# Ernst Fraenkel Vorträge

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Politik, Wirtschaft, Gesellschaft und Geschichte

Herausgegeben von Carl-Ludwig Holtfrerich

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Robert E. Baldwin

**Recent U.S. Trade Policy at the Multilateral and Bilateral Levels**

Thomas J. Sargent

**Interpreting the Reagan Deficits**

Rüdiger Dornbusch

**The Economic Decline of the U.S.? The Dollar and the Adjustment Options**

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## Editor's Preface

This series published by the John F. Kennedy Institute of the Free University Berlin aims at preserving in a longer perspective the results of the Ernst Fraenkel lectures on American politics, economy, society and history and making them accessible to a broad public outside of Berlin as well. These lectures are dedicated to Ernst Fraenkel, himself a German-American and an internationally renowned political scientist and expert on American affairs, who taught at the Free University from 1951 to 1967 and whose initiative led to the founding in 1963 of the John F. Kennedy Institute for North American Studies. As was the case with Ernst Fraenkel's life and work, these lectures held by eminent American scholars and authorities of some particular field are meant to contribute to forging an academic link across the Atlantic and to provide stimulation for research at the Kennedy Institute as well as at other European institutes for North American studies.

This issue contains lectures delivered at the Kennedy Institute by three outstanding American economists on fundamental questions of American economic policy: July 6, 1989, **Robert E. Baldwin** (University of Wisconsin at Madison) on recent issues in U.S. foreign trade policy; November 15, 1989, **Thomas J. Sargent** (Hoover Institution, Stanford) on theories and policy implications of the Reagan budget deficits; January 18, 1990, **Rüdiger Dornbusch** (MIT) on policies against U.S. economic decline.

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Berlin, March 1990 Carl-Ludwig Holtfrerich

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**Robert E. Baldwin**

## I. INTRODUCTION

In recent years the United States has demonstrated a greater willingness to act unilaterally and bilaterally, in contrast to multilaterally, on trade policy matters. The marked increase in the number of successful antidumping and countervailing-duty cases is one manifestation of the greater emphasis on a unilateral strategy. For example, as of 1987 there were 146 antidumping duties in effect, and the number of new affirmative cases has been over 40 per year. The action by the Office of the U.S. Trade Representative in June, 1989 of citing Japan, Brazil, and India under the so-called Super 301 Section of the Omnibus Trade and Competitiveness Act of 1988 as countries following a persistent pattern of unfair trade practices is another illustration of this new approach.

The increased emphasis on achieving trade-policy objectives through bilateral negotiations is demonstrated by the special trading arrangements concluded with Israel, Canada, the Caribbean countries, and Mexico. There is also talk of entering into a special relationship with some Pacific Rim countries. Of course, the United States has not abandoned multilateralism, as our active participation in the Uruguay Round negotiations demonstrates, but, as one negotiator told me recently: "Much of the action is at the bilateral level."

These have not been the only major shifts in U.S. trade policy in the 1970s and 1980s. Another key change has been the decrease in the importance of trade liberalization as the main U.S. trade objective and the increase in the importance of the goal of achieving "fair trade". Such slogans as "We want free but fair trade" or "We want a level playing field" are standard fare for most politicians. This is quite different from the period from the 1940s through the 1960s. The term, fair trade, is not even mentioned in the trade legislation that was passed in this period. Since the Trade Act of 1974, however, the term has appeared dozens of times in trade legislation. The tightening of U.S. legislation covering dumping and government subsidization, the passage of the so-called Section 301 legislation aimed at unreasonable, unjustifiable, and discriminatory activities of foreign countries, and our focus in the Uruguay Round in bringing the protection of intellectual property rights under the GATT indicate our greater concern with unfair trade.

Still another major recent change in U.S. trade policy is our greater willingness to use nontariff measures rather than tariffs to limit trade, especially ones that are

country-selective and thus inconsistent with the most-favored-nation rule of the GATT. Within the last few years, the United States has negotiated voluntary export-restraint agreements (VEAs) covering steel, automobiles, machine tools, seminconductors, and footwear.

This paper analyzes the various economic and political factors that seem to have brought about this remarkable shift in U.S. trade policy and considers how well they will serve the interests of the United States and the community of trading nations in the decade of the 1990s and beyond. Part II discusses the nature of the trade policies pursued by the United States as it emerged after World War II as the dominant world economic power, while Part III analyzes how basic structural changes in the world economy brought about a decline in U.S. hegemony and the concomitant rise to international economic prominence of the European Community and Japan, and the emergence of a group of newly industrializing developing countries. In Part IV it is argued that these structural changes coupled with U.S. macroeconomic policies leading to a sharp appreciation of the dollar in the first part of the 1980s and to a massive U.S. trade deficit have led to significant trade-policy shifts that emphasize the priority of domestic interests over foreign policy goals. Part V appraises the effectiveness of these new trade policies in meeting the international economic challenges the United States is likely to face in the 1990s and the early part of the next century, while Part VI summarizes the conclusions.

## II. THE EMERGENCE OF U.S. HEGEMONY

The expansion of productive facilities in the United States during the World War II coupled with the widespread destruction of industrial capacity in Germany and Japan gave American producers an enormous advantage in meeting the worldwide pent-up demand of the late 1940s and the 1950s. The U.S. share of industrial country exports rose from 25.6% in 1938 to 35.2% in 1952 (Baldwin, 1958). In contrast, the combined share of Germany and Japan fell from 24.0% to 11.4% between these years. Thus, the United States became the dominant economic trading power in the period immediately following World War II.

Due to the failure of the United Kingdom to return to anything like its prewar position as a world economic power and the unwillingness of either China or the USSR to participate in a market-oriented international economy, the United States also became the dominant political power in the non-socialist world economy. But perhaps the most important factor leading to U.S. hegemony was the effort by the Soviet Union to expand its political influence into Western Europe and elsewhere. American officials believed they had little choice from a national security viewpoint but to assume an

active political, economic and military leadership role in the world to counter this expansionist policy, an action that most non-communist countries welcomed.

Static trade theory suggests that a hegemonic power will take advantage of its monopolistic position by imposing trade restrictions to raise domestic welfare through an improvement in its terms of trade. However, like the United Kingdom when it was a hegemonic nation in the 19th century, the United States reacted by promoting trade liberalization rather than trade restrictionism. A restrictionist reaction might have been possible for a highly controlled, planned economy that could redistribute income fairly easily and did not need to rely on the traded-goods sector as a major source of employment generation or growth, but the growth goals of free-market firms together with the nature of the political decision-making process rules out such a response in modern non-socialist industrial democracies.

Industrial organization theory emphasizes that firms in oligopolistically organized industries take a long-run view of profitability and strive to increase their market share. By doing so, they try to prevent both new competitiors from entering the market and possibly causing losses to existing firms and old competitors from increasing their shares to the point where others might suffer progressive and irreversible market losses. U.S. firms, organized in this manner, seized the postwar competitive opportunities associated with American dominance to expand overseas market shares both through increased exports and direct foreign investment. The desire of U.S. political leaders to strengthen non-communist nations by opening up American markets and providing foreign aid complemented these goals of U.S. business, and most business leaders actively supported the government's foreign policy aims. Even most producers in more competitively organized, less technologically sophisticated sectors such as textiles and miscellaneous manufactures favored an outward-oriented hegemonic policy at this time, since they too were able to export abroad and were not faced with significant import competition.

The United States behaved in a hegemonic manner on many occasions in the 1950s and early 1960s. As Keohane (1984, chap. 8) emphasizes, in doing so, it did not coerce other states into accepting policies of little benefit to them. Instead, the United States usually proposed joint policy efforts in areas of mutual economic interest and provided strong incentives for hegemonic cooperation. In the trade field, for example, U.S. officials regularly pressed for trade-liberalizing multilateral negotiations and six such negotiations were initiated between 1947 and 1962. The United States traded short-term concessions for the prospect of long-run gains, since the concessions by most other countries were not very meaningful in trade terms due to the exchange controls maintained by many other countries until the late 1950s. The economic goal was to

increase U.S. market shares in Europe and Japan significantly as these countries eased and finally eliminated their controls over imports.

The hegemonic actions of the United States aimed at maintaining a liberal international economic framework and strengthening the non-communist countries of the world as a means of turning back the expansion of the Soviet Union succeeded very well. By 1960 the export market shares of France, Germany, Italy, and Japan had either exceeded or come close to their prewar levels. Among the industrial countries only the United Kingdom failed to regain its prewar position by this time. The restoration of peacetime productive capabilities in these countries meant, however, that the exceptionally high market shares of the United States in the early postwar years declined correspondingly. The 35.2% U.S. export share of 1952 had dropped to 29.9% by 1960, a figure that was, however, still higher than the U.S. 1938 share of 25.6% (Baldwin. 1962).

For manufactured products alone, the picture is much the same. The U.S. world export share decreased sharply from 29.4% in 1953 to 18.7% in 1959, while the shares of Western Europe and Japan rose from 49.0% to 53.7% and from 2.8% to 4.2%, respectively (Branson, 1980). The export market share of Western Europe remained unchanged in the 1960s, but the Japanese share continued to rise and reached 10.0% in 1971. At the same time the U.S. share of world exports of manufactures fell to 13.4% by 1971.

