THE U.S. TRADE DEFECIT : THREE UNORTHODOX SOLUTIONS

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There is broad agreement on how we arrived at a merchandise trade deficit of $120 billion and rising.[1] Loose fiscal policy has depleted the pool of American savings, creating ample room for an inward flood of foreign savings. Tight monetary policy has raised the yields on U.S. financial assets and made them highly attractive to foreigners. Concurrently, the substantial appreciation of the U.S. dollar against foreign currencies has made American goods hugely overpriced on world markets and foreign goods exceptionally cheap to American buyers.[2] Additional ingredients are lower imports by the debt-burdened countries of Latin America, and a lagging business cycle in Europe and Japan. The result: a $120 billion merchandise trade deficit.

One camp says that we should watch the deterioration carefully, pray for smaller budget deficits and faster foreign

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1. A merchandise trade deficit of $120 billion implies a current account deficit of $90-$100 billion.

2. The international consequences of President Reagan's economic package were predictable and even predicted. See, Gary Clyde Hufbauer, U.S. International Economic Policy 1981: A Draft Report, International Law Institute, Georgetown University, Washington, D.C., April 1982. Also see, C. Fred Bergsten, "The International Implications of Reaganomics," Kieler Vortrage 96, February 1982.

* [In this statement made on 28 June 1984 to the subcommittee on Trade of the Senate Finance Commitee of the US Congress, Dr. Hufbauer, Senior Fellow of the Institute for International Economics, Washington D.C., discusses three unorthodox solutions to the problem of the US trade defecit. All would require changes to US law and policy, and the second and third solutions would have to be considered in the context of international trade law.]

growth, but otherwise do nothing.[3] Enthusiastic supply-siders believe that Federal budget deficits will soon be curbed by spending restraint and fast U.S. growth, with no need for painful tax increases.[4] Others in the do-nothing camp say that large budget deficits are likely to persist, that their reduction requires work as well as prayer, but that, in the meantime, inflows of foreign capital and a corresponding trade deficit help finance our fiscal excesses and hold down inflation.[5] The do-nothing camp believes that, so long as foreigners are willing to buy U S. financial assets, all is well. And, when foreigners no longer want to acquire U.S. assets, the dollar will decline. Again all will be well.

A second camp of thought sees three dangers with the watch and do-nothing approach.[6]

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3 See, for example, Economic Report of the President, February 1984, chapter 2.

4. Paul Craig Roberts, "The Deficit Scare Has All But Faded Away, Business Week, June 25, 1984, p. 16.

5. Martin Feldstein, "Improving the Trade Balance: Deficit Reduction, Not Tariff Surcharge," Statement before the Subcommittee on Trade of the House Ways and Means Committee, March 29, 1984.

6. See, for example, Stephen Marris, "Crisis Ahead for the Dollar", Fortune, December 26, 1983, p. 25, and C. Fred Bergsten, "The United States Trade Deficit and the Dollar," Statement before the Subcommittee on International Finance and Monetary Policy of the Senate Committee on Banking, Housing and Urban Affairs, June 6, 1984.

First, the U S dollar could abruptly collapse, with adverse consequences for world financial stability A 20 percent decline in the exchange value of the dollar over two years is one thing, a 20 percent decline over two months is quite another.[7]

Second, until the great collapse occurs, the sectors of the U.S economy that produce traded goods will suffer enormously, both from import competition and lost export sales.

Third, foreign competition built on misaligned exchange rates will increase protectionist pressure within the United States. As protectionist pressure is translated into protectionist action, an unfortunate demonstration effect will occur around the world.

I associate myself with this second camp. Like most members of both camps, I would welcome resolute reduction of the Federal budget deficit. Alas, the modest "down payment" bill appears to have exhausted Administration and Congressional enthusiasm for higher taxes and lower spending. Perhaps 1985 will bring a renewed assault. In the meantime, it would seem prudent to explore alternative measures that address the trade deficit directly. Before turning to some of my own unorthodox suggestions, I should say something about the broader savings-investment context of all trade deficit solutions.

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7 I hasten to add that neither Marris nor Bergsten foresees a decline as drastic as 20 percent in two months.

