

United States General Accounting Office 132965 Report to Congressional Requesters

**May 1987** 

## INTERNATIONAL TRADE

Symposium on the Causes of the U.S. Trade Deficit





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# GAO

United States General Accounting Office Washington, D.C. 20548

National Security and International Affairs Division

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May 15, 1987

The Honorable Robert Kasten United States Senate

The Honorable William Frenzel House of Representatives

As part of the response to your request that GAO study the causes of the increased U.S. trade deficit and ways that it could be reduced, we sponsored a symposium attended by leading international trade specialists on December 11, 1986. This is a summary of that symposium, published as a supplement to the GAO report <u>The U.S.</u> Trade Deficit: Causes and Policy Options for Solutions (GAO/NSIAD-87-135)

The summary was written by Professor Richard Cooper of Harvard University, who chaired the symposium. The agenda used by the participants is in the appendix

Copies of this summary are being sent to various congressional committees and other interested parties and will be made available to others upon request.

allan R. Mendelowitz

Allan I. Mendelowitz Senior Associate Director

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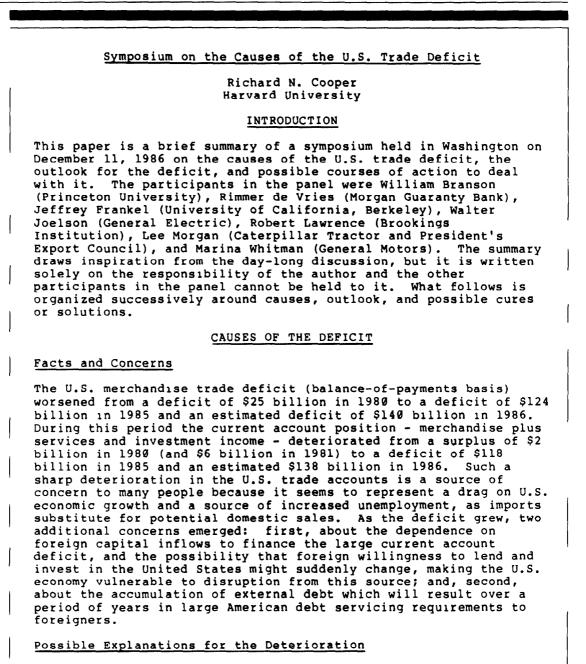
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### Symposium on the Causes of the U.S. Trade Deficit—by Professor Richard Cooper, Harvard University



Many reasons have been advanced to explain this dramatic deterioration in the U.S. trade position. One puts heavy emphasis on foreign restrictions on imports of U.S. products and foreign incentives for foreign products which compete with U.S. goods in third country markets. A second focuses on the fact that during \_

