The Heritage Foundation Backgrounder

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UNDERSTANDING THE FEDERAL DEFICIT PART 4: PUTATIVE IMPACT ON TRADE

INTRODUCTION

One of the most serious--yet unsubstantiated--charges hurled in the current budget debate is that the federal deficit is the cause of the "overvalued" dollar and the deepening U.S. merchandise and current account deficits. Government deficits, the argument goes, have intensified the demand for credit and pushed up real U.S. interest rates. These comparatively high U.S. rates, in turn, encourage foreigners to buy dollars and invest in the United States. The result: a soaring U.S. dollar.*

The rising U.S. dollar, continues the theory, increases the price of U.S. exports and drives down the price of imports, creating the massive trade deficit. The moral: budget deficits severely harm exporting industries (such as farming and aircraft manufacturing), those sectors competing with imports (such as the U.S. automobile industry), and interest-sensitive industries (such as housing). Some prominent economists claim that the U.S. trade deficit may have cut the nation's Gross National Product (GNP) by 2 percentage points, destroyed up to 3 million jobs, jeopardized the economic recovery and eroded America's industrial base.[1]

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* This study is the last of a four-part series examining the nature and effects of the federal deficit. Part I explored the problems of forecasting the deficit; Part II analyzed the components of the deficit; and Part III examined the deficit's impact on the domestic economy.

1 See, for example, Statement by C. Fred Bergsten, Director of the Institute for International Economics, "Economists See Shortfall in '84 of $100 Billion," The Washington Post, January 28, 1984. See also, David Ernst, Evans Economics, and Malcolm Baldrige, Commerce Secretary, reported in "1983 Trade Deficit Hit $69.4 Billion," The New York Times, January 28, 1984.

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On the face of it, the theory seems plausible. The robust U.S. dollar has been accompanied by a deep fall in U.S. exports. The U.S. merchandise trade deficit reached $42.7 billion in 1982, soared to $69.4 billion in 1983, and is forecast to be $110 billion in 1984.[2]

Yet the theory that budget deficits are the major force pushing up the dollar, widely accepted in the press and Congress, has little basis in fact. It involves a serious mistake of analysis which could lead to disastrous policy initiatives that could cause U.S. international competitiveness to deteriorate, rather than improve.

Much research sheds considerable doubt on the link between budget deficits and the international trade balance, interest rates, and capital flows. Policymakers should ponder this research carefully before taking impulsive action.

1. Historical evidence and scholarly research have not found a strong link between U.S. interest rates and the level of the federal deficit. U.S. real and nominal interest rates have fallen substantially in recent years, while the budget deficit has soared.

2. Even if budget deficits did raise interest rates, the strong dollar probably is not caused by the current level of U.S. interest rates. Since the summer of 1982, both real and nominal interest rates have moved opposite from the direction moved by the value of the dollar. Interest rate differentials between the U.S. and most of the world have narrowed, yet the dollar has soared.

3. Capital flows show no clear relationship to U.S. budget deficits. While capital inflows undoubtedly will increase in the years ahead, the reason seems to have little to do with U.S. budget deficits.

4. Foreign ownership of the U.S. national debt actually has decreased since 1978, even though the U.S. budget deficit has grown. There is no indication that foreign capital is financing an unusually high proportion of the U.S. federal debt.

5. Budget deficits in various countries have existed alongside both strong and weak currencies. The budget deficit, by itself, is not the major factor determining the value of the dollar. Monetary policy is much more important.

6. Low budget deficits by themselves do not spur exports, nor do high budget deficits necessarily depress exports.

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2 "1983 Trade Deficit Hit $69.4 Billion," The New York Times, January 28, 1984.

If the burgeoning budget deficit is not to blame, what is causing the widening of the current account deficit? A number of influences are to blame--factors that are more a sign of U.S. economic strength than weakness:

-- The recovery is much more robust in the U.S. than in most other countries, so the world demand for U.S. exports is lagging behind the U.S. demand for imports.

-- Many less-developed countries are reducing imports and increasing their exports to pay the interest charges on their enormous foreign debts.

-- Capital flowing to the U.S. from abroad is attracted by business opportunities and the stable political environment.

-- U.S. inflation has fallen, compared with the rest of the world, bolstering the value of the dollar relative to other currencies.

It is also a mistake to believe that a strong dollar and international current account deficit threaten the U.S. economy. Since each dollar a foreign company receives for products imported by Americans can only be used to buy American goods or invest in the U.S., every trade and services deficit is matched by a capital account surplus. So any loss of jobs or growth due to low U.S. exports is offset by investment and jobs resulting from capital inflows. A trade deficit does not destroy jobs, it only rearranges them throughout the economy. Many commentators also overlook the point that the availability of cheaper foreign imports in the U.S. enhances consumers' spending power and choice. Foreign imports also impose competitive discipline on U.S. business, encouraging improved productivity.