## III. THE DECLINE IN U.S. ECONOMIC DOMINANCE

Not only had the prewar export position of the United States been restored by the late 1960s, but the absence of significant import pressures in major industries with political clout had come to an end. Stiff competition from the Japanese in the cotton textiles industry was evident by the late 1950s, and the United States initiated the formation of a trade-restricting international cotton textile agreement in 1962. A broad group of other industries began to face significant import competition in the late 1960s. The products affected included footwear, radios and television sets, tires and inner tubes, semi-conductors, hand tools, earthenware table and kitchen articles, jewelry, and some steel items.

Trade pattern changes in the 1970s and early 1980s were much influenced by the price-increasing actions of the Organization of Petroleum-Exporting Countries (OPEC). This group's share of world exports rose from 5.4% in 1970 to 14.6% in 1980 (Economic Report of the President, 1985). By 1985 OPEC's share had, however, fallen to 7.1%, as the power of the cartel declined (Economic Report of the President, 1986). During the 1973-1987 period the U.S. world export share fell from 12.1% to 9.8%. The export share of the European Community rose from 36.6% to 38.2% as the number of members

expanded, while the Japanese share rose from 6.4% to 9.2%: (International Trade, 87-88, Volume II, GATT, 1988).

The increase for Japan reflected that country's strong performance in manufacturing. Japan's share of industrial countries' manufacturing exports rose from 10.0% in 1973 to 12.7% in early 1987 (International Trade, annually, GATT). However, the U.S. manufacturing export share declined from 12.6% in 1973 to 10.3% in 1987. Another major development of this period was the increase in the manufacturing export share of the developing countries from 6.9% in 1973 to 13.7% in 1987.

Another important feature of the trade-pattern shifts in industrial countries during the 1970s and 1980s is the severe import competition faced not only by labor-intensive sectors like textiles, apparel, and footwear but also by large-scale, oligopolistically-organized industries such as steel, automobiles, and shipbuilding. Machine tools and consumer electronic goods have also come under increasing import pressure.

The decline in the dominance of the United States in trade-policy matters became apparent in the Tokyo Round of multilateral trade negotiations as well as when the United States proposed a new negotiating round in 1982. As it had in the Kennedy Round, the United States proposed an across-the-board linear tariff-cutting rule at the outset of the Tokyo Round, whereas the European Community again proposed a formula that cut high tariff rates by a greater percentage than low duties. This time the United States was not able to impose its negotiating wishes. The other participants treated the United States and the Community as two major trading blocs whose broad negotiating objectives must both be satisfied. The compromise duty-cutting rule adopted met the U.S. desire for a deep average cut and at the same time produced the degree of tariff harmonization sought by the European Community.

At the 1982 GATT ministerial meeting the United States again called for a new multilateral exercise that included as major agenda items negotiations aimed at reducing export subsidies in agriculture and extending GATT rules to trade in services. The Community and the developing countries both rejected the U.S. proposals. Although the United States eventually was successful in placing these items on the agenda for the Uruguay Round beginning in 1986, it has become clear that this country can no longer largely determine the timing and nature of multilateral trade negotiations.

## IV. THE U.S. TRADE-POLICY RESPONSE

Except for the two politically powerful industries, oil and textiles, import-injured industries, up until the latter part of the 1960s, were forced to follow the administrative route for providing import relief under the escape clause provisions of the GATT. Moreover, many of the affirmative industry determinations by the International Trade

Commission under this procedure were rejected by the president on foreign policy grounds, specifically, the need for a hegemonic power to maintain an open trade policy. Industry subsidies provided by foreign governments, though subject to U.S. countervailing duty laws, were also largely ignored by the executive branch for the same reason.

The official position of the United States began to change under the strong import pressures of the late 1960s. As their constituents described the competitive problems they were facing, members of Congress became less willing to accept the standard argument that a liberal U.S. trade policy was essential to strengthen the free world against Communism. The change in members' views is indicated by Congress's rejection of President Lyndon Johnson's 1968 request for new trade authority and by its near approval in 1970 of protectionist legislation. The growing unwillingness of our allies to accept the unquestioned leadership of the United States in international political, military, and economic affairs also caused officials in the executive branch to question the traditional American position on trade policy.

A view that gradually began to gain the support of private interests concerned with trade matters was that much of the increased competitive pressure on the United States was due to unfair foreign policies such as government subsidization, dumping by private and public firms, preferential government purchasing procedures, and discriminatory foreign administrative rules and practices relating to importation. This argument had appeal for several reasons. No new legislation was required to provide import relief; a stricter enforcement of long-existing domestic legislation seemed to be all that was necessary. By placing the blame for their decline in competitiveness on unfair foreign actions, U.S. managers and workers could also avoid the implication that increased import pressures might be due to a decline if their efficiency relative to certain other countries. Finally, U.S. government officials could maintain they were still supporting the rules of the liberal international regime that the United States had played such a major role in designing.

Emphasis on the greater need for fair trade is evident in the 1974 legislation authorizing U.S. participation in the Tokyo Round of multilateral negotiations. In reshaping the proposal of the president, the Congress stressed that the president should seek "to harmonize, reduce, or eliminate" nontariff trade barriers and tighten GATT rules with respect to fair trading practices. Officials in the executive branch supported these directives not only on their merits but because they deflected attention from more patently protectionist policies.

It was, however, the emergence of a massive U.S. trade deficit, beginning in the late 1970s and becoming especially severe after 1982, that gave the greatest impetus to the

acceptance of the view that a major cause of U.S. competitive problems was unfair trade actions by foreign governments. This deficit has its roots in the significant fall in aggregate savings brought about by the increase in federal government expenditures relative to tax collections. Since private savings did not increase to offset this decline in government savings, the effect of the increase in federal government expenditures had to be a crowding out of either domestic investment or net foreign investment. The rise of interest rates as the government bid for funds and the Federal Reserve pursued a tight monetary policy to halt the double-digit inflation that had emerged not only tended to discourage private investment but attracted a large inflow of foreign funds and a return of U.S. funds previously invested abroad. Consequently, as the international demand for dollars increased and the trade balance turned sharply negative the value of the dollar rose significantly compared to the late 1970s. Other contributing factors to the deficit were the slow rate of growth in many other countries, tax changes in the United States making U.S. investments more attractive, and the removal by the Japanese government of certain controls over foreign investment.

The sharp appreciation of the dollar not only exacerbated the profitability difficulties of such "problem" import-competing industries as textiles and apparel, footwear, steel, and automobiles but brought significant international competitive pressures to most traditionally vigorous export-oriented and import-competing industries. The widespread nature of this competitive problem caused the trade deficit to be a matter of serious concern to almost all members of Congress and most parts of the executive branch.

Both Congress and the Administration faced difficult political problems in trying to correct the conditions causing both the budget and trade deficits. President Reagan had pledged not to raise taxes and was also committed to large defense expenditures. Cutting social spending was the Administration's proposal for solving the problem. Members of Congress, especially the Democrats, rejected this approach both on ideological grounds and for fear of disapproval from their constituents. Voting for an increase in taxes, especially when the president was likely to veto such a bill, also was not a politically feasible alternative for Congress. Instead, more and more members of Congress began to adopt the view that the unwillingness of foreign governments to open their domestic markets to the extent that the United States had already done was a major cause of the U.S. trade problem. Blaming foreigners did not involve the risk of voter disapproval that raising taxes or cutting social or defense expenditures did. The fact that the administration had not made widespread use of this argument also made it attractive as a way of shifting blame for the trade deficit problem from Congress to the Administration.

Implying that the main cause of the large U.S. trade deficit with most countries is the failure of these countries to open their domestic markets sufficiently has proved to be very popular with voters, and most members of Congress seem to have adopted this view. This was evident from the nature of the trade bills that passed both branches of Congress in 1987. The House bill required the U.S. Trade Representative (USTR) to determine whether "excessive surplus countries" maintain a pattern of unfair trade practices and then to negotiate with these countries to eliminate the practices. If the negotiations failed, the United States Trade Representative (USTR) was required to take action to reduce the countries' surpluses by 10% a year. The president could waive this retaliation but Congress could override the waiver by a two-thirds vote. The Senate bill did not explicitly link trade surpluses and unfair trade practices but required USTR to determine which countries maintain a consistent pattern of unfair trade practices against U.S. exports and then to negotiate agreements eliminating these practices. Retaliation would follow if these negotiations failed.

Because of objections by the Executive branch, these various provisions explicitly linking unfair foreign trade practices and the U.S. deficit were omitted from the legislation finally passed, namely, The Omnibus Trade and Competitiveness Act of 1988. Nevertheless, eliminating unfair trade practice by foreign governments is still the central theme of this measure.

This widespread support in Congress for a tougher trade policy forced the Reagan Administration to adopt a much more aggressive approach than it followed in its earlier years. The U.S. government has, for example, retaliated against the Japanese for alleged dumping of computer chips in this country and in third-country markets, drawn up a list of retaliatory items against Brazil in an effort to open this market to U.S. computers and computer software, and threatened retaliation against South Korea unless they further opened their markets for cigarettes and beef. A greater emphasis on fair trade is also evident from the marked increase recently in the number of antidumping and countervailing duty cases. The number of cases initiated rose between 1980 and 1985 from 30 to 104.