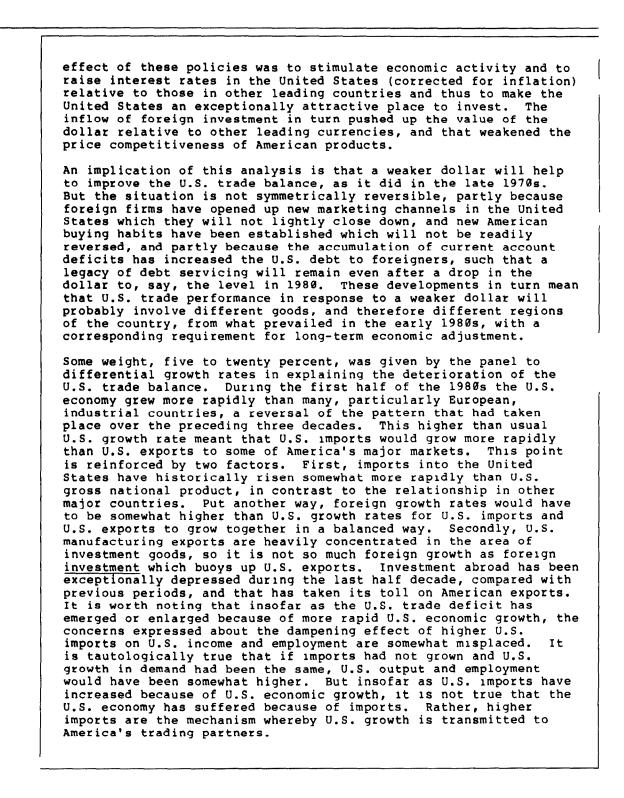
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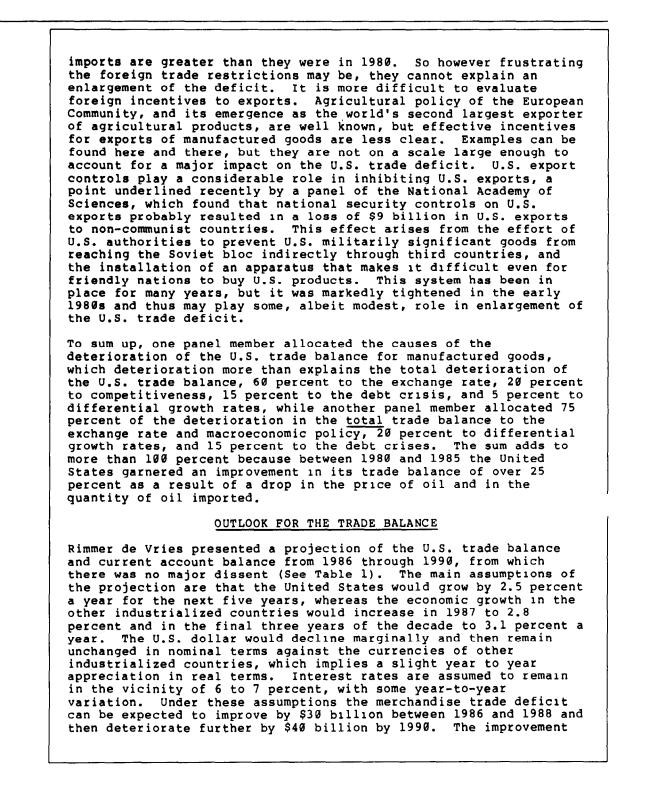
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much of the early 1980s the U.S. economy was growing more rapidly than many other countries, so U.S. demand for imports increased faster than foreign demand for U.S. exports. A third explanation, in part related to the second, focuses on the world debt crisis and the fact that U.S. exports are disproportionately concentrated on sales in Latin America, such that U.S. exports are depressed when Latin America 1s depressed, as it has been since 1982.
A fourth explanation, especially pertinent to the decline in U.S. agricultural exports, focuses on increases in world supply of agricultural products and, again, on the slow world economic growth which depressed commodity prices.
A fifth explanation focuses on the dramatic increase in the value of the dollar between 1980 and early 1985, relative to other leading currencies such as the Japanese yen and the German mark, with a consequential loss in price competitiveness of American products relative to products from those countries, both in the U.S. market and abroad.
A final explanation focuses on a loss of U.S. "competitiveness" apart from the factors mentioned above and in particular apart from appreciation of the dollar. This loss in underlying competitiveness in turn is attributed partly to the fact that U.S. productivity growth has been very slow, resulting in higher increases in unit labor costs than can be found in some (but not all) other industrial countries. It focuses in part on the rapid diffusion of new U.S. ideas abroad, such that the U.S. economy cannot enjoy the benefits for so long as it once did of producing and exporting new products in demand around the world, combined with the fact that innovation is taking place more rapidly abroad than it used to. The loss of competitiveness may also arise from lassitude by U.S. business management, an increasing preoccupation with short term financial results with correspondingly less emphasis on innovation and long term market development, the preoccupation with acquisitions and protection against being acquired, and an increasing dominance by lawyers and accountants as opposed to engineers and marketing specialists in the top management of U.S. corporations. Needless to say, a number of these explanations are highly debated and even contentious.
Judgments of the Panel The panel registered the judgment that, while diverse explanations could plausibly be put forward, the deterioration in the U.S. trade balance over the early 1980s was overwhelmingly due to the rise of the value of the U.S. dollar. That of course did not occur in a vacuum. It was largely attributable to the monetary and fiscal policy mix in the United States and in other leading countries. In particular, the United States had a very expansionist fiscal policy from 1982 to 1985, leading to a large structural budget deficit, combined with a moderate to very tight monetary policy, whereas other leading countries such as Japan, Germany, Britain and (after 1983) France were all engaging in fiscal contraction. The net