A trade deficit, in short, does not signal the loss of U.S. international competitiveness, a migration of jobs overseas, or a present threat to the recovery. Thriving countries such as South Korea, Taiwan, Singapore, and other rapidly expanding nations have continually run current account deficits. They, along with the U.S., have experienced large capital inflows as a means to finance the more rapid development of their economies.

Some would retort that foreign capital inflows give foreigners, not Americans, claims on U.S. assets. Yet foreigners can only use the dollars they earn from their investments and exports to buy U.S. products, or sell the dollars to others who wish to buy American exports. Seen from this perspective, the current account deficit is a sign that foreigners have confidence in U.S. products, services, and investments. The strong dollar, in other words, symbolizes the strength of the recovery and the resurgence of the American economy.

BACKGROUND

Most news reports focus almost exclusively on the trade deficit when describing the export-import situation. A more complete picture of the U.S. trade position, however, would include the U.S. trade in services, investment income, government grants, remittances, pensions and transfers. Exports of services are just as important to national income as exports of goods (and may be even more important in the future) and should be included in trade calculations. The U.S. service surplus, in fact, widened from $13.8 billion in 1975 to $33.2 billion in 1982. And America has traditionally enjoyed large and growing surpluses in the service account, offsetting a large part of the trade deficits.

Chart 1 shows the current account balance for the first three quarters of 1983. While the merchandise deficit was a record $41.6 billion, it was offset by a surplus of services, amounting to $21.8 billion. The near record service surplus kept the three quarter 1983 current account deficit to $25.5 billion.

CHART 1

U.S. Current Account Balance for the First Three Quarters of 1983

		Billions of dollars
Merchandise	-$41.6	
Other goods and services	+21.8	
Trade (total goods and services)		-$19.8
Remittances, pensions, and transfers		-5.5
Total current account balance		-$25.3

Source: Department of Commerce

U.S. BUDGET DEFICITS: DO THEY UNDERMINE U.S. COMPETITIVENESS?

A number of economists claim that the U.S. budget deficit is the principal cause of high U.S. interest rates and hence the high-priced dollar, and this threatens to choke off the recovery by devastating vital export industries. An examination of the elements of this theory, however, reveals little evidence to support its major contentions.

(1) The federal budget deficit and real interest rates

Many economists and legislators claim that current and anticipated budget deficits are causing real U.S. interest rates

to remain high. This unfounded claim has been dealt with at length in an earlier paper in this series.[3] The analysis shows that interest rates and budget deficits have, in fact, been moving in opposite directions in recent years. And rather than intensifying credit demand and raising interest rates, government borrowing has simply replaced depressed sector borrowing in most instances.

(2) Interest rates and the U.S. dollar

Even if budget deficits could be shown to raise interest rates, it does not necessarily follow that interest rates are the primary cause of the strong dollar. In fact, the value of the dollar and interest rates have been moving in opposite directions. Real and nominal interest rates in the U.S. fell rapidly after August 1982, virtually eliminating the differential between the U.S. and its major trading partners (see Figure 1). Yet the dollar continued climbing. And from early July 1982 to early June 1983, short term U.S. interest rates declined by 6 percentage points. Despite this, the dollar did not fall in value.[4] Those who claim that high real U.S. interest rates are the cause of the high value of the dollar are directly contradicted by the historical evidence.

(3) Budget deficits and capital flows

Net capital flows show no simple or automatic relationship with federal deficits. Yet capital inflows in 1982 have been estimated by the Department of Commerce at $11 billion. Estimates for 1983 range as high as $30 billion.

These estimates of capital inflows, however, are likely to be exaggerated, because they assume that the entire $40 billion statistical discrepancy in the trade accounts consists entirely of unreported capital inflows. This discrepancy arises because all the elements of the trade and capital accounts are measured separately, yet the totals must balance. The discrepancy is the sum of the errors in each calculation.