The unfair trade argument has also been used in support of most other trade-restricting or trade-promoting actions taken by the United States in recent years. The textile and apparel sectors have been described by government officials as "beleaguered" by disruptive import surges, thus justifying more restrictive import controls. Similarly, when temporary orderly marketing agreements (OMAs) were negotiated in the 1970s with selected East and Southeast Asian countries, the implication conveyed was that these were responses to unfair export activities by these nations. Even the Japanese voluntary export restraints on automobiles were sometimes justified by American

industry and government officials on the grounds that the industry's competitive problem was in part due to the unfair targeting practices of the Japanese government. On the export-promoting side, it is routinely claimed that subsidized export credits through the Export-Import Bank and special tax privileges to exporters are necessary to counter unfair foreign practices in these areas. In short, fair trade arguments using such phrases as the need for "a level playing field" or "to make foreign markets as open as U.S. markets" have become the basic justification for the greater use of trade-distorting measures by the United States.

## V. AN EVALUATION OF RECENT U.S. TRADE POLICIES

The immediate purpose of the vigorous U.S. efforts to open foreign markets has been to reduce the U.S. bilateral deficits with most countries. While these efforts may succeed in cutting these deficits somewhat, it is doubtful that trade barriers by other countries have been a cause of the U.S. trade deficit. As late as 1981, the United States had a current account surplus of $7 billion and a merchandise account deficit of only $27 billion in contrast to a $145 billion merchandise deficit for 1987. While there were U.S. trade deficits with Japan and Canada of $16 billion and $2 billion, respectively, in 1981, there were U.S. trade surpluses of $7 billion and $300 million with Western Europe and the non-OPEC developing countries, respectively. The record shows that Japan and the non-OPEC developing countries have generally been lowering their trade barriers against U.S. exports since the early 1980s. Consequently, it is hard to argue that the trade balance shifts resulting in 1987 U.S. deficits of $56 billion and $12 billion with Japan and Canada, respectively, and of $26 billion and $52 billion with Western Europe and the non-OPEC developing countries are due to new trade barriers in these countries.

Of course, if these markets had been more open, the U.S. macroeconomic policies that are the major cause of the U.S. trade problem may not have produced as large a deficit as in fact emerged. But there is disagreement among trade specialists as to whether import ratios are artificially low in countries such as Japan or the Asian NICs because of unusually high nontariff trade barriers. Saxonhouse (1983, 1985), Bergsten and Cline (1985), and Noland (1987), for example, all find Japan's trading pattern to be explained adequately by the same basic real factors accounting for the trade of other countries, and they reject the hypothesis that Japanese trade barriers are a major explanatory factor. In contrast, Balassa (1986) and Lawrence (1987) find that unusual trade barriers in Japan do play a role in accounting for the Japanese trade surplus. Lawrence, for example, estimates that the removal of unusual trade barriers would lower Japan's total trade surplus in manufactured goods by about $9 billion. This would mean

about a $4 billion or only 7% reduction in the $56 billion U.S. deficit with Japan. A recent multi-country study by Leamer (1987) of the role of hidden trade barriers in accounting for trade patterns concludes that "unusual aspects of patterns of net exports occur most frequently from the export side and are related to historical factors or to special resources, and not to trade barriers."

If one concludes that U.S. bilateral efforts to reduce nontariff trade barriers in other countries, even if successful, will not reduce the U.S. trade deficit appreciably, it still could be argued that these efforts are worthwhile because they tend to raise world real income and, most probably, real income in the countries reducing the barriers. It is difficult to make significant changes in existing GATT rules, even though economic circumstances are now quite different than when these rules were written. The recent GATT negotiations between the United States and the European Community on agricultural protection illustrate this point. Similarly, most developed countries are reluctant to engage in significant concession-swamping negotiations with the developing countries because they know the developing countries have the right under Article XVIII of the GATT to maintain trade barriers more or less indefinitely on balance-of-payments grounds. However, the recent success in bringing traded services and the enforcement of intellectual property rights with the GATT framework also demonstrates that significant changes can be made in the GATT, if the United States assumes a strong leadership role.

Possible adverse political effects can result, however, from the resentment generated by so-called Japan and Korea bashing by U.S. officials. These countries might not support the foreign policy goals of the United States as vigorously as we would wish because of this weakening of good will toward the United States.

More tangible economic losses are possible in the long-run. Japan and most developing countries have been urged to turn their demand-creating activities inward rather than rely so much on exports as a source of growth. If this advise is followed, it means that import-substituting activities will be stressed more strongly by the governments of these countries and, therefore, that U.S. exporters of goods and services will face increased competition from domestic producers in these countries. Current U.S. trade policies also encourage the strengthening of existing regional groups and the formation of new regional arrangements. For example, one of the arguments used by leaders of the European Community to sell the 1992 exercise to members is the need to rely more on intra-Community trade in view of the shifts in U.S. trade policy. The same argument is used in efforts to strengthen the ASEAN free trade arrangement. Since these groups provide special trade preferences for their members, countries like the United States lose export markets through the trade diversion that occurs.

The importance of favorable export markets for the United States has increased in recent years because of the growing net debtor position of this country. The net debtor position of the United States is estimated to have grown by $150 billion in 1987 to a net position of $400 billion. While the income required to service this debt is less than one-half of one percent of the U.S. GNP at a 5% real rate of return, servicing claims would consume 2% of the GNP by the end of the century at this real rate of return (Economic Report of the President, 1988). The ability of the United States to export becomes increasingly important as these servicing charges rise. Yet, the current U.S. policy of advocating bilateral trade balance as the desirable norm may be turned against us when U.S. export surpluses become important for servicing our net foreign debt.

The increased willingness of the United States to become an initiator of special bilateral and regional trading arrangements is probably an inevitable outcome of the decline in U.S. hegemony. As the countries of Western Europe have discovered, the formation of such groups can significantly increase one's clout in international economic negotiations and enable countries with common goals to take fuller advantage of the benefits scale economies. But it is important for economic and political stability in the world economy that these liberalizing arrangements be extended as much as possible on a multilateral basis. Unfortunately, the pressure for such multilaterialization is not as strong as it had been in the 1960s and 1970s, when the United States pushed vigorously in this direction.

An especially important issue is the extent to which Japan and the newly industrializing countries of the Pacific Rim will either join existing free trade arrangements or form new ones themselves. The divergent economic and political interests of these countries and the significant differences between their economic competitiveness and that of the countries of North America and Europe suggest that neither alternative is feasible in the short term. But there is clearly a shift in world economic power toward the Far East and, if these countries come to believe they are unfairly shut out of the markets of these regions, some could seek a regional solution to their problems that might further erode the great benefits achieved through multilateralism in the last 50 years.

## VI. CONCLUSIONS

The history of U.S. trade policy since World War II can be explained in political economy terms as a response both to changing world patterns of comparative advantage and to major political and economic shocks outside of the trading sector. Trade-policy decisions in the early postwar period were shaped by the emergence of the United States from World War II as the dominant economic power among the market-oriented

economies and the political leader of the efforts to contain Soviet expansionism. A liberal American trade policy not only facilitated the economic recovery of other nations opposing Soviet political expansion but, by leading to liberal trade policies on the part of other countries, enabled U.S. exporters and investors to establish strong world market positions prior to the full economic recovery of those industrial competitors whose economies had been crippled during the war.

The outward-looking policies of the United States not only greatly benefitted this country but helped to facilitate the highly successful recovery and modernization efforts in most industrial countries and in a number of developing nations. An understandable consequence, however, was that a growing list of labor-intensive and low-technology U.S. industries began to face severe competitive pressure from foreign producers and, therefore, to lobby for import protection. The easing of the Cold-War tensions also made it more difficult to resist these domestic pressures on the grounds that an open trade policy was needed to help strengthen the free world against communist expansion.

An effective argument used in lobbying for protection has been that unfair trade practices by other countries are a major cause of U.S. competitive problems. It has the appeal of diverting attention from any domestic factors that might explain these problems and of enabling public and private officials to maintain that they still favor free trade. They maintain that this trade must be fair as well as free, however. The importance of this view is indicated by the strong U.S. emphasis on negotiating new codes of behavior on fair trade issues in the Tokyo Round. The United States and other industrial countries also began to direct their protective actions toward particular countries that they felt were unfairly disrupting domestic markets with sharp increases in exports.

The sharp dollar appreciation in the early 1980s adversely affected most export-oriented and import-competing industries and changed trade policy from being a matter of concern to only a small number of industries into being a matter of national concern. This development gave impetus to the view that unfair actions by foreigners adversely affected almost all industries and were a major cause of the massive U.S. trade deficit. Emphasis shifted from foreign unfair measures being a major cause of import surges to these measures being a major cause of the failure of U.S. exporters to sell more in foreign markets. Consequently, in recent years there have been a series of vigorous bilateral efforts by the Administration to open the markets of Japan and a number of developing countries.

