Trade and Debt

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Few subjects have received as much comment in recent years as the so-called twin deficits in the Federal budget and in net exports of goods and services. Many economists and most politicians point out the dire consequences of the budget deficit for the future of the economy and of the trade deficit for the future of domestic manufacturing. The deficits are blamed for high interest rates, weakness in manufacturing output and sluggish growth of employment at home.

Yet, despite the frequent discussion of these deficits for four years, the central problem has escaped attention. Few have tried to look through the paper transactions to the reality that lies below. Had this been done, the deficits would appear as symptoms—not causes—of the problems of the U.S. economy. And, while there are no easy solutions, some of the proposed solutions—protection, currency devaluation, easier monetary policy, general tax increases—would be seen to be mistaken or less attractive than some available alternatives.

The main economic problem is that as a nation we consume too much relative to what we produce. The excess of spending over production shows up in the national accounts and affects both deficits. The government spends mainly for consumption—health, welfare, most of defense spending—and very little on investment. Privately, the share of spending for consumption remains near the highest rate we have experienced, while net investment remains at a very low rate. To maintain spending in excess of production, we sell assets and borrow abroad. The counterpart of this borrowing is the trade deficit—net imports from abroad. For the last year, net imports have remained at about 4% of total output—about $150 billion in constant 1982
dollars.

In the past four years, we have borrowed so much that, instead of owning net foreign assets of nearly $150 billion, as at the end of 1982, we had net foreign debts of more than $200 billion at the end of 1986. Large borrowing will continue even on the most favorable assumption. By the end of the decade we will owe foreigners between $600 and $900 billion.

These numbers seem large in an absolute sense, and they are. The U.S. is a wealthy country, however, with assets of from $10 to $15 trillion and with gross foreign assets of $1 trillion or more. Visions of U.S. citizens living in homes, or working in factories and office buildings all of which are owned by foreigners remains far from reality.

Still, there is a sense of unease. We accumulated the stock of foreign assets over a period of 70 years. In just four years, we have wiped out the net accumulation of several generations.

Should we be disheartened and ill at ease? Are a foreign debt and trade deficit of this size good or bad for the economy? The answer depends not mainly on the size of the deficit but on how the resources obtained through borrowing and net imports are used. If our borrowing financed a high rate of productive investment, the returns on the investment would pay the interest and principal. Our future standard of living would be higher. Since borrowing is used mainly to finance consumption, we live better now but leave a debt to be serviced and paid in the future. At some time, we or our children will be faced with two options.

Since our international borrowing is denominated in dollars, one option is to reduce the real value of the debt by inflating faster than people now believe likely. Increased inflation reduces the real cost of paying interest on the debt. Inflation imposes a large cost on the foreigners who bought the bonds and, as recent experience with inflation and disinflation shows, there are large costs at home also. The precise effect on international monetary arrangements of another period of U.S. inflation cannot be predicted. A new monetary arrangement may emerge, or we may return to the chaos of the 1930s.

The second option is to service the debt without inflating. This requires producing more than we consume and selling the surplus abroad to pay the interest on the foreign debt. This option requires a trade surplus for the U.S. large enough to cover net interest payments abroad. Using an interest rate of 8% and a net foreign debt of $600 billion to $900 billion, our trade surplus has to remain at $50 to $70 billion per year indefinitely.
A larger surplus in any year would reduce the debt and future interest payments; a smaller surplus would add to the debt and raise future interest payments.

The change from net imports of $150 billion to net exports of $50 to $70 billion requires a major shift in world trade patterns and resource use. Because the debt remains outstanding, the shift to a surplus must be permanent. A shift of this size, though large by current or past standards is not large in comparison to the size of the U.S. economy. A trade surplus of $60 billion by 1990 will be less than 1% of real GNP in that year.