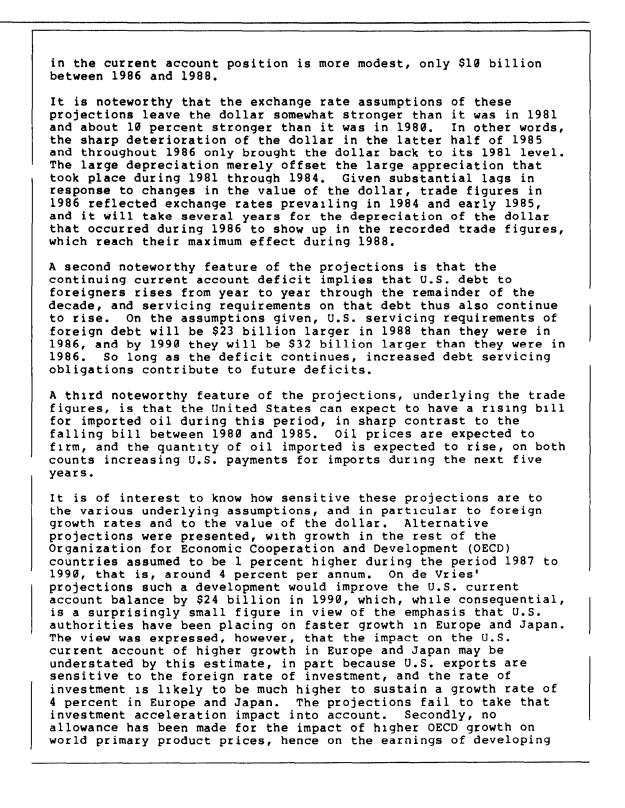


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The panel also gave consequential importance to the fact that Latin America has been economically depressed, and these countries play a disproportionate role as the destination for U.S. exports. Thus when Brazil and Mexico, two major markets, moved into economic decline as a result of their heavy external debt, U.S. exports suffered. As oil prices have fallen, spending by Organization of Petroleum Exporting Countries (OPEC) has also sharply diminished, in turn depressing U.S. exports (but also the exports of Europe and Japan).
There was some agreement that U.S. "competitiveness" had declined, although the importance of this variable is difficult to assess. The first point is that the term needs to be defined carefully, since it is a word that carries many different meanings. In particular, if we are to distinguish this from other factors it is necessary to correct the notion of "competitiveness" for changes in the exchange rate, for relative growth, and for the introduction or relaxation of trade restrictions. This leads to a focus on product quality, unit labor costs and unit capital costs in national currency, rates of innovation, new and aggressive market development abroad, and a host of other factors such as reliability in follow-on servicing. It is noteworthy that U.S. unit labor costs grew less rapidly than European unit labor costs measured in national currency during the early 1980s, but somewhat more rapidly than those in Japan. Much anecdotal evidence suggests a more rapid diffusion of new product ideas abroad than took place, say, ten or twenty years ago, such that U.S. firms enjoy the temporary monopoly of new product development less long than used to be the case, and this would represent some decline in U.S. competitiveness. So would more extensive new product innovation abroad, although the evidence on this development is not especially strong.
It is noteworthy that, according to the calculations of one panel member, the share of developing countries in U.S. imports of manufactured goods rose negligibly between 1981 and 1985, from 24.6 percent to 25.4 percent, suggesting that the widespread impression that U.S. production is being much more rapidly relocated to developing countries, and this is the source of U.S. import growth, does not carry much support. Manufactured imports from developed countries grew almost as rapidly. Moreover, while much is made in popular discussion of the large Japanese surplus with the United States, that surplus grew barely more between 1981 and 1985 than would have occurred if Japan merely got its 1981 share of the large U.S. deficit. A proportionate growth in Japan's trade with the United States would have resulted in a deterioration of \$28.6 billion, whereas the actual deterioration 1981-85 was \$29.9 billion. In other words, there does not seem to be much of a specifically Japanese factor in the worsening of the U.S. deficit either.
The panel agreed that trade restrictions against U.S. products played a negligible role in the emergence of the large U.S. trade deficit. If anything, trade restrictions today on American exports are lower than they were in 1980, and U.S. trade restrictions on