Although all countries are likely to benefit economically from more open markets, the United States may be paying an undesirable price in foreign policy terms for its aggressive behavior. The U.S. advise to surplus countries that greater emphasis on

stimulating demand from domestic activities is needed also may have undesirable long-run growth effects in the world economy, if import-substitution policies are given greater prominence in countries' growth efforts. Foreign market opportunities for U.S. goods may be less favorable because of these policies. In addition, as the importance of an export surplus grows due to the increasing service charges required for the growing U.S. net indebtedness position, the argument that fairness requires bilaterally balanced trade may be thrown back at the United States to thwart the achievement of such a surplus.

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# Interpreting the Reagan Deficits[1]

**Thomas J. Sargent**

Tonight I want to explain or interpret the large deficits that my government has been running. Figures on government deficits are difficult to interpret because the economically relevant budget constraint is an intertemporal one. As such, it restricts the present value of a sequence of government deficits but not the size of deficits for particular years or even for long strings of years. For any observed string of government deficits, there always exists a string of prospective future surpluses that renders the budget in balance in the present value sense.

By alluding to prospects for future government surpluses, anyone can therefore assert that a record of observed deficits is consistent with maintaining sound government credit and a stable government currency. Several years of big deficits by themselves therefore fail to indicate that the entire sequence of government budgets is out of balance. This fact opens recent deficit figures for the United States to alternative interpretations, some hopeful, others foretelling doom.

My purpose this evening is to try to rationalize the large net-of-interest deficits in the federal budget of the United States that marked the Reagan Administration and that now mark the Bush administration. I take for granted that the recent deficits are temporary and that they foretell future government surpluses. I spend no time discussing the view that the deficits are simply a mistake, a failure of policy, or the result of shortsightedness or ignorance of the intertemporal government budget constraint. Instead I focus on alternative interpretations of recent events that are consistent with George Stigler's vision that all agents in a social system are rational and purposeful. I seek to explain the fiscal and monetary actions observed during the Reagan administration as reflecting the optimal decisions of government policymakers.

There will be one equation in the background of my discussion, one whose validity is granted by all competing theories of macroeconomics. This equation is the intertemporal government budget constraint. It states that, at any moment, the value of interest-bearing government debt is equal to the sum of two terms: the present value of future government surpluses net of interest, and the present value of future govern ment revenues from printing currency ("seignorage" revenues).

Presumably, the government deficit net of interest and the revenues from currency creation are controlled by separate and independent agencies of the U.S. government. However, one of my themes tonight shall be that in a recurrent and strategic sense,

such independence is simply not feasible. Because revenues from printing currency are one component of the government budget constraint, the notion that there can be truly independent monetary and fiscal authorities is a myth.

Arithmetic makes the strategies of the monetary and fiscal authorities interdependent.[2] Classic recommendations for the conduct of monetary policy, such as Friedman's (1959) k-percent growth rule for currency or the gold standard, are well understood as coordination rules for monetary and fiscal policy. For these coordination rules to be feasible, the intertemporal government budget restraint must be respected. This evening, I will always assume that a version of Friedman's k-percent coordination rule (one with a small value of k) is followed.

I seek to interpret the following observations about monetary and fiscal policy during the Reagan and now the Bush years: a string of large annual net-of-interest government deficits accompanied by a monetary policy stance that has been tight, especially before February 1985, and even more so before August 1982. I take as indicators of tight monetary policy high real rates of interest on U.S. government debt, with pretax yields that exceed the growth rate of the economy. (Real rates of this magnitude imply that the interest-bearing government debt is growing relative to the size of the economy unless the net-of-interest government budget is in sufficient surplus.) I take for granted that the string of net-of-interest government deficits and tight monetary policies (low rates of seignorage production) cannot both continue forever, simply because they would violate the intertemporal government budget constraint.[3]

I shall describe two rationalizations of recent observations on government policy, each of which is consistent with the government budget constraint, under the hypothesis of "rational expectations" and the presumption that the government as a whole is committed to a monetary regime with low inflation rates over the long haul. The last stipulation is equivalent to an assumption that the present value of seignorage in the government budget restraint is taken for granted to be small.

## I. BARRO TAX SMOOTHING

The first rationalization is constructed by applying the optimal tax smoothing model of Robert Barro (1979). I assume that the monetary authorities are committed to supplying little or no seignorage, and that this is beyond dispute. It follows therefore that the present value of seignorage is small. Because of the government budget constraint, the net-of-interest government budget must be in surplus in present value by an amount equal to the current value of interest-bearing government debt. How can

this implication be reconciled with the string of large net-of-interest deficits observed during the Reagan administration? Barro's model supplies a possible answer.

Barro's model of tax smoothing can be thought of as a reinterpretation of Milton Friedman's (1956) model of permanent income as developed by Robert E. Hall (1978).[4] The permanent income model of consumption confronts a consumer with an exogenous process for labor income and a constant real rate of return on savings. The consumer has preferences over a long horizon that can be represented as a discounted sum of a current period utility function that depends on current consumption alone. That is, preferences are additively time-separable, and the utility function is concave in current consumption.

Hall showed that for a discount factor equalling the reciprocal of the gross interest rate on assets, the marginal utility of consumption follows a random walk. To the extent that the marginal utility of consumption is approximately linear in consumption, consumption itself may approximately follow a random walk. As Hall has stressed, for any income process, no matter how unsmooth, the model predicts that consumption is approximately a random walk. This means that at every point in time, future consumption is expected to be approximately constant.

Hall's model precisely represents the consumption-smoothing idea present in Friedman's original work on the consumption function. A possibly very unsmooth labor income process is used to support a consumption process whose future is expected at each point in time to be perfectly smooth. Borrowing and lending are used to convert an unsmooth income path into a smooth consumption path. At any time, the mean of the consumption path is set so that the present value of consumption equals the present value of labor income plus initial nonhuman assets.

Barro can be regarded as having changed the names of the variables in Hall's model and applied them to the government. In place of the household budget constraint, Barro uses the government budget constraint. What was the exogenous labor income process in the Friedman model becomes an exogenous process for government purchases. What was consumption in the household budget constraint becomes total tax collections in Barro's model. What were household assets become the stock of interest-bearing government debt. The interest rate confronting the household in Hall's model becomes the interest rate at which the government can borrow and lend in Barro's model.

The intertemporal version of the re-interpreted budget constraint is precisely the intertemporal government budget constraint described above, with seignorage assumed to have a present value of zero. In place of the preference function used by Hall, Barro

uses an additively time-separable loss function measuring distortions from taxing. The current period loss function is convex in total tax collections.

Barro poses the problem of a government that faces an exogenous and given stochastic process for government purchases and that chooses a tax strategy to minimize the expected discounted value of losses from tax distortions. In mathematical terms, this model is equivalent to Hall's consumption model, with the change of variables described above. It follows that the model gives the result that optimally, total tax collections should follow a random walk. That is, in the face of an unsmooth government expenditure stream, tax collections should be smoothed. In this way, distortions are allocated over time in a way to minimize the present value of the distortion.

We note that this result depends critically on the feature of the loss function that the distortion at time t is assumed to depend only on total tax collections at t, and not on future tax collections, as would occur in a model in which private agents are speculating about future government tax collections. In Barro's model, expected future tax collections are set equal to current tax collections, with current tax collections set to satisfy the intertemporal government budget constraint.

The Barro model can be used to rationalize the observed deficits of the Reagan Administration as part of an optimal tax smoothing response to an "innovation" about the present value of government expenditures that arrived coincidentally with Reagan's election.

Assume that the election of Reagan signalled a downward revision in the size of the U.S. government, as measured by the expected present value of federal expenditures. Assume further that the path of reductions, compared to the path that could have been expected prior to Reagan, was skewed toward the future or "back-loaded". That is, the election of Reagan meant reductions in the government expenditures could be expected to take place gradually over time, with larger reductions in the future than in the present.

Given such a change in the path of expected government expenditures at the start of the Reagan administration, Barro's tax smoothing model predicts that the (optimal) response of the government would be an immediate permanent reduction of tax collections, relative to the pre-Reagan path. The consequence of these immediate reductions would be a string of deficits while expenditures remained high, to be followed by a string of net-of-interest government surpluses after the reductions in expected government expenditures had been realized.

According to this scenario, there is nothing pathological about the large deficits we have observed. Instead, they are to be interpreted as the result of optimal tax

smoothing by the federal government. Note that Barro's argument implies that the Reagan Administration should have tried for a 25 percent reduction in tax rates at one shot, rather than the 5-10-10 phasing in over three years embodied in the Kemp-Roth tax legislation.

Barro's model implies that the large deficits observed pose no inflationary threat because they pose no danger of being monetized subsequently. The fact that the interest-bearing U.S. government debt has grown under Reagan is merely a signal that the budget will swing into surplus at some time in the future, and that government expenditures are destined to fall relative to their pre-Reagan path.