The problem cannot be solved in isolation, however. We are not the only debtor. Many other countries have debts that must be serviced also, so these debtors, too, must have trade surpluses if they are to service their debts, currently close to $1 trillion. This limits our options. For example, we cannot expect to solve our problem by increasing net exports to Latin American debtors unless they increase their net exports to Europe and Asia. Nor, can we continue to be a net lender to Latin America to finance their trade and development. Every dollar we lend them has to be borrowed from the rest of the world or earned by exporting more than we import.

There is no way to avoid the conclusion that, if the debts accumulated in the seventies and eighties are to be serviced, there must be a major change in trading patterns and, therefore, in economic and trading relations. The U.S. must become a large net exporter to Europe and especially to Asia. Europe and Asia must become net importers. The postwar strategy of export led growth to finance investment in many countries of Europe, Asia and parts of Latin America was highly successful. Standards of living rose. That strategy must change to reflect the debtor position of the United States.

The magnitude of the required change is impressive. Currently, the U.S. exports about $370 billion and imports more than $520 billion in constant dollars. Closing the gap between exports and imports and paying the interest on its debt is equivalent to a 6% increase in the amount of current exports (in constant dollars) by 1990, or reducing current imports by 40 or 50%, or some combination of the two. These amounts are more than 10% of total current world exports and, perhaps more relevantly, more than three times the average trade surpluses (with all countries) of the two principal surplus countries--Germany and Japan. Much of Germany's surplus is earned within the European Economic Community, while much of Japan's surplus comes from trade with the U.S. It becomes clear that these countries must become, for the first time,
large net importers from the U.S. and other debtor countries if the debts are to be serviced. To illustrate, Japanese and German trade deficits equal to 2% of their 1990 output would provide only $75 billion toward interest payments of the U.S. and other major debtors. This is about one-half the amount of 1990 interest payments of these debtors.

Many observers who discuss the twin deficits appear to reach conclusions that are superficially similar. They urge monetary expansion by Germany and Japan to lower interest rates and stimulate demand for our exports. Others urge monetary expansion by the Federal Reserve to depreciate the dollar or monetary expansion in all three countries and perhaps elsewhere. These are stop gaps, not solutions. They work by putting the bandaid of additional demand on a problem that requires adjustment of costs and prices of exports and imports. They offer short-term, not long-term, solutions.

The problems of trade and debt are not mainly problems of weak demand. Output growth in the U.S. has not been held back by weak domestic demand. Consumer demand has been strong, but a large part of the demand has been satisfied by imports. Faster money growth abroad can produce a temporary spurt in world demand, an increase in U.S. exports and a reduction in the trade deficit. But, faster money growth abroad cannot solve the long-term problems of trade and debt. And, by increasing inflation, faster money growth sets the stage for another period of disinflation and another round of stop and go that will make the problem harder to solve.

OPTIONS

To eliminate the trade deficit and service our debt, we must lower costs of production relative to prices. There are four options. None offers an easy, attractive solution. Each deals in a different way with the problems of trade and debt.

We can inflate, as many now urge. Inflation lowers the value of the debt and devalues the dollar. The decline in the value of the debt transfers wealth from the rest of the world but, sooner or later, inflation raises all prices including interest rates and wages. The rise in wages and other costs of production offsets the effect of the devaluation on trade. To reduce the trade deficit permanently, we must reduce the cost of domestically produced goods. Inflation not only does not solve the trade problem but, by encouraging consumption it makes the problem worse.
We can protect against imports using quotas, surcharges and perhaps tariffs. This lowers spending on imports but invites retaliation and shrinks the amount of world trade. A lower level of trade makes more difficult the task of squeezing out $60 billion to pay interest on our foreign debt. In addition to all the other, well advertised disadvantages of trade restrictions, we must add that they are in a real sense counterproductive when we view the trade and debt problems as a whole.

We can devalue the dollar. We have done a lot of that in the past two years. A real devaluation, unlike inflation, raises prices relative to costs of production. This method of adjustment, like protectionist policy, reduces standards of living relative to foreigners and perhaps in absolute terms. We cannot avoid devaluation, but we should avoid policies aimed at manipulating exchange rates and "talking the dollar down."