The government admits, however, that it really does not know what makes up the statistical discrepancy. At least one respected analyst believes that $20 billion of the discrepancy can be traced to unreported service and trade exports, not unreported capital inflows.[5] Restatement of the figures in this way would bring the 1982 current account into surplus and the capital account that year would show a net outflow. This would substan-

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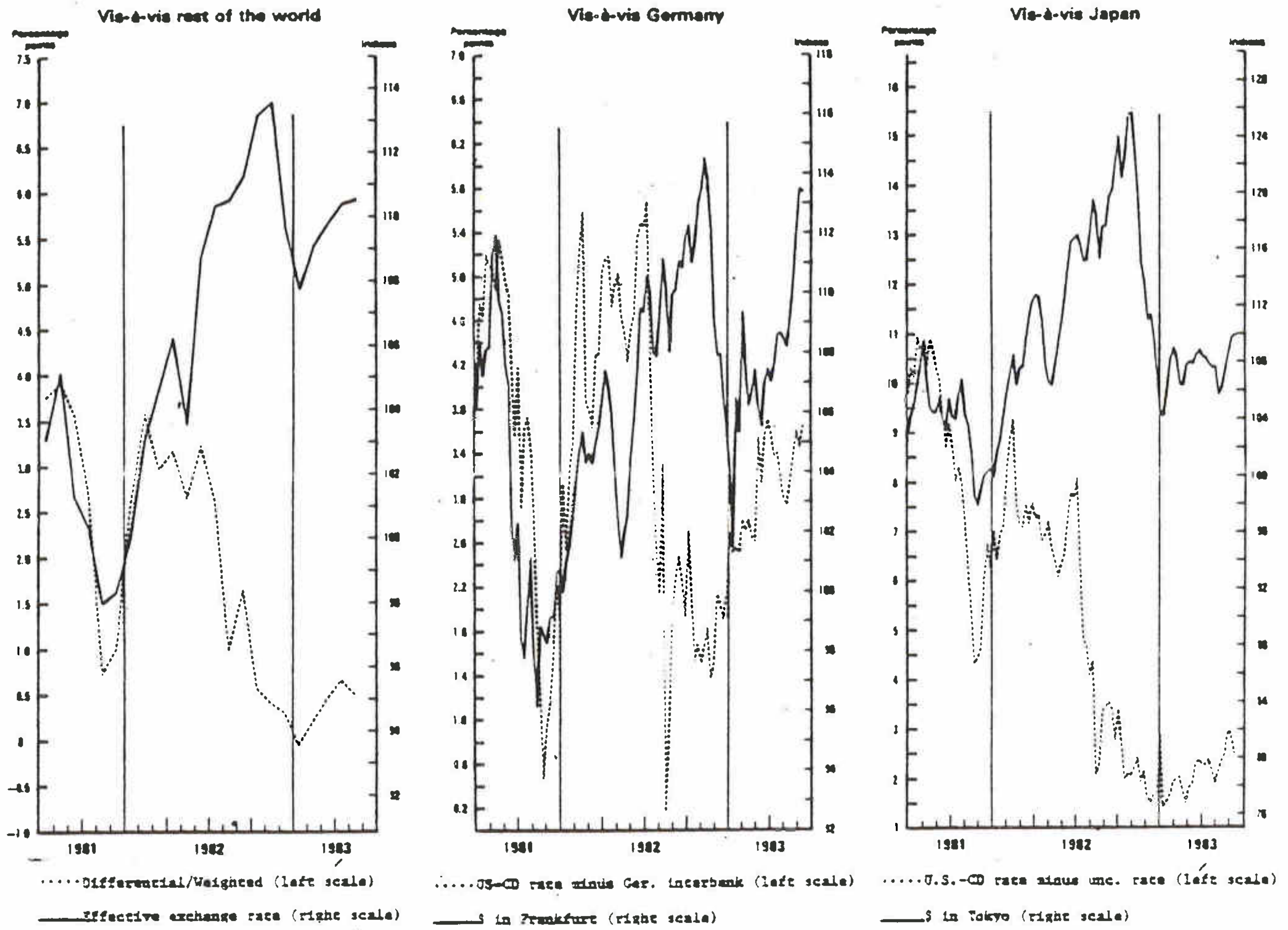
3 Thomas M. Humbert, "Understanding the Federal Deficit, Part 3: The Unproven Impact," Heritage Foundation Backgrounder No. 330, January 27, 1984.

4 OECD Economic Outlook Organization for Economic Cooperation and Development, July 1983, p. 74.

Figure 1

U.S. EXCHANGE RATES AND INTEREST RATE DIFFERENTIALS



Source: OECD, July 1983.

tially alter the complexion of the so-called balance of payments problem.

Even if all the statistical discrepancy occurs in the capital account (a very unlikely assumption), there still is no clear correlation between deficits and capital inflows (see Chart 2). The U.S. budget deficit in 1975 and 1976, for example, amounted to nearly 4 percent of GNP, then the largest peacetime level in history. If budget deficits lure foreign capital into the U.S., these should have been bumper years for capital inflows. Yet the U.S. actually registered large capital outflows in both years--the 1975 capital outflow was the largest in recent U.S. history.