The scenario described depends critically on a controversial aspect of Barro's specification of the function measuring the current loss from tax distortions in the government's objective function. In particular, Barro specifies that the current distortion at time t depends only on current tax collection, and is not a function of the public's expectation of future taxes set by the government. This feature is critical in giving rise to the random walk characterization of taxes, which is at the heart of our interpretation of the Reagan deficits. It is also crucial in rendering Barro's solution of the optimal tax problem time-consistent.[5]

However, in models in which there is capital, either physical or human, the current distortion from taxation at time t typically depends in part on peoples' expectations about future taxes. In making investment decisions, people look and respond to the government's strategy for taxing in the future. Expectations about future taxes therefore distort private decisions.[6] Such distortions would alter Barro's loss function in a way that would make it suboptimal if tax collections followed a random walk. It would also render the solution of the optimal tax problem time-inconsistent. A sequence of administrations differing over time would therefore be unable to carry out any solution.

As it turns out, when optimal tax problems are solved for systems with physical or human capital, the optimal tax strategy usually is far from a random walk prescription. Usually high taxes are called for in the present, to be followed by lower taxes in the future. Since high taxes now are imposed on existing capital and existing capital is perfectly inelastic in supply, the taxes take on a lump sum character. As a result, such current taxes should be imposed heavily to minimize the present value of distortions. Anticipated future taxes, in contrast, do distort investment decisions and therefore future values of capital. As a result, they should be used sparingly. The assymmetry in attitude toward current and future taxes on capital is at the heart of the time inconsistency of the solution, as well as of the suboptimality of tax smoothing.

In summary, by restricting the nature of the function that is assumed to measure the losses from the distortions that taxes impose, Barro was able to create a model calling for "tax-smoothing". By tax-smoothing, he meant that, even if government expenditures were expected to vary in the future, it would be optimal for consumers to expect taxes to remain unchanged. Applied to the current situation in the U.S. (supposing that the election of Ronald Reagan signalled that government expenditures would fall relative to their pre-Reagan path), the model rationalizes a string of deficits like the one we have experienced. Not only does the model "explain" those deficits, but it also implies that they are not signs of a "problem". Rather, the current deficits are simply a "signal" of future reductions in the path of government expenditures.

This application of Barro's model is attractive because it explains many aspects of the current situation and supports a sanguine interpretation of recent U.S. deficits. However, such an application is not beyond criticism for reasons alluded to above. In particular, the restrictions on the loss function measuring distortions in Barro's model are very strong ones. Indeed, the restrictions suppress any "supply side" effects flowing from expectations about future taxes to current decisions.

## II. WALLACE'S GAME OF CHICKEN

I now turn to an alternative interpretation, one due to Neil Wallace. Wallace's interpretation hinges on the observation that economic policymaking in the United States is decentralized over a variety of agencies, and that government expenditures cannot be reduced without a struggle among those agencies. Wallace's explanation makes the deficit an instrument in that struggle.

Wallace's interpretation assumes that the "game" played by government policy authorities has a different structure from that asssumed by Barro. In particular, Wallace has interpreted monetary and fiscal policy during the Reagan Administration as unfolding like a game of chicken among distinct branches of government with different preferences about the size of the U.S. federal government.[7] In this game of chicken, reducing the present value of government expenditures is not a given, but instead is the objective of one of the participants in the game. This objective, in turn, is actually opposed by another player. The players' weapons consist of their separate authorities to set paths for government expenditures, tax collections, and currency creation. Using Wallace's analogy, the Reagan Administration plays the game for the purpose of reducing the present value of government expenditures - an objective whose attainment Barro's explanation took for granted.

The game of chicken is played among decentralized branches of government that control separate elements of the government budget constraint. There is a tax authority, whose role I shall assign to the Reagan Administration, and whose responsibility is to select a stochastic process for tax collections. There is a government expenditure authority, here assigned to Congress, that determines the stream of government expenditures. Finally, there is a central bank (the Federal Reserve System) that determines a time stream of emissions of currency and thereby controls the present value of seignorage that appears in the government budget constraint.

While these three players, the tax authority, the expenditure authority, and the monetary authority, must coordinate their strategies because of the arithmetic of the intertemporal government budget constraint, they are not forced to do so on a day-to-day basis by any formal legal or constitutional mechanism. The coordination of monetary and fiscal policy in the United States is not governed by a set of well-understood, recurrently applied, or explicit rules. Instead, policy actions seem to emerge from a process that is decentralized across institutions (Congress, President, and Federal Reserve) and spread over time through a succession of administrations and personalities. This decentralization opens the way to the playing of what Neil Wallace has characterized as a game of chicken.

In the game of chicken being played under the Reagan Administration, the tax and monetary authorities jointly desire a reduction in the present value of government expenditures (something they do not control) as well as a stable price level. The expenditure authority is assumed to desire a larger government in the sense of a larger expected present value of government expenditures than does the tax authority.

To achieve its objective, suppose that the tax authority plays the game as follows. It achieves a once-and-for-all reduction in tax collections that reduces the present value of tax collections relative to its initial value. The tax authority (the President) then encourages the central bank to adhere to a k-percent rule for the monetary base for the indefinite future. Such a monetary policy implies that the central bank withholds seignorage revenues from the government. Given these "plays" by the President and the Federal Reserve, the only plays open to the government expenditure authority are ones that capitulate to the President's objective and that reduce the present value of government expenditures by an amount commensurate with the reduction in the present value of tax collections. As long as the President and the Federal Reserve adhere to their strategies, the stream of government expenditures must be reduced because of the arithmetic of the government budget restraint.

Congress may, however, reason as follows. It can simply refuse to reduce the present value of government expenditures despite the tax reduction engineered by the

tax authority. Then, as long as the monetary authority refuses to monetize interest-bearing government debt, the arithmetic of the government budget constraint requires that the tax authority eventually reverse itself and raise taxes by an amount that makes the present value of taxes equal to the present value of expenditures plus whatever debt has accumulated. If the monetary authority and Congress both refuse to chicken out, then the arithmetic of the budget constraint asserts that the only feasible thing for the tax authority to do is to raise taxes.

Of course, it is feasible that neither the tax authority nor the expenditure authority will chicken out. In that case, the central bank would be forced to chicken out by departing from its k-percent rule and generating substantial seignorage. By monetizing the debt, the central bank would permit government expenditures to exceed tax collections in present value terms, albeit at the cost of generating inflation.

While the authorities are playing this game of chicken, we would observe large net-of-interest government deficits, low rates of monetization of government debt (low growth rates for the monetary base), and maybe also high real interest rates on government debt. The result of high real interest rates on government debt and the net-of-interest government deficit is a growing real value of the stock of interest-bearing government debt. The rising stock of this debt would be a signal that the game is not yet over, in the sense that there has been insufficient capitulation. In the U.S. today, the real stock of interest-bearing federal debt continues to grow in relation to GNP.

The game of chicken interpretation has a number of merits as an explanation of these events. While it is tempting to criticize resorting to a game of chicken as an inferior way to run a government, such criticism ignores the extensive decentralization across time and institutions that exists under U.S. government. Given the limited power assigned to the Presidency for economic policy in general and government expenditures in particular, resorting to the game of chicken may be the best method available for achieving the preference, reflected in Reagan's policies, for reducing the size of the U.S. government.

Several important macroeconomic policy events during the Reagan years bear interpretations in terms of one party or another in our game of chickening out. The Federal Reserve partly chickened out on two occasions, one in August 1982, and another at the start of 1985. Each time, the Fed was responding to outside pressures that were partly consequences of, and which in turn fed back upon, the original game of chicken.

In August 1982, the Fed substantially eased monetary policy, increasing the growth of narrow monetary aggregates and driving real interest rates downward. These

actions were in large part responses to the international debt crisis that coincided with the high real interest rates associated with the game of chicken that dominated U.S. macropolicy. The Fed eased its monetary policy specifically in response to the Mexican crisis and the threat it posed for U.S. financial stability. Such concerns limit the Fed's ability to continue to play a tight monetary policy in the face of continued net-of-interest U.S. government budget deficits.

The second partial capitulation by the Fed was associated with a move starting in early 1985 to lower real interest rates in the U.S. as a device to drive down the value of the dollar. The Fed was responding to the increasing strength of protectionist pressures in the U.S. that were themselves responses to the U.S. trade deficit which was, in turn, one consequence of the string of government deficits associated with the game of chicken.

## III. CONCLUSION

While they differ in a number of respects, our two alternative rationalizations of the Reagan deficits share the premise that, compared to the pre-Reagan path, U.S. federal expenditures are destined to fall. In Barro's model, the fall in the path of expenditures occurs exogenously, and precipitates the Reagan deficits via optimal tax smoothing. In Wallace's view, the fall in the path of federal expenditures relative to the pre-Reagan path is an outcome of (or "reward to") the game of "chicken", with an endless string of prospective budget deficits being the stick by which the President and Federal Reserve persuade a reluctant Congress to reduce federal expenditures. According to both explanations, large net-of-interest deficits are signals of prospective surpluses to be achieved via reductions in expenditure.

Each rationalization relies on the looseness of the intertemporal government budget constraint to which I referred at the beginning of the paper. A long string of large deficits is consistent with budget balance provided that sufficient surpluses occur later. We have rationalized the large Reagan deficits by appealing to the idea that they are temporary and bound to be replaced by surpluses long before they damage the economy.