Any measures designed to decrease the trade deficit that do not simultaneously reduce the budget deficit will necessarily entail either an increase in some other category of savings or a decrease in investment. An increase in some other type of savings is much to be preferred over a decrease in investment

Table 1 gives the U.S. savings-investment balance for 1983 (preliminary data), and my own estimates (based in part on DRI forecasts) for 1984 and 1986. My projections for 1986 assume a \$25 billion inflow of savings from abroad,[8] a modest rise in personal savings, and little reduction of the federal deficit. My projections also assume a continuation of the very desirable rise (though at a slower pace) of gross private domestic investment.

I believe that the great bulk of additional savings needed to finance the rising level of private domestic investment and to replace foreign savings will have to be supplied by business In other words, policy measures that meaningfully improve the trade account will, at the same time, have to facilitate a rapid increase in business savings. The requisite jump in business savings probably means that prices will have to rise faster than wage costs per unit of output. This in turn means that corporate profits must rise more sharply than GNP. I see nothing wrong

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8. This corresponds to a merchandise trade deficit of about \$40-\$50 billion in 1986. In other words, I am assuming that a combination of exchange rate changes, slower growth at home and faster growth abroad, and deliberate policy measures will work to reduce the trade deficit by \$70 to \$80 billion over the next two years

Table 1 Estimated Sources of Gross U.S Savings, $ billions

	1983	1984 est.	1986 est.
Net savings from abroad	35	95	25
Personal savings	114	130	150
Gross business savings	455	480	645
Federal deficit	-182	-180	-175
State and local surplus	51	65	55
Total savings available for domestic use	472	590	700
Gross private domestic investment	472	590	700
GNP	3311	3650	4260
Total savings as percent of GNP	14.3%	16.2%	16 4%
Gross business savings as percent of GNP	13.7%	13.2%	15 1%

Source: For 1983, Survey of Current Business, April 1984; for 1984 and 1986, author's estimates based in part on Data Resources, Inc. forecasts.

with surging corporate profits. U S corporate profits have been too low for too long. But I hasten to add that not everyone would agree with this judgment.

What follows are three unorthodox approaches for dealing directly with the trade deficit. Other solutions are certainly possible. In any event, the trade deficit is now so large that a combination of measures, including a large dose of budget restraint and substantial foreign growth, will be needed to restore order to our internatinal accounts.

First Solution: A New Exchange Rate Policy

When the leading nations, at U.S. urging, adopted a system of floating exchange rates in 1973, it was widely believed that exchange rate fluctuations would ensure that the current account position of each of the major trading nations would stay roughly balanced. Events have not worked out that way. Ever larger capital flows have come to dominate the exchange of goods and services. The question now is whether exchange rates should be managed to achieve their "implied promise". I believe they should.

Three points are relevant to the question of how exchange rates can be managed.

First, the Fed already looks at other variables, in addition to the money supply, when it determines monetary policy. Indeed, the Fed's target cones of monetary growth are wide enough for a supertanker to turn in; and if money growth by one definition or another bumps against its boundary at an inconvenient moment, the lane is simply redrawn.

Second, while the Fed looks at other variables such as interest rates, GNP growth and inflation rates, it pays little or no attention to the real exchange rate between the United States dollar and key foreign currencies. (The real exchange rate is calculated by adjusting the nominal exchange rate for differential inflation between the United States and its trading partners). Changes in the real exchange rate are critically important in determining the U.S. merchandise trade deficit and deserve greater policy attention.[9]

Third, the Fed has enormous "announcement powers." It can influence financial markets by mere whispers. Look what happens to bond markets when Paul Volcker suggests that the economy is overheating or underheating. Small actions by the Fed can move financial mountains.

Bearing these points in mind, I think that the overvalued dollar can be corrected without much change in the present

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9. For more on this subject, see John Williamson, The Exchange Rate System, Institute for International Economics, Washington, D.C , September 1983.

eclectic approach to monetary policy What is needed is an announced change in emphasis. What the Fed needs to say is that it will pay attention to real exchange rates. Then the Fed needs to back up this statement by actively intervening in the exchange markets on a sufficient scale in a manner carefully timed to catch the speculative winds rather than fight them.[10] A 20 percent decline in the dollar, engineered over a two-year period, would curb the trade deficit and, at the same time, improve the earnings of U.S. firms that compete with imports or sell their goods in export markets.

