from the Bureau of Labor Statistics,

Table 20.-Average Prices, Imports to the United States (1977= 100)

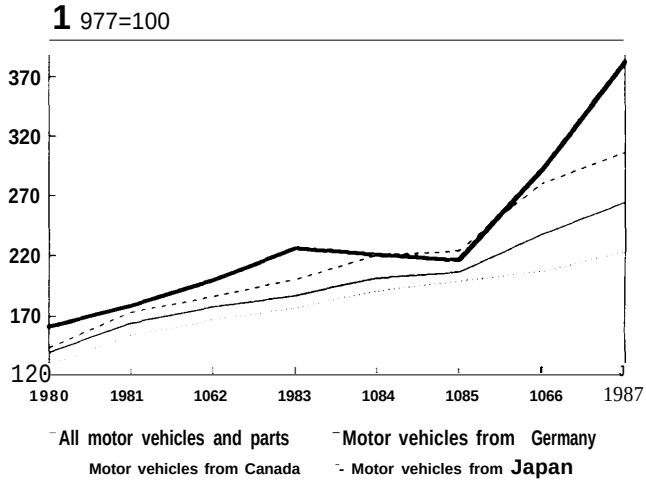
	1980	1981	1982	1983	1984	1985	1986	1987
All commodities 161.4		170,3	167.5	160.6	163.5	159.4	154.0	164.6
Manufactured goods 140.6		145.5	148.1	143.6	148.0	148.1	153.0	163,2
Consumer goods, non-food, non-auto 131.1		137,1	141.0	133.5	134.8	128.9	130.1	133.9
Autos ., ., . . 139.8		163.5	177.2	186.5	200.3	206.0	236.9	264.2
Autos from West Germany . . 160.8		178.2	198.9	225.6	220.2	215.1	200.8	361.4
Autos from Canada 129.3		153.3	166.8	176.0	189.8	197,5	205.9	222.6
Autos from Japan 143.6		172.6	185.4	199.2	220.1	223.2	279.5	306.3
Nondurable goods 1410		1428	156.1	120.5	115.5	104.5	103,9	99.2
Woven cotton fabrics ., ..., 126.4		143.5	147.9	144.4	156.0	144.4	140,2	163.0
capital goods 126.7		123.1	126,4	122.0	128.6	131.0	136.2	142.4
Industrial supplies and materials 192.1		2066	195,3	180.6	178.1	167.2	129,5	143,1
Textile machinery except weaving .. .2155		2182	204,9	220.2	246.1	247.4	283,6	356.2

NOTE: Average prices for imported items are expressed as unit value indexes
SOURCE: United States Department of Commerce, Bureau of the Census, unpublished data

rose 44 percent over the same period.[145] Because most textile industry machinery is imported, textile makers are, in most cases, unable to switch to cheaper domestically-made machines. This could handicap the efforts of the industry to improve product quality, raise productivity, and compete with less expensive, imported textiles.

Another danger of relying only on further devaluation of the dollar to reduce the trade deficit is the risk of a severe recession. If we take no other action to reduce imports, increase world demand, reduce the budget deficit, and raise exports, foreign governments and private investors will force a solution by curtailing investment in American assets and securities. If that happens, we face a period of rising real interest rates as consumers, investors and the U.S. treasury compete for an increasingly limited supply of capital. Exchange rate markets would also be in turmoil, as the dollar, no longer supported by foreign demands for dollars, declines further, and sharply. These developments could

Figure 29
Average Price, Imported Motor Vehicles and Parts



NOTE: Average Prices for imported commodities are reported as Unit Value Indices,

SOURCE: U.S. Department of Commerce, Bureau of the Census, various years, unpublished data.

force the U.S. economy into a recession, which would almost certainly engulf other nations whose welfare depends substantially on the American economy. According to

145Source: Department of Commerce, unpublished data on Unit Value Indexes for Imports.

some analysts, such a recession would include increasing inflation as well as rising interest rates–both of which would depress consumption (and thereby, standards of living). Rising interest rates also choke off investment, which would hamper the ability of American firms to improve their competitiveness. In short, a recession generated by a cutoff in foreign capital inflows would be a setback to our efforts to balance trade in manufacturing by means other than protection from imports.

Finally, relying on currency adjustments for further improvement in trade performance is undependable at best. Many businesses that are beginning to boom as export orders rise are reluctant to add capacity or make significant long-term investments in plant and equipment solely on the strength of a currency-induced upturn, since currency adjustments are beyond the direct control of manufacturers. According to one article, manufacturers still are unconvinced of the durability of the dollar's drop, and even those that are reaching production limits are reluctant to expand capacity. Some companies are even passing up export business, preferring to serve domestic customers instead as they push production closer to capacity. Many manufacturers see the dollar's fall as a windfall, offsetting its disastrous rise — much as farmers welcome rain after a drought. Long-term improvement in our trade picture cannot be based on such windfalls. Sustained improvement must be based on something more reliable: improved competitiveness.

In terms of the macroeconomic adjustments, the least painful course would be steady and substantial progress by the United States in reducing government deficits, reducing the growth of consumption and increasing savings; more expansionary policies and stimulatation of demand in major developed nations; efforts to find ways for developing nations to reduce their debt burdens and begin to open their markets.

This is a tall order. At best, such changes will take years, and an extraordinary degree of cooperation between nations. But progress must be made if we are to restore some degree of predictability and stability to international markets.

Besides these changes, prompt and comprehensive efforts to improve U.S. manufacturing performance are needed. Technology-broadly defined–has been a source of strength. Promoting development, acquisition and diffusion of new product and process technologies will help to improve competitiveness. Other actions that government might undertake include improving education and training workers and managers in new skills, helping firms to export, encouraging investment in productivity-enhancing machinery and qualified people, and providing information about effective ways of organizing production and developing new markets. The government could also evaluate how other policies encourage longer term investments in product and process improvement. This is not a catalogue of government policy options to

146Alan Murray, "Aided by Weak Dollar, Factory Output Leads Economy Once Again, ''Wall Street Journal, Jan. 26, 1988.
147Ibid.

foster improved manufacturing performance; it is only a short list drawn from past work.[148]

The trade patterns of the 1980s are a significant departure from any past experience, and the enormous current account deficits of the United States have changed economic relationships throughout the world. While some remedies will make more of a difference than others, solutions that aim at only one area — such as promoting competitiveness or reducing federal spending or further devaluing the dollar or opening foreign markets – cannot achieve more than limited success. We must make progress in many areas to overcome the trade deficit while minimizing the impact on standards of living. Whatever solutions we adopt, we are in uncharted waters: we have never had such problems to solve before.

148See, for example, U.S. Congress, Office of Technology Assessment, International Competitiveness in Electronics, OTA-ISC-200, (Washington, D. C.: U.S. GPO, November 1983); U.S. Congress, Office of Technology Assessment, International Competition in Services, OTA-I%0-328 (Washimgto, D. C.: USGPO, July 1987), U.S. Congress, Office of Technology Assessment, Technology and Structural Unemployment, OTA-ITE-2S0 (Washington, D. C.: USGPO, February, 1986); The President's Council on Industrial Competitiveness, Global Competition: The New Reality, op. cit.; and Thurow and Tyson, op. cit.