Some readers may find the entire endeavor of rationalizing the large Reagan deficits to be misplaced. Perhaps it is farfetched to rationalize deficits in the ways that we have, and better to regard them simply as reflecting shortsighted mistakes that the U.S. is bound to pay for in the future via more inflation, increased financial fragility, or higher

taxes. Nevertheless, to reach the conclusion that the U.S. deficits of the last decade were mistakes, one must first understand the arguments that could rationalize them.

**Notes**

[1] This talk is based on the paper "Interpreting the Reagan Deficits" that I published in 1986.

[2] Sargent and Wallace (1981) describe some of the implications of the interdependence between monetary and fiscal policy.

[3] This is Sargent and Wallace's unpleasant monetarist arithmetic.

[4] See Sargent (1987, chapters XII and XIII) for a formal technical comparison of the features of Hall's and Barro's models.

[5] See Kydland and Prescott (1977) for a discussion of the time- inconsistency problem in macroeconomics. See Lucas and Stokey (1983) for a study of dynamic inconsistency in the context of an optimal tax smoothing model that shares many features with Barro's model.

[6] See Sargent's (1987) chapter on dynamic optimal taxation for an extended example exploring the time-inconsistency phenomenon created by the responsiveness of investment to anticipations of future taxes.

[7] Wallace advanced his ideas orally in March 1981 during discussions that later led to our co-authoring "Unpleasant Monetarist Arithmetic" (1981).

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# The Economic Decline of the U.S.? The Dollar and the Adjustment Options

**Rüdiger Dornbusch**

The U.S. twin deficits, of the budget and of the external balance, are a focal point of world criticism and of domestic debate. For some observers the U.S. situation is acutely precarious, so much so that if adjustment does not come soon there is a risk of major disruption of economic stability world wide. For others economists have cried wolf already for too long, - they have been wrong for seven years and they will be wrong for another seven years. Deficits they argue, can be financed without much strain. And if the financing is available, why adjust? In fact, some argue that deficits are not a "policy problem" in any significant sense. If people want to spend more than their income, and if they can finance their plans by running down assets or by borrowing, who is to find fault with their spending plans?

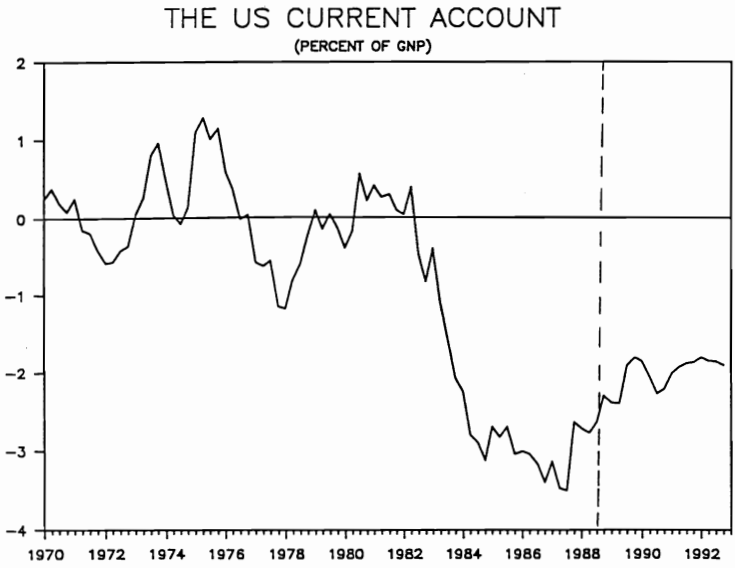
This essay assesses the U.S. external balance situation from a policy perspective. Specifically three issues are addressed:

- What are the reasons for the deficit? Is the deficit mostly a reflection of the overvalued dollar in the 1980-85 period and is the persistence of the deficit a reflection of very slow adjustment to the gain in competitiveness that has been achieved since? Or are there important structural reasons for the deficit? These might be either found in the domestic macroeconomy or in changing trends in world trade.
- What are the policy responses and what are their advantages or disadvantages? The possible adjustments, accompanying the evident need for higher national saving, include dollar depreciation, increased foreign direct investment, improved market access abroad or protection at home. Some are desirable, some are inevitable and protection should be resisted firmly.
- What are the broader political economy issues raised by U.S. adjustment? The dominant concern is the tension between the obvious need for retrenchment in domestic spending and living standards and the widespread perception of a middle class squeeze already in place. With the adjustments that lie ahead the squeeze has not even started and that means economic policy risks turning populist. We now examine these issues in turn.

VARIETIES OF DEFICITS

In early 1989 the U.S. merchandise trade deficit at an annual rate amounted to $107 billion, down from the more than $150 billion of 1986. The broader measure of the current account, including not only merchandise trade but also services and investment income, showed a deficit of $124 billion. While this deficit, too, had declined over the past year from a peak of $160 billion, it was actually back on the rise. In Figure 1 the current account data are shown as a fraction of GNP.

Forecasts for the U.S. economic balance do not show significant improvement in the next three years. For example DRI/McGraw Hill predicts that by 1992 both the current account and the trade deficit still exceed $100 billion.




There is no presumption that current accounts should be balanced in the short run or even over extended periods of time and in fact they have not, as Table 1 shows.

Table 1 External Imbalances
(Current Account % of GDP)

| | 1960-79 | 1980-87 |
|---|---|---|
| Australia | -1.7 | -4.5 |
| Canada | 0.4 | -0.3 |
| Japan | 0.5 | 2.1 |
| Germany | 0.8 | 1.3 |
| U.S. | 0.6 | -1.8 |

Source: OECD

Germany has a virtually uninterrupted string of surpluses in the past 25 years, and Japan exhibits a growing trend toward an external surpluses, with reversals in the 1970s associated with the oil price shocks. Australia, by contrast, has a persistently large current account deficit. The pattern of persistent deficits or surplus raise the question whether deficits are a policy issue and whether there is an automatic adjustment mechanism, however satisfactory it may be.

To discuss the adjustment mechanism and problems of adjustment, it is useful to start off with a classification of sources of external imbalance. A point of departure in classifying deficits is the national income accounts identity:

(1) Current Account = Saving - Investment

Because this is an identity, a deficit reflects an excess of spending over income or of investment over saving. Any theory of the deficit must ultimately explain why a particular disturbance affected the balance between saving and investment. There is always an incipient or virtual link between a disturbance and the external balance, but it is often difficult to understand why (with budget constraints in mind) the disturbance should translate into actual imbalances. A tariff, for example, is likely to raise the relative price of imports. But why should that lead to lower saving or higher investment and thus to an external imbalance? In looking at particular "stories" of the sources of imbalances we have to bear in mind the need to establish a link between the disturbance and its effects on the saving-investment balance. Often the government's budget provides the missing link. This is certainly part of the explanation in the U.S. case,

although the significant decline in private saving also contributed to the fall in the national saving rate shown in Table 2.

Table 2 U.S. Net National Saving and Domestic Investment
(% of GNP)

| | Saving | | Investment |
|---|---|---|---|
| | Total | Federal | |
| 1950-59 | 7.8 | 0.0 | 7.5 |
| 1960-69 | 7.8 | -0.4 | 7.1 |
| 1970-79 | 7.2 | -1.1 | 6.9 |
| 1980-88 | 3.1 | -3.7 | 4.7 |

Source: OECD

The realized saving (including the budget deficit) and investment rates are only the proximate causes of the deficit, they do not help identify the fundamental reasons. It is helpful to go beyond to identify eight different sources of external imbalance. The identification is important as an ingredient since it helps to know whether deficits are benign or malignant.

- Development Deficits. In countries with low per capita income saving is low relative to the investment opportunities. Net foreign borrowing will supplement domestic saving in providing resources for investment. By contrast, in mature creditor countries investment opportunities are low relative to saving. Thus high income countries tend to be capital exporters. This is the case for Germany, for example. In Korea, by contrast, the external deficit averaged 8.2 percent of GDP in the 1950-79 period because investment opportunities were high even relative to the high national saving rate.
- Deficits driven by poor public finance. The prototypes of this kind of deficit is the experience in Latin America in the 1970s, Ireland in the 1970s and early 1980s, and the United States in the 1980s, as shown in Table 2 above.
- Deficits induced by adverse terms of trade shocks. Because the disturbance is transitory or adjustment is not instantaneous, there will be a transitory imbalance between income and expenditure. If disturbances are transitory, consumers will smooth consumption and absorb the adverse terms of trade effect over time. If they are permanent (and understood to be such), consumers may respond immediately, but there

will typically be an investment response to adjust the economy to the new price structure.

- New investment opportunities, say an oil discovery. In fact, if there is good news for households, increased consumption (ahead of the as yet unexploited income opportunities) will add to the deficit.

- Enhanced financial intermediation (domestic or international) which gives households or firms financing opportunities (or terms) that were unavailable before. Improved financial intermediation (with lower rates or reduced credit rationing) will induce individuals looking forward to a rising income profile to anticipate future incomes. Rationed firms will increase investment spending.