An important technical question deserves mention: should exchange rate intervention by the Fed be "sterilized" (i.e., offset by equivalent sales of U.S. Treasury bills, leaving no net effect on the U.S. monetary base) or should it be "unsterilized" (i e , allowed to increase the monetary base)? I believe that sterilized intervention -- if pursued adroitly and resolutely, without the usual nay-saying by senior Treasury and Fed officials -- could dramatically change sentiment in the foreign exchange markets and create the right atmosphere for a very substantial correction in the exchange value of the dollar. Many of my professional colleagues disagree; they think that only unsterilized intervention, with its attendant inflationary risks, would do the trick. Whatever the merits of this academic debate,

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10. For more, see Ronald I. McKinnon, An International Standard for Monetary Stabilization, Institute for International Economics, Washington, D.C., March 1984.

the right strategy for the Fed is not to announce a strategy Monetary policy is best played like a poker game: don't show your cards. If the markets know that the Fed is watching real exchange rates, but do not know whether Fed intervention will be sterilized or unsterilized, then the Fed can play the strongest hand with the least inflationary risk.

Second solution: import tariff and export bounty

A possible answer to the grotesque merchandise trade deficit is to impose a balance-of-payments tariff on all imports at a rate say, of 20%, and to provide an equivalent bounty on all exports. This solution was roundly condemned by Martin Feldstein when he appeared before the House Ways and Means Committee.

One argument against the tariff/bounty approach is that it would move the exchange rate in the wrong direction, thereby offsetting some of the competitive gain. I doubt very much that the induced exchange rate change would completely offset the competitive gain.

Another argument is that a tariff/bounty approach runs against GATT strictures. Balance of payments quotas are, in fact, permitted by GATT Article XII. Balance of payments tariffs and bounties are a superior adjustment tool, less disruptive of market forces than balance of payments quotas. Unfortunately, this superiority is not openly acknowledged in the GATT. It can be argued that balance of payments tariffs are implicitly permitted, both by the wording of Article XII and by evolving pratice, but the same cannot be said of balance of payments bounties.

A third argument against the tariff/bounty approach is that it would poison the well for international negotiations aimed at liberalizing trade and could trigger a harmful round of imitation. I think this is the most forceful argument.

All in all, I prefer to marry the economic logic of a tariff/bounty approach with an old idea that has its own logic· border tax adjustments for direct taxes.

In my view all direct taxes -- corporate and personal income taxes and social security taxes -- should be imposed on imports and rebated on exports.[11] This proposal is spelled out in more detail elsewhere.[12] The basic idea is that all direct taxes paid on export earnings would be rebated and all direct taxes imposed on import competing industries would be collected at the border. The system is approximately revenue neutral; but it

11. See Gary Clyde Hufbauer and Joanna Shelton Erb, Subsidies in International Trade, Institute for International Economics, forthcoming 1984.

12. Thomas Horst and Gary Hufbauer, "International Tax Issues· Aspects of Basic Income Tax Reform," in Charls E. Walker and Mark A. Bloomfield, editors, New Directions in Federal Tax Policy for the 1980s, Ballinger Publishing Co., Cambridge, Massachusetts, 1983.

would dramatically change the price map facing U S producers. On average, according to my estimates, U.S. imports would be about 20 percent more expensive and U.S. exports about 20 percent cheaper following implementation of a border adjustment system for direct taxes. Price changes of this magnitude would clearly add to the profit and output levels of firms making traded goods, especially those in highly-taxed industries.

Border adjustment for direct taxes is not now permitted by GATT The GATT Subsidies Code should be modified, on an emergency basis, to deal with an emergency problem -- namely the U S trade deficit. I would add one important qualification Rebates and taxes should be phased in according to "need": a country must first incur large and persistent current account deficits before it can implement the new border tax adjustment system.