CHART 2

Budget Deficits and Capital Flows*

	Capital Outflows (inflows -) in billions of dollars	Federal Budget Deficit (percentage of GNP)
1971	-1.433	2.2
1972	-5.795	2.1
1973	7.140	1.2
1974	1.962	0.3
1975	18.136	3.1
1976	4.207	4.0
1977	-14.511	2.4
1978	-15.446	2.3
1979	-0.964	1.2
1980	0.421	2.3
1981	4.592	2.0
1982	-11.211	3.6
1983 (estimate)	-32.700	6.1
1984 (estimate)	-50.400	5.2

Source: Department of Commerce, Bureau of Economic Analysis

* Assumes all statistical discrepancies can attributed to unreported capital inflows.

The U.S. budget deficit was much smaller in 1977-1979, in GNP terms. Capital inflows should have been narrowed if smaller deficits mean less capital from abroad. In fact, capital inflows increased. Such patterns shed doubt on the simplistic view that budget deficits are the major determinate of capital flows into the U.S.

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5 "World Financial Markets," Morgan Guaranty Trust Company of New York, May 1983.

(4) Budget deficits and the dollar

High budget deficits have been associated with both a weak and a strong U.S. dollar, as have small budget deficits. If high budget deficits automatically produce a strong dollar, the dollar should have been extremely robust in 1975, given that year's huge deficit. The value of the dollar, however, was appreciably lower that year than during the 1960s and early 1970s, when budget deficits were much smaller.

The foreign experience also exhibits no clear relationship between budget deficits and the strength of their currencies. The Japanese budget deficit throughout the 1970s, as a proportion of GNP, was higher than that of the U.S., and Japan enjoyed a strong currency. But Italy, which ran deficits over twice the share of GNP experienced in the U.S., suffered from a weak currency. The United Kingdom ran up large budget deficits from 1975 to 1977, but the pound fell in value. There are many other examples of budget deficits coexisting with both strong and weak currencies. Clearly budget deficits do not provide an adequate explanation for the relative value of world currencies.

(5) Budget Deficits and World Trade

Budget deficits do not always mean a loss of competitive advantage. Japan's export trade expanded almost sevenfold during the 1970s, despite large deficits.[6] And Italy, which ran budget deficits in the range of 10 to 15 percent of its GNP throughout the 1970s, experienced nearly a sixfold expansion of exports.

U.S. merchandise exports did drop by about 10 percent in 1982, as the deficit increased, and by another 5.5 percent in 1983. But then so did the trade volume of almost every U.S. trading partner, including Canada, Japan, France, West Germany, and the United Kingdom. This reduction in trade did not result from the U.S. budget deficit, but from the worldwide recession. During other recessions, world trade also shrank.

CAUSES OF THE CURRENT ACCOUNT DEFICIT

If the budget deficit is not closely linked to the trade situation, then what are the causes of America's enormous current account deficits. While there is no consensus, there appear to be a number of factors causing American exports to decline, imports to grow, and capital to be attracted to the U.S.:

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6 The Economic Report of the President, Council of Economic Advisors, February 1983, p. 282.

(1) The robust U.S. recovery

Trade deficits normally accompany strong economic expansions. In the current U.S. recovery, the phenomenon is compounded by the slower rate of recovery in the rest of the world. In 1983, the U.S. economy grew 3.8 percent faster than a weighted average of the rest of the world, and it is expected to continue growing at a much faster pace than in the rest of the industrial world during 1984. Many foreign countries are still just turning the economic corner. While U.S. consumers are buying more imports, therefore, America's trading partners have not increased their imports as rapidly. This component of the current account deficit, however, is primarily a cyclical phenomenon. As foreign economies catch up to U.S. rates of growth, the trade deficit should shrink to more typical levels.

(2) The problems of less developed countries

U.S. exports to less developed countries and financially weak countries have fallen sharply because many of these countries are struggling to cut imports and expand exports to pay interest charges on their huge foreign debts. U.S. exports to less developed nations declined by over $100 billion between 1981 and 1983. Moreover, the OPEC countries no longer have huge oil surpluses to buy Western goods and technology.

(3) Capital flows to the U.S. from abroad

The Department of Commerce attributes billions of dollars in errors and omissions in the trade balance sheet to unrecorded capital inflows. This is an unsupported assumption. If only half of these errors were actually in the service account, the current account in 1982 would have shown a surplus, and the U.S. capital accounts would have shown a net capital outflow.

Even if there is, in fact, a net capital inflow into the U.S., federal budget deficits are probably not to blame. Funds also are attracted because the U.S. economy is much more safe and stable than that of very many other countries. The U.S. is experiencing greater productivity and higher real rates of return on investments, and holds the promise of continuing low rates of inflation.