We can increase productivity. There are many ways to do this, none easy to accomplish. At the national level, the four most important policy changes in my judgment, are: (1) without increasing taxes, shift taxation from capital to consumption so that the share of consumption spending falls and the share of capital spending rises to levels substantially above those achieved in the last twenty years; (2) reduce government spending, particularly consumption spending and, if possible, shift government spending from consumption to productivity enhancing investments in infrastructure; (3) make a commitment to maintain these policies—and a long-term pro-growth strategy—to reduce uncertainty about future after tax returns to investment. Elements of this strategy include more deregulation, less costly means of reducing pollution, enforcing product liability, safety and health. (4) shift from a policy of lending to foreign debtors to a policy of encouraging repatriation of foreign capital and debt reduction by foreign debtors. It makes little sense for a debtor country, the U.S., to borrow and sell assets to finance loans to Latin American debtors. Instead, we should encourage Latin Americans to sell equity in their large state sectors or to adopt policies that attract some of the capital held abroad by their citizens.

CONCLUSION

The problems of trade and debt require that we produce more relative to what we spend and that we transfer part of the difference abroad to service the debt. The four options take different approaches to the problem.
Inflation does little to solve the trade problem and, by encouraging consumption, makes the problem more severe. Devaluation (in real terms) and protection solve the problem by lowering standards of living at home relative to living standards abroad. None of these options works to increase output and productivity. A general tax increase to reduce the budget deficit would raise the tax on investment to maintain government spending on consumption. This is the opposite of a policy to close the gap between spending and production by increasing production. It is only by adopting measures that increase productivity that we can hope to service our debt while shifting output from domestic use to exports without increasing inflation and without permanently reducing standards of living relative to foreigners and, perhaps, absolutely. Reductions in government spending on consumption, higher taxes on private consumption -- and lower taxes on investment and capital -- shifts resources toward investment and raises productivity.

A few numbers bring the problem into perspective. Interest payments by the end of the decade will be about \(1\frac{1}{2}\%\) of real output. If real output grows at an average rate of \(2\frac{1}{2}\%\) to \(3\%\) per year, output per capita will rise at no more than \(2\%\) per year. The interest payments absorb all, or most, of the increase. In addition, we must eliminate the current net exports deficit of \(4\%\) in 1982 dollars.

These numbers imply that per capita incomes do not rise much to the end of the decade. To increase growth of per capita income, the options must include more than inflation, protection and devaluation. A pro-competitive, pro-growth policy achieved through a permanent change in taxation must be part of our policy. This policy does not avoid a reduction in current consumption, but by increasing output per worker, it assures that the reduction is temporary, not permanent.

There is no easy way out. Selling assets buys time, but something must be done with the time that we buy. To avoid having all of the problem solved by permanently reducing the real wages of American workers and the real incomes of American consumers, through inflation, devaluation and protectionist policy, we must begin, now, on a sustained effort to increase productivity. A shift of taxes from capital to consumption is an important first step. If we could add just one-half percent to the average growth rate for the next four years, we would have $100 billion more available for consumption, exports and investment in 1990.

Much depends on our choices. For the past forty years, the United States
has had the relative wealth and power to maintain or impose a degree of political, economic and trade stability on much of the world. We have not always succeeded; we have made mistakes; but, we have avoided the return to the disorder that characterized the interwar period, particularly the 1930s.

If we solve our problems of trade and debt by reducing our relative wealth, we move to a position of co-equal in a multi-centered world. New arrangements must develop for sharing responsibility for defense, finance, trade and the maintenance of such order as can be provided. We have done little to develop arrangements commensurate with the reduced role that our relative wealth and power will bring. If we fail to increase productivity, such planning is essential to avoid a return to the uncertainties of the interwar period.