With this qualification, the United States could implement border adjustments as soon as its administrative machinery was ready; Japan and most European countries would have to wait until they experienced large current account deficits for some period of time before implementing the same system.

This proposal should not in any way obstruct the growing support for consumption-based taxation. True, under present GATT rules, consumption taxes can be imposed on imports and rebated on exports. But I have never thought that the main reason for adopting consumption-based taxation was to secure the advantage of the present, unduly restrictive, GATT border-adjustment rules. Rather, the rules should be broadened so that direct and indirect taxes are treated in an equivalent manner.

Another approach to the trade deficit would have foreign countries tax their exports of capital to the United States, or would have the United States tax its capital inflows from abroad. The taxation of capital flows would lower the exchange rate, thereby encouraging exports and discouraging imports. In broad terms, the impact of capital taxes on the trade deficit is similar to the solutions already mentioned. But I have two problems with taxing the international flow of capital. First, such taxes are extraordinarily difficult to administer and they invite the creation of loopholes. Second, if effective, they would raise the interest-rate differential between the cost of funds to U.S. firms and the cost of funds to foreign firms. A larger differential would disadvantage firms doing business in the United States.[13]

Third solution: harnessing the wind

While the present U.S. trade deficit finds its origins in a bizarre combination of monetary and fiscal policy, those origins

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13. In effect, a foreign tax on exported capital would offset the recent decision to repeal the 30 percent U.S. withholding tax on interest paid to foreigners

should not prevent us from harnessing the resulting wind to the good ship "trade liberalization".

In my view, each of the major trading nations -- starting with the seven summit countries -- should accept the obligation to unilaterally and automatically liberalize its trading practices when that country runs a persistent current account surplus. Just such an approach was the *de facto* policy of the United States during the years of dollar surplus, from the late 1940s to the early 1960s. Concessions given by the United States during the first five rounds of GATT tariff negotiations were much larger than concessions received from Europe or Japan. Similarly, in the 1950s, the European nations fulfilled more of their non-discrimination commitments every time their balance of payments improved. Unfortunately, in recent years, as other major trading countries have become surplus countries, they have not stepped up to assume the same obligations to the international system. Instead, the view has come to be accepted that the deficit country should shoulder the burden of adjustment. And the deficit country often resorts to solutions that restrict trade.

Elsewhere, I have spelled out an approach that would link unilateral and automatic trade liberalization to current account surpluses [14] I would require concessions to be respond to the request lists of countries with current account deficits. As an interim measure, surplus countries could grant bounties on their imports and impose taxes on their exports, an approach that runs into no GATT difficulties.[15] As an ultimate (and hopefully little used) means of persuasion, I would permit deficit countries to impose low rate directional tariffs on their imports from surplus countries.[16]

But the main point is not the details. Rather, the central idea is acceptance by major trading countries of their duty to liberalize unilaterally and automatically whenever their current accounts are in surplus for an extended period of time. The amount of liberalization should fully correspond to the size of the surplus. Applied today, this principle would require Japan to liberalize on a grand scale -- with no concessions asked Applied five years from now, this principle could require the United States to liberalize -- again with no concessions asked These are weighty obligations. But they could help restore the

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14 Gary Clyde Hufbauer, "The Unconditional Most-Favored-Nation Principle: Should it be Revived, Retired or Recast?" Conference on International Trade Problems and Policies, Monash University, Melbourne, Australia, February 13-14, 1984.

15 However, the United States (and perhaps some other countries) would encounter domestic constitutional barriers to the imposition of export taxes.

16. This step would require a waiver of GATT rights by target countries. Such a waiver might prove more acceptable if undertaken jointly and prospectively.

dynamic process of liberalization that so greatly benefited all countries during the 1950s and 1960s.

Conclusion

Objections can certainly be raised to these solutions. None is painless or easy. Other solutions may be better. Perhaps the best thing is to work for smaller budget deficits in 1985, wait for Europe and Japan to increase their growth relative to the United States, but otherwise do nothing. But if orthodox remedies could correct the trade deficit, or if easy and painless solutions were at hand, or if everyone agreed that the trade deficit must remain hostage to domestic budget politics and foreign growth, then the subject would scarcely merit Senatorial attention.