Trade, Debt, Growth, and Standard of Living

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The trade deficit is certain to be an important issue in the 1988 election campaign. A constructive program to reduce the cost of adjusting to a position of balanced trade must be part of any economic policy statement. Three points are central to understand where we are headed and what we should do.

First, restoring balance to trade and payments involves reduction in the standard of living relative to other countries. Currently, we balance our payments by selling assets (farms, land, buildings, factories, equities, bonds) to foreigners and by devaluing the dollar. Asset sales and foreign loans create claims against our future income. Part of what we earn in the future must be paid to foreigners. Devaluation lowers current real income by making our imports more expensive and our exports less expensive. Devaluation can only work by reducing costs of production (real wages) relative to selling prices and relative to costs of production abroad. This, too, lowers our standard of living relative to other major countries.

Second, our goal should be to restore balanced trade with the smallest reduction in living standards. Balanced trade means that U.S. exports finance U.S. imports and pay the interest on the amounts we have borrowed and dividends on the equities or real assets (land, factories) sold to foreigners. With balance defined in this way, we neither borrow nor sell assets to foreigners. Emphasis on balanced trade lends itself to analogies that many people understand from their own experience. We pay our bills (for imports, interest and dividends) without going deeper into debt.

Third, to lessen the reduction in current or future income, we must increase productivity and efficiency. It is important, therefore, to present trade issue as part of a program to increase productivity, growth and future living standards.
Why The Trade Deficit Is A Problem

There are two aspects to the trade problem. One is redistributive. The other is the effect on overall standards of living.

The redistributive problem is from exporters and producers of imports to importers and consumers of imports. Buyers (consumers) clearly benefit from the opportunity to purchase high quality imports at attractive prices. Producers in some industries face increased competition from abroad. Some producers lose their market and must cut their costs or close. Workers must shift to new jobs. Such changes occur constantly in a competitive economy, but adjustments occur slowly and painfully and foreign competition concentrates attention on the painful aspects. A growth strategy helps by creating new jobs at a faster rate and, thus, reduces the loss perceived by producers.

The problem of living standards arises because, currently, U.S. imports are mainly consumer goods. To maintain spending in excess of production, we sell assets and borrow abroad. The counterpart of the borrowing and asset sales is (approximately) the trade deficit -- net imports from abroad. If the borrowing financed a high rate of productive, domestic investment, the returns on the investment would pay the interest and principal. Our future standard of living would be higher. But since our borrowing is used mainly to finance consumption, we live better now but leave a debt to be serviced and paid in the future.

In the past four years, we have borrowed so much that, instead of owning net foreign assets of nearly $140 billion, as at the end of 1981, we had net foreign debts of about $250 billion at the end of 1986. Large borrowing will continue even on the most favorable assumption. By the end of the decade, I estimate we will owe foreigners between $600 and $900 billion. (Others project debt of more than $1 trillion). In just five years, we have wiped out the net accumulation of several generations.

Options For Foreign Lenders

Foreigners will continue to lend, and we will continue to borrow, because for a time foreign lenders will continue to regard loans to us and purchases of assets as in their interest. An example is Japan, a large lender and buyer
of U.S. assets. The Japanese have been funding their pensions by investing here. They will have a large increase in retirees within the next decade, and they have the longest life expectancy in the world -- up to 85 years. By lending and buying assets now, they build up a fund that they can draw upon in the future to maintain their increased standard of living. If they draw on this fund by selling assets in the future on a large scale, they could have a net capital inflow and we would be net exporters.

Japan, Germany and other large lenders produce more than they purchase, and they save at a higher rate than we do. They have five options from which to choose. Since the options are not exclusive, they can combine parts of each.

(a) They can continue to lend and buy assets here. If they reduce their lending, the dollar will fall reducing their trade surplus and our trade deficit.
(b) They can buy more U.S. exports either because they spend more as their wealth rises or they work less and produce less at home.
(c) They can permit the dollar to fall (devalue) until their exports decline and their imports rise toward a balance in the trade account.
(d) They can change their policies, for example by removing barriers to agricultural imports.
(e) They can change their tax system to encourage more consumption for example, by reducing their consumption taxes. Some of the additional spending will be on imports.

The long-term solution, to which they will eventually come, is to import more, consume more, produce and export less. Revaluation of their currencies has made them richer, so sooner or later they will decide to consume more of their higher wealth and higher incomes. With the possible exception of further devaluation, large changes are not likely to occur quickly. Absent such changes, the lenders will continue to lend to us and buy assets here. We have time to develop a long-term policy. We do not need a quick fix, but the problem will remain as long as we save relatively little and consume at a high rate relative to our domestic production of goods and services.

Options for the U.S.

The trade problem must be considered in a global context. Proposals that
look to increased U.S. exports to Latin America are looking in the wrong place. 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.

If the debts incurred by the United States in the 1980s are to be serviced, there must be a major change in trading patterns and, therefore, in economic and trading relations. The United States must become a large net exporter to Europe and especially to Asia. Europe and Asia must become net importers. The postwar strategy in many countries of export-led growth must change to reflect the debtor position of the United States.