	<u>1985</u>	<u>1986</u> bi	<u>1987</u> 11ions d	0f dolla	<u>1989</u> ars	<u>1990</u>
J.S. current account with no further dollar depreciation	-\$118				-\$147	
Trade deficit (c1f) Trade deficit (fob) Invisibles excluding net interest	-124	-141	-150 -124 16		-150 -123 21	-147
Net debt*	-2 107		-25 38Ø		-45	-48
Interest rate (%)	7.7	6.5	6.6	7.6		
Real growth (%) United States Non-U.S. OECD	2.7	2.5 2.5				
Effective dollar (1980-82=100) Narrow nominal Narrow real	127 121	106 103			104 104	104 107
Memo: Current account with U.S. import income elasticity higher than foreign import income elasticity**			-138	-139	-162	-192
ource: Morgan Guaranty Trust Compa	ny					
*Net debt is the net investment pos eversed. This concept assumes that tates remains unchanged since the e he current account deficit is a bui broad. The flow of income from the position is included in service inco	the ne nd of ld up curre	et equi 1985 an of inte	ty posid d that d rest pay	tion of the cour ying U.S	the Uninterparts. liab:	ited : of ilities
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]	countries and the ability of those countries to import from the United States. But the quantitative impact of these two additional
	effects was not estimated. An alternative projection was also made for a further 15 percent depreciation of the dollar during 1987 from rates prevailing in late 1986. This would take the real effective exchange rate roughly back to the level that prevailed in 1980, and would be consistent with exchange rates of 130 yen to the U.S. dollar, 1.6 marks per dollar, and 1.30 Canadian dollars per U.S. dollar (although other combinations of exchange rates could achieve the same overall result). Such a depreciation would improve the U.S. current account position by \$56 billion by 1990. These projections show that the two factors together would improve the U.S. current account balance by \$90 billion, bringing the deficit below \$100 billion but still leaving a substantial deficit.
ļ	CURES FOR THE DEFICIT
	General Observations It is important to understand the causes of the deficit clearly, to avoid fundamental misunderstandings about its nature and hence fanciful proposals for dealing with it. But it is also worth noting that identifying the causes of a phenomenon does not automatically lead to the solution, since causes may not be subject to policy manipulation and in any case other actions, unrelated to the underlying causes, may nonetheless help to rectify the situation.
	In evaluating proposed cures, however, it is necessary to keep in mind the relationship between the current account deficit of any country to its total economy. From the national accounting identities, the total output of any economy (Y) must be disposed of through private consumption (C), domestic investment (I), government expenditure (G), or exports (X), after deducting the import content (M) of all of these magnitudes (Y = C + I + G + X - M). Similarly, total output gives rise to income which must either be consumed (C) or saved (S) or paid to the government in
	either be consumed (C) or saved (S) or paid to the government in taxes (T), $(Y = C + T + S)$ . It follows from subtracting one of these accounting identities from the other that the current account deficit, $M - X$ , must equal the difference between domestic investment, and private plus government savings, $I - S + (G - T)$ . A reduction in the current account deficit therefore requires a reduction in the gap between domestic investment and private plus government savings, where the latter in turn is equal to the consolidated public sector surplus (Federal plus State and local). It is worth noting here that an investment boom, other things being equal, will worsen the current account deficit; similarly, a growing budget deficit, by increasing public dissaving, will also increase the current account deficit if investment drops more rapidly than government tax revenues.