There is also, of course, disintermediation. Countries that can no longer borrow in world capital markets are forced into involuntary trade surpluses.

- Structural change in the world economy. Traditionally this was called "loss of markets". In the case of the U.S., this might today be called new competitors or new entrants in world manufacturing. Table 3 shows the change in U.S. trade with the NICs since 1981. Part of the $70 billion shift in trade reflects the debt crisis (loss of markets), but a major part is a reflection of the entrance of new competitors in world trade. These deficits will be persistent only to the extent that exchange rates are not allowed to adjust and the income adjustment process is slow.

Table 3 U.S. Manufacturing Trade With Developing Countries
(Billion $)

| | Exports | Imports | Balance |
|---|---|---|---|
| 1981 | 67.3 | 39.1 | 28.4 |
| 1988 | 78.0 | 108.8 | -30.8 |

Source: U.S. Department of Commerce

- Demographic deficits result during a transition period as the economy adapts to a changing age structure. Demographic factors influence the external balance via the saving-investment relation.[1] A slowing down of population growth implies an increase in the average age of the population. In the beginning, the average household becomes relatively more middle-aged. In a life cycle saving context, this implies an increase in average, hence national, saving. There is no presumption of an increase in investment, so the nation's current account surplus would increase.

As the demographic structure converges to the new steady state there is a relatively larger fraction of households in retirement, this in the dissaving phase of their life cycle. At this stage, they are dissaving which implies a lower national saving rate. Thus, for the entire transition period, there would be a transitory bulge of the saving rate and a long run decline. This is the explanation often offered for the growing Japanese and German external surpluses.

Table 4 shows the changing actual and prospective age structure in the U.S., Japan and Germany. The exact effect on the current account will depend on the relative decline in population growth and on national saving characteristics including, in particular, differences that stem from different social security arrangements and the resulting impact on saving rates.

Table 4 Changing Age Structure in OECD Countries
(% of Population age 65 and over)

| | Japan | U.S. | Germany | OECD |
|---|---|---|---|---|
| 1980 | 9.1 | 11.3 | 15.5 | 12.2 |
| 2000 | 15.2 | 12.2 | 17.1 | 13.9 |
| 2020 | 20.9 | 16.2 | 21.7 | 17.9 |

Source: OECD

- Finally there are trade deficits that are the result of misaligned exchange rates. Misalignment of exchange rates only imply a sustained deficit if some process (like fiscal policy) sustains a level of spending in excess of income. The U.S. case, for which we show the real exchange rate relative to all trading partners, is an outstanding example. In 1980-85 the dollar appreciated in real terms more than 30 percent. As a result export industries became uncompetitive in world markets and import penetration increased sharply. Of course, it is important to bear in mind that the dollar appreciation did not just "happen"; it may have been an equilibrium response to one of the fundamental reasons for deficits noted above. But there is also a school of thought that sees in the dollar appreciation a bubble rather than fundamentals.[2]

Which alternative and not exclusive hypotheses about imbalances in hand, we can next ask whether there the deficits are a "problem" problem and what, if anything should be done about it.

## IS THERE A NEED FOR ADJUSTMENT?

There are two basic schools of thought on the adjustment issue. One is the new classical school in the tradition of Lucas (1986, 1987). It holds that agents optimize subject to the budget constraints they face and that markets clear. If governments also optimize, and why should they not, then there is nothing left to be done - the price is right and the less government intervention there is, the better. Whether countries chose to save like Japan, or to dissave as is the case in the U.S., who is to double guess the individual economic agents' choices?

The immediate implication of the new classical model for the question of the adjustment mechanism is that there is no "problem". The budget constraint assures that spending plans cannot (ex ante) be out of line with incomes. Government policy is optimizing in imposing an efficient timing of taxes. The entire economy behaves as if maximized by a social planner. There is nothing left for policy to do.

The new classical approach leaves the other school, policy activists, basically speechless. A world where all is well, except overzealous government, squares poorly with the perception that exchange rate movements are excessive, trade imbalances too large and too persistent, and complaceny overabundant. It is tempting to dismiss the new classical approach simply on the grounds that it has nothing to offer about "obvious" policy problems.

But if the new classical model cannot support policy activism, it also challenges policy activists to demonstrate rather than assert the need for and welfare improving effects of their policy intervention. Policy activists have not brought that proof, which removes some of the persuasiveness of their case. A useful approach might be to question particular assumptions in the new classical model and explore whether, on that basis, policy activism comes into its own.

There are two areas where a new classical approach has always had broad appeal. These are the long run issues of economic development and demographic transitions and the process of catching-up with technical progress in advanced countries. These are long run adjustment processes that affect, respectively, a country's saving rate and the equilibrium pattern of relative prices. It is important to recognize these long run processes, because they are potentially part of the current imbalances, and correcting them by offsetting macroeconomic policies would certainly be undesirable.

Clearly, in the U.S. the demographic issue is not present at this time (except in the most remote fashion) and unfortunately the country is not in the position of claiming that dissaving represents high rates of investment in response to extraordinary development opportunities. On the contrary, there is just no way of disguising the fact

that the deficits represent consumption, both private and public. Moreover, the high levels of consumption relative to income are not warranted by high future income opportunities. On the contrary, the demographic trends point to growing social security problems in the future.

There are two central reasons to favor early adjustment. The first is that borrowing today accumulates debts the interest of which will ultimately have to be paid by a reduction in the standard of living, most likely in absolute terms. Since there is no reason to expect that the debts will simply vanish, by inflation or otherwise, it is appropriate to start adjustment as early as possible. This argument is reinforced by the fact that the high value of the dollar associated with our monetary-fiscal mix promotes deindustrialization. When ultimately adjustment does come about the decline in the standard of living will be larger because we will not have invested in those activities that earn foreign exchange.

The second argument for early adjustment draws attention to the risk of a funding crisis. For the time being there is no sign of any reluctance of the rest of the world to continue financing our imbalances, but that situation can change from one day to the next as indeed happened in the Carter administration. A rapid turn in foreign confidence (or merely a foreign belief that we might not keep interest rates high enough to reward the risks of holding an overvalued asset) can turn asset markets in no time. Unlimited dollar selling could then easily translate into a major dollar fall and possibly even a world wide financial collapse. Better then to control events by bringing about adjustment in a controlled fashion rather than under the gun.

## ADJUSTMENT OPTIONS

The very first point to make is that the trade problem cannot be solved except in combination with fiscal adjustment. The U.S. economy is at full employment. Any improvement in the external balance, and hence any increase in demand for domestic goods, would translate into an overheating and a crowding-out of investment. The external balance problem might be "solved", but merely at the expense of lowering investment even further and raising inflation. Clearly that is not satisfactory. In this sense it can be argued that the Fed is right in maintaining a strong dollar.

Once fiscal adjustment does take place there is, however, a need for crowding-in: investment and net exports will have to rise so that the fall in consumer and government spending finds an offset in increased investment, higher exports and reduced imports. Only in that way can a recession be avoided. In the face of fiscal restraint, actual and safely prospective, the Fed would be expected to cut interest rates. The fall in interest

rates in turn could be expected to stimulate investment and, via a decline in the dollar, to raise net exports.

The extent of dollar decline, and the extent of the decline in the U.S. standard of living, will depend on how late the adjustment occurs and what parallel channels of adjustment are likely to be at work. Specifically three alternatives to dollar depreciation present themselves, foreign direct investment in the U.S. traded goods sector, increased access for U.S. goods abroad and protection at home. Before returning to the dollar question we explore these alternatives.

Foreign direct investment in the U.S., specifically in the traded goods sector, offers an important and attractive alternative to depreciation. The traditional arguments in support of foreign direct investment brought in development economics apply with equal force to the U.S. case. Nationalism on the issue of foreign capital is as misguided in Mexico and in Canada as it is in the U.S. today.3

Table 5 reviews the recent data on the U.S. foreign investment position. We note from Table 5 that the U.S. net foreign asset position has declined sharply as a result of the string of deficits. But, interestingly in view of the clamour, little of the foreign financing has in fact taken the form of direct investment. While Japanese foreign direct investment in the U.S. has been highly visible it accounted in 1988 for only 16 percent of the total. But in 1988-89 that share was rising as foreign businesses, especially Japanese firms, increasingly turned from financial claims to real assets.

Table 5 U.S. Net Foreign Asset Position
(Stock position, end of year, billion $)

| | 1980 | 1986 | 1988 |
|---|---|---|---|
| U.S. Net Foreign Investment Position | 106.2 | -267.8 | -532.5 |
| U.S. Assets Abroad | 607.1 | 1073.3 | 1253.6 |
| Private | 516.6 | 935.3 | 1120.4 |
| Foreign Direct Investment | 215.4 | 259.8 | 326.9 |
| Foreign Assets in the U.S. | 500.8 | 1341.1 | 1786.2 |
| Private | 324.8 | 1099.2 | 1464.1 |
| Foreign Direct Investment | 83.0 | 220.4 | 328.9 |

Source: Survey of Current Business June 1989.