This will require massive changes in trade flows. Currently, the United States exports about $370 billion and imports more than $520 billion in constant 1982 dollars. Closing the gap between exports and imports by 1990 and paying the interest on our debt is equivalent to doubling the amount of current exports (in constant dollars) by 1990, or reducing current imports by more than half, or some combination of the two.

The size of our adjustment to reach balanced trade is 5 percent of U.S. GNP, but it is about 10 percent of total current world exports. Perhaps more relevantly, the adjustment in Germany, Japan and other surplus countries required to permit the U.S. to balance its payments is large relative to their economies. If Germany and Japan run trade deficits equal to 2 percent of their 1990 GNPs, their trade deficits would provide $75 billion toward financing the trade deficits and interest payments of the United States and other major debtors in Latin America and elsewhere. This is about one-half the projected 1990 interest payments for these debtors.

To eliminate the trade deficit and service our debt while permitting foreigners to service theirs, we must lower costs of production relative to prices and lower our prices relative to foreign prices. There are five options. None offers an easy, attractive solution.

We can inflate. Inflation lowers the value of the debt and devalues the dollar. But sooner or later, inflation raises all prices and costs of production. This offsets the effect of the devaluation on trade. Indeed, by encouraging consumption and discouraging investment, inflation makes the problem worse. Since much of our debt to foreigners is short-term, inflation
will be reflected in higher interest payments without much reduction in the real value of the foreign debt.

*We can protect against imports, using quotas, surcharges and perhaps tariffs.* This 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 future foreign debt. In addition to other, well-known undesirable features, protectionist policies increase the difficulty of servicing our debt.

*We can continue to devalue the dollar.* Since February 1985, the dollar has fallen by almost 50 percent against major currencies, lowering our standard of living but modestly improving our trade balance. Devaluation raises prices relative to costs of production and raises domestic prices relative to foreign prices. 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 or pushing it up". Exchange rates should be allowed to fluctuate freely. Preventing the dollar from falling blocks the principal means of adjustment available to us.

*We can force a recession.* This is the classic method of reducing spending and has been used recently in Mexico, Brazil, and elsewhere. A recession reduces imports relative to exports. It is costly for us and for the world -- including other debtors. We should not choose this course but we should be aware that restrictive monetary policy to prevent dollar depreciation carries this risk.

*We can increase productivity.* There are many ways to do this, none easy to accomplish. At the national level, the three most important policy changes, in my judgment, are:

1. 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 20 years. This is a "growth" strategy to raise productivity. Net investment has been relatively low in recent years, and the 1986 tax act discourages investment.
2. Reduce government spending, particularly consumption spending and, if possible, shift government spending from consumption to productivity-enhancing investments in infrastructure. If we are to
export more, we can use better roads, railroads, docks, etc.  

(3) Shift from a policy of lending to foreign debtors to a policy of encouraging repatriation of foreign capital and debt-equity swaps. It makes little sense for a debtor country, the United States, to borrow and sell assets to finance loans to Latin American debtors instead of encouraging them to sell their assets.

The Budget Deficit

The relation between the budget deficit and the trade deficit is not as simple and clearcut as many pretend. Concentration on reducing the budget deficit as a solution to the trade deficit leads to the mistaken view that a tax increase to shrink the budget deficit would be helpful. This is not entirely true. A large tax increase would slow the economy and possibly cause a recession. The recession would reduce imports and the trade deficit. The cost of this approach is high.

Concentrating on the budget deficit obscures the main problem. The U.S. consumes too much -- privately and publicly -- relative to what it produces. If the private sector or the government borrowing financed productive investment, the deficits would not be a serious problem. The borrowing would be serviced and repaid from the earnings of the productive investment.

As much as possible, emphasis should be shifted from the deficit to the use of resources. Instead of offering a program to close the deficit, programs should aim at higher growth and increased productivity and higher living standards. Tax policy should be used to increase productivity and reduce consumption.

Conclusion

To solve the problems of trade and debt, the U.S. economy must produce more relative to what we spend and transfer part of the difference abroad to service the debt and assets owned by foreigners. The various options take different approaches. Recession reduces the trade deficit by reducing incomes. 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.

Only by adopting measures that increase productivity can we hope to service the debt while shifting output from domestic use to exports without increasing inflation and without permanently reducing standards of living relative to foreigners. Reductions in government spending on consumption and increases in government investment shift resource use toward investment. Higher taxes on private consumption -- and lower taxes on private investment and capital -- also shift resources toward investment and raise productivity.

A few numbers bring the problem into perspective. Interest payments in real terms will be about ½% of real output by the end of the decade. If real output grows at an average rate of 2½% to 3% per year, output per capita will rise at no more than 2% per year. The real interest payments absorb part of the increase. In addition, we must eliminate the current net export deficit of 4% in 1982 dollars.

These numbers imply that per capita incomes do not rise much to the end of the decade and rise slowly thereafter even if we avoid a recession. 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 and a shift in spending is a more attractive option because it raises living standards. This policy does not avoid a reduction in current consumption, but by increasing output per worker, it limits the reduction.

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, the U.S. must have a program 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, we would have approximately $20 billion more available each year for consumption, exports, investment and debt service. This would pay the real interest due on the assets acquired by foreigners.