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This relationship is an after the fact identity. It represents an important check on the consistency of any proposed policy, since in order to reduce the current account deficit the policy actions must also affect savings and investment in the required way. But this accounting identity says nothing about the dynamics of the impact of policy actions on the economy.

#### Increased Growth Abroad

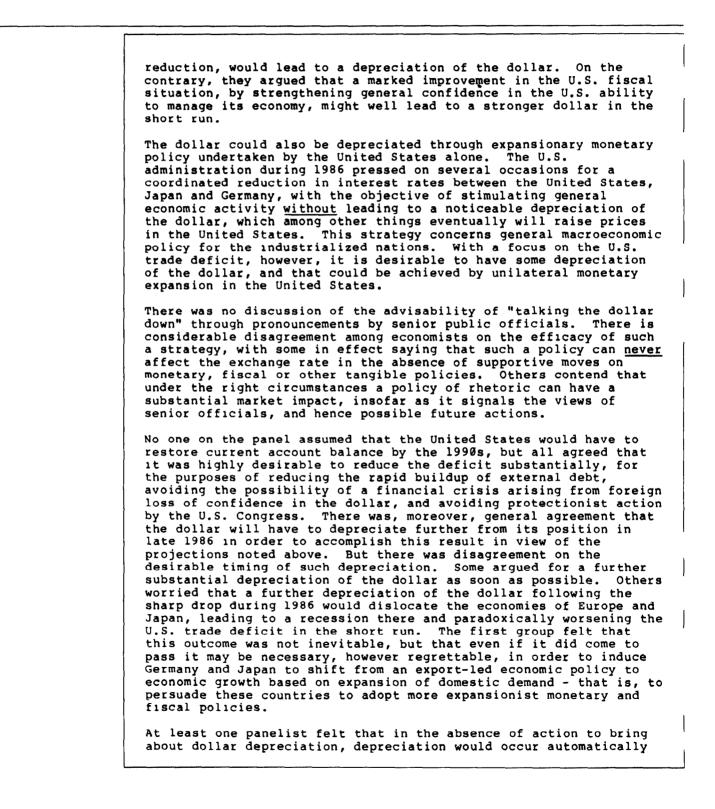
The panel agreed that increased growth abroad would be desirable for its impact on the U.S. current account deficit, although there was some disagreement over just how important this effect would be quantitatively, and therefore on how much emphasis the Executive Branch should give to it. For example, the direct impact of a 2 percentage point increase in Germany's growth rate - a substantial increase - on the U.S. trade balance would be quite small. However, insofar as Germany operates as a constraint on growth elsewhere in Europe, a 2 percent increase in Germany's growth rate might lead to substantial increases elsewhere in Europe, increased rates of investment, and firming of world primary product prices and thus also enlarge the capacity of many developing countries to import.

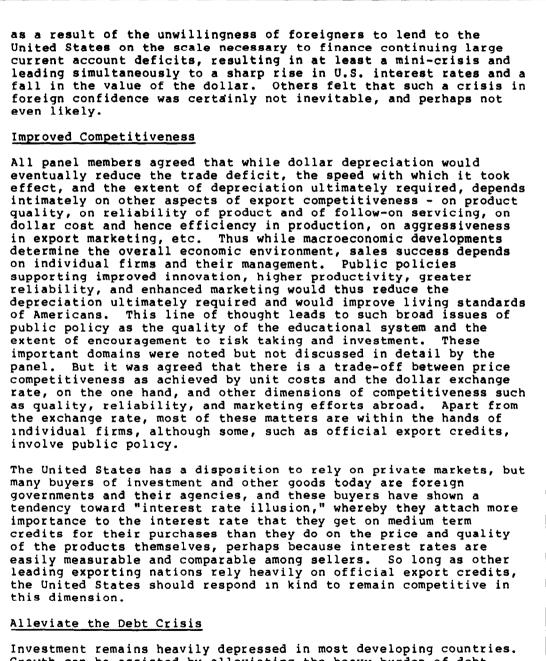
#### Depreciate the Dollar

All panel members agreed that further depreciation of the dollar would eventually lead to an improvement in the U.S. trade balance, albeit with a lag that arises in part because of temporary reductions in margins by foreign suppliers in order to hold their U.S. market and in part to inevitable delays in shipments of new orders that follow the change in relative prices, both with respect to U.S. imports and especially with respect to U.S. exports. There was, however, some difference in judgment on how best to bring about a further decline in the dollar.