DO DEFICITS AND THE STRONG DOLLAR ENDANGER THE RECOVERY?

The current account deficit, therefore, results from a strong U.S. economy, not a weak one. But does the current account deficit jeopardize the U.S. economic recovery by destroying American jobs and signalling a loss of U.S. international competitiveness?

The answer is no. One cannot even speak of an "overvalued" dollar in a strict sense--any more than one can speak of an

overvalued stock, bond, or house. The market determines the value of currency in response to supply and demand pressures, just as it does with any other asset. If an individual believes that the market price of the dollar is too high, he will sell the currency and eventually make a profit. Just as it does with an overvalued stock, the market will soon respond to an overvalued currency.

While reports focus on the loss of jobs due to falling exports and increasing imports, very little attention is paid to the offsetting benefits. Consumers save money by buying lower-priced imports, for instance. This raises the U.S. living standard and frees money for consumers to spend on other products, most of which are produced domestically--meaning more jobs. Moreover, capital inflows--the flip-side of current account deficits--are very beneficial to the recovery. Foreign capital provides funds for new investment, reducing the pressure on the capital markets and interest rates. Foreign capital inflows are likely to reach about $80 billion om 1984, or 2 percent of GNP.

Some economists complain that a strong dollar costs jobs in exporting industries. But this is only part of the story. The costs of a strong dollar can be measured only against the benefits.[7] One of the most important benefits is lower domestic inflation. According to most estimates, inflation drops 0.1 to 0.2 percent for every 1 percent increase in exchange rate. Using this rule, the U.S. inflation rate has probably fallen between 2 and 2½ percentage points because of the strong dollar. Added to the extra consumer purchasing resulting from lower cost imports, this means higher real living standards and a stimulus to industries catering for the domestic market.

A strong currency, moreover, does not necessarily harm export competitiveness. For example, the Japanese yen increased by almost 40 percent against the dollar in the 1970s; Japanese exports did not suffer. The French franc, by comparison, plunged over 50 percent in value against the dollar between 1980 and 1983; this anemic franc did not spur France's exports, which fell sharply.

In short, a strong U.S. dollar does not automatically doom the U.S. to a permanent loss of international competitiveness--if its value reflects a strong U.S. economic recovery and lower inflation. Similarly, a weaker dollar would not guarantee more U.S. exports, if the dollar's declining value simply reflects an inflationary increase in the supply of money in an effort to depress interest rates.

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8 See Robert J. Samuelson, "Trade Deficit Offers Danger, Opportunity," The Washington Post, January 24, 1984.

CONCLUSION

Many factors bolster the U.S. dollar. Fundamentally, investors hold dollars for the same reasons they hold any asset: they believe dollars will yield a greater return than other available assets. The price of currency, like stock prices, responds to news concerning that return. And currency prices, like stock prices, may change without any substantial change in the volume of trade, simply because the market changes its view about future returns.

The expectations that the U.S. inflation rate will continue to remain low, and economic growth strong, compared with that of other countries, are probably the most important causes of the dollar's increased value. It is the political stability of the U.S., the promise of economic vitality, improving productivity, and other such factors that encourage foreigners to buy dollars--not the federal deficit.

While government budget and trade deficits are not necessarily debilitating, the deficit could have an enormous--and very damaging--impact on domestic and international trade if it prompts dangerous economic "remedies" in Congress. Many of the initiatives offered to reduce deficits could harm gravely the U.S. economy and international trade:

1. <u>Tax increases</u>. Higher taxes on savings, investment, and corporations, designed to reduce the budget deficit, would shrink capital formation and undermine U.S. international competitiveness.

2. <u>Rapid expansion of the money supply</u>. Excessive expansion of the money supply, to generate a short term acceleration of economic growth and temporarily reduce interest rates, would merely ignite inflation and lead to stagnation in both export and domestic industries.

3. <u>Tariffs and quotas</u>. Tariffs and quotas would trigger trade wars and reduce U.S. living standards by raising the cost of imported products. Moreover, tariffs only shield inefficient firms from lower-priced foreign competition, and therefore reduce long-term competitiveness.

Congress can increase U.S. exports and domestic production by reducing government spending, lowering tax rates to encourage investment, and eliminating burdensome regulation. This would release resources to the private sector for investment, research, and spending. Money growth should be held stable and predictable, creating a climate for price stability and economic expansion. And policymakers should emphatically reject protectionism. Taking these steps, rather than flirting with trade barriers and tax increases, would assure continued growth and prosperity.

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