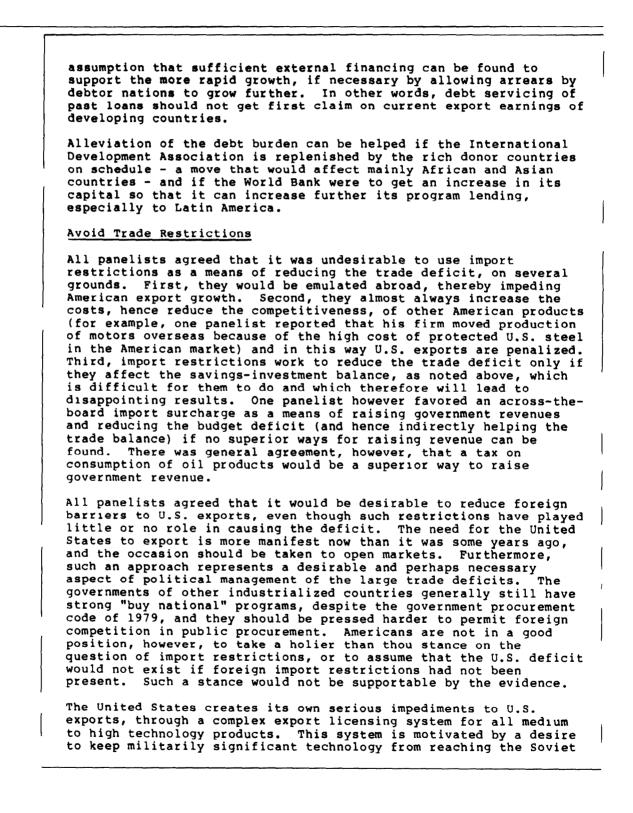
Some felt that the key to reducing the trade deficit was a sharp reduction in the U.S. budget deficit. Drawing on the National Accounts Identity noted above, a reduction in the budget deficit would increase national savings relative to investment and would result in an improvement in the current account balance. This result would be brought about by a reduction in long-term interest rates as the government experienced lower requirements for deficit financing, and that in turn would lead to a depreciation of the dollar, which would in turn lead eventually to an improvement in the trade balance. The relationship between the budget deficit, long-term interest rates, the exchange rate, and the trade balance is the key to the effect here, but because financial markets can work quickly, a firm and credible commitment to a reduction in he budget deficit might well lead to a reduction in interest rates and a depreciation of the dollar well before a substantial reduction in the observed budget deficit actually took place.

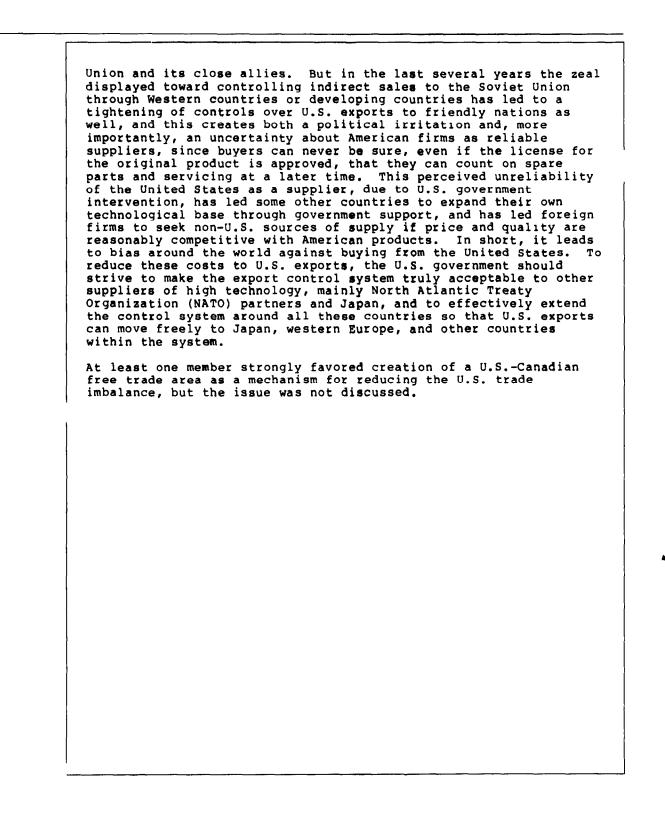
Others disputed the fact that a credible commitment to a reduced budget deficit, or even actual steps toward budget deficit





Investment remains heavily depressed in most developing countries. Growth can be assisted by alleviating the heavy burden of debt which many of these countries now have. While mechanisms were not discussed in detail, implied in this injunction is that the International Monetary Fund should lean more toward economic expansion in its programs for developing countries, on the





# Issues for the GAO Symposium

What are the major causes of the U.S. trade deficit?

1. Academic discussions of the U.S. trade deficit tend to focus on the savings-investment imbalance. Discussions by businessmen of the trade deficit generally focus on issues such as foreign trade barriers, a loss of U.S. competitiveness, and unfair foreign trade practices. Which side is right? Or are they both right? How can the two arguments be reconciled? Is each side missing some aspect of the other's argument?

2. How would you define competitiveness and what would be the indicators that you would examine in analyzing its status in the United States?

3. What is the role of the U.S. budget deficit in determining the trade balance? Can the trade balance can be significantly reduced without reducing the budget deficit?

4. What is the effect of each of the following on the U.S. trade deficit? What percentage of the trade deficit does each of following account for.

- a. foreign non-tariff barriers
- b. differing growth rates in the U.S. and in foreign countries
- c. the high value of the dollar
- d. the debt problem in less developed countries
- e. loss of U.S. competitiveness

**5.** To what extent can the Federal Reserve Board affect the U.S. trade deficit through its monetary policy?

6. Do microeconomic factors such as foreign trade barriers and a decline in U.S. competitiveness have much effect on the trade deficit? If not, what effects do they have?

What will happen to the U.S. trade deficit in the next 3 years?

1. Has the dollar depreciated sufficiently to eliminate the current account deficit or must it depreciate even more?

2. How long can the United States continue to run \$100+ billion trade deficits? Is adequate U.S. economic growth possible with such large U.S. trade deficits?

3. Does it matter that the United States has become the largest debtor nation in the world? When will the United States have to repay this debt

or will it be able to increase it annually, much like the federal budget deficit?

4. What will happen when the United States has to repay its foreign debt? Will the U.S. standard-of-living fall?

What steps can the United States take to reduce the trade deficit? What are the costs of taking these steps?

1. What effect would the following actions have on the trade deficit:

a. Coordinating intervention in exchange rate markets with other central banks

b. Changing U.S. tax policy to increase investment opportunities c. Subsidizing U.S. exports

d. Imposing an import surcharge

e. Reducing U.S. budget deficit (Would it matter if done through increased taxes or reduced expenditures?)

2. To what extent do reductions in the U.S. trade deficit depend on the actions of other countries (e.g., foreign economic growth rates, foreign interest rates, LDC debt problems, foreign non-tariff barriers, etc.)

3. Should the U.S. attempt to persuade other countries to either increase their economic growth rates or increase the values of their currencies?

4. What other actions can Congress take to reduce the trade deficit?

5. Should the Fed attempt to lower interest rates in an attempt to lower the value of the dollar?

6. Has the United States lost competitiveness? If so, should any steps be taken to try to restore U.S. competitiveness to its previous level?

7. Have undue government regulations such as paperwork requirements and environmental regulations been major factors in the trade deficit? Should U.S. government regulations be reduced? Which ones?

8. What effect will the new tax laws have on the trade deficit? Will the elimination of the investment tax credit reduce investment and help erase the savings-investment imbalance?

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