Foreign direct investment is politically controversial. Purchases of "hard" assets by foreigners are seen as an intrusion into sovereignty and substance. The feelings often expressed that the country is robbed if foreign owners of U.S. firms "take the profits out". But, however pervasive these feelings, they entirely miss the point. If we spend more than our income of necessity we run down assets or borrow and that means we compensate foreign creditors either by dividends or by interest payments. Should we have a preference for foreign ownership of our bonds over our stocks or real assets?

In fact a good argument can be made to favor foreign direct investment. It brings (as we do not tire telling Mexico) three essential elements of business success: finance, technology, management and market access abroad. We need all four and should therefore prefer foreign direct investment over bond finance. Foreign direct investment is likely to create "good jobs at good wages", bond finance will do little to get us ahead.

It is quite apparent that in the automobile industry foreign direct investment is increasingly replacing imports. In fact, Japanese producers in the U.S. are even already shipping U.S. made cars to Japan. The more foreign direct investment moves in the direction of opening new export industries, or replacing imports with domestic production, the less need for depreciation lies ahead.

A common objection to direct foreign investment is that either it replaces U.S. jobs or that the import content of foreign production is high and hence the true benefits of these investment in terms of employment creation are vastly overrated. In either case one must ask what the counterfactual experiment is. One possibility is that foreign direct investment replaces activities that otherwise would have taken place abroad entirely. In that case there is little doubt that we gain net job creation in the U.S. But, implicitly, unions and other opponents of direct investment take the view of a closed economy. In that perspective, of course, any penetration from abroad is anathema. Of course, the U.S. is not a closed economy and a closing, if it ever were tried, could not fail to bring about a 1930s style collapse of world trade with obviously detrimental effects on U.S. exports. Against that background foreign direct investment appears an attractive way of locating some production in the U.S. and if it takes component imports to make it profitable we should not be disturbed by that fact. The union claim for pervasive protection against any and all competition, in a fully employed economy, has no substantive argument to support it.

Another way of avoiding the decline in the U.S. standard of living is to open markets abroad. Among industrial countries, with the exception of Japan, markets are substantially open after several rounds of tariff cutting under the auspices of GATT. But the Japanese market, and the markets of developing countries remain substantially

closed. If the U.S. could gain improved market access this would be an alternative to dollar depreciation. It would not solve the trade problem, but it would cushion the fall in the standard of living attendant upon correction of the budget and the external balance.

The proposition that Japan continues to be closed is not controversial, but what to do about it certainly is. Table 6 makes the basic point: whereas in other industrialized countries the ratio of manufactured imports to GNP has increased in the past 20 years, this has not happened in Japan. This is prima facie evidence of closedness, whatever the mechanism - government intervention, corporate redlining, consumer discrimination against imports. Two-way trade in consumer and capital goods is the standard pattern for all industrialized countries, but it simply has not occurred in Japan. At issue is not, of course, that Japan is a net exporter of manufactures. The question rather is why Japan does not export even more manufactures and, in exchange allows the imports of some foreign produced manufactures.

Table 6 Import Penetration in Manufacturing
(Percent of Apparent Consumption of Manufactures)

| | 1975 | 1980 | 1985 |
|---|---|---|---|
| Japan | 4.7 | 5.8 | 5.3 |
| Germany | 22.9 | 22.7 | 31.7 |
| UK | 14.2 | 25.3 | 33.2 |
| U.S. | 5.5 | 9.3 | 12.9 |

Source: OECD "The OECD Compatible Trade and Production Data Base: 1970-85". Paris, mimeo, 1988.

An effective policy to open Japan might go along the following lines: A target is set for Japanese imports from the U.S., say 15 percent growth per year for 10 years. If imports fall short of this target the U.S. automatically applies an across-the-board tariff on Japanese exports proportional to the shortfall.

This method is far superior to the alternative of bilateral trade balancing that has also been suggested as a target in our trade negotiations with Japan. Insistence on bilateral balancing could easily lead Japan to restrict its exports rather than grant expanded market access. Our import prices would rise and there would be no favorable

effects on the export side. The export targets, by contrast, do not stand in the way of freer trade and thus are far preferred.

It is interesting to speculate how Japan might try and implement an accelerated import program. Among the possible means is very likely the increased investment of Japan in U.S. export operations. If Japanese trading companies hold the key to the Japanese market there should be no objection to have them apply their services in making American labor a greater success at export.

More broadly the U.S. should reassess trade policy. An argument can be made that while the U.S. upheld the public good of an "open, liberal trading system" the rest of the world has been taking a free ride. In Europe since the 1950s the multilateral tariff cuts have been accompanied by an increasingly closed regional integration. The trade diversion effects of this regional integration have been accepted under GATT rules ("anything is Gattable") and the process has invariably been welcomed. The Europe 92 initiative is a further step in that direction. While European policy makers do emphasize that there is no attempt to build up a "fortress Europe" the final results are clearly not in. Part of the Europe project, specifically the implementation of the "social dimension" requires an upgrading of the labor conditions in the poorer regions. It is questionable whether these regions can continue to be profitable production locations once wages, benefits, social and workplace regulation have been pushed upward. Similarly, if Europe 92 conveys large gains by exploitation of scale economies then there will be many firms who disappear in the process. The losers are still to be heard from. Some protection may ultimately be a building stone of the internal European market.

In Asia, similarly, a process of integration is underway. Japan appears to be constructing a new co-prosperity zone including such countries as Korea, Indonesia, Malaysia, Thailand and the Philippines. The arrangement is informal and direct investment is the key driving force, but the emergence of the trading zone and of financial integration centered on Tokyo is a reality. Table 7 shows the prospective growth rates in the Pacific Rim countries. Clearly, this will be the dynamic region of the next decade, not plagued by financial instability or lack of saving, and Japan is placing itself at the center of the experience.

Table 7 Economic Growth in Asia

| | 1982-89 | 1990-2000 |
|---|---|---|
| Asian Tigers | 8.3 | 7.3 |
| ASEAN | 4.1 | 6.8 |
| China | 10.4 | 8.0 |

Source: Nomura Research Institute

In the face of these developments, should the U.S. continue its multilateral stance or is it time to enter a parallel track of trade negotiation? The common argument is that any departure from multilateralism today would undermine the Uruguay round negotiations. The unfortunate fact is that there is no fall-back position. Worse, success is quite consciously never defined and therefore by definition, the Uruguay round cannot fail. The argument can be made that the Uruguay round will not bring important successes, neither in agriculture nor in services. In any event, a fall-back position should be developed to raise the stakes of those countries who are lending less than full support to the negotiations.

An attractive alternative for the U.S. is to draw the lessons from the European experience and use the free trade area concept to gain market access while at the same time rolling back the creeping protectionism now underway at home. The U.S. should announce a conditional most-favored-nation policy of removing all trade barriers against all those countries who agree to do the same on their part in respect to U.S. exports. Some countries would immediately accept, for example Mexico and quite possibly Korea. By accepting, these countries would gain an advantage in the U.S. market over third countries, quite possibly displacing the latters' exports. Third countries must then choose whether to follow suit, liberalizing in turn, or whether they prefer to give up their place on the U.S. market in order to continue their protection of the home market. It is quite plausible that a few rounds of this exercise dramatically open markets in heavily protected developing countries worldwide in a way that GATT has not had the edge to do.

It would be particularly desirable if this policy approach were used with respect to Europe. Why not challenge Europe 92 with an offer of a North Atlantic free trade area? The EFTA countries learnt early on that the Common Market integration would be to their detriment unless they found a way of associating themselves. There is now free

trade already and a "European space" and discussions are underway for linking the EFTA countries with the measures of Europe 92. There is absolutely no reason why the U.S. should not play hard to join rather than be left out of a dynamic trade region.

There seems to be no disposition in Washington for ambitious trade policy. The Uruguay round, specifically, and the GATT and the liberal trading system, generally, continue to mesmerize the Special Trade Representative's Office. There they view the choice as one between Gephardt (i.e. protection) and GATT, failing to recognize that the plurilateral route may well be a more effective way to freer trade. Their insistence on multilateralism is particularly striking in the failure to move in a far more determined fashion on freer trade arrangements with Mexico. There is a widespread recognition that over the next decade the U.S.-Canada agreement should be expanded, in most directions, to include Mexico so as to generate a North American integrated market.

Mexico has indicated that there is a strong interest in an early, sector-by-sector liberalization (avoiding the word "free trade" and "integration": which are politically dirty words in Mexico) covering the major part of trade. For Mexico an early liberalization would create investment opportunities in many industries and thus might prove a lever for a return of capital flight. The U.S. administration is failing to recognize this extraordinary opportunity to push market opening, measures which ultimately would support our national security interest in Mexico's political and economic stability on the broadest front.

Another response to the adjustment problem would be protection. A policy of a uniform import tariff has been advocated as a means of solving the trade and budget problems in one and the same way. At first sight a tariff appears an attractive revenue source and a protection, a solid response to a playing field that is perceived as tilted against the U.S. But protection would certainly backfire. In Latin America it would worsen sharply the economic and political prospects, in Europe it would lead to retaliation and in Asia it would reinforce and speed up the formation of an isolationist region. The decline of America in the world could be speeded up beyond control. An export-oriented, aggressive trade strategy serves our interests as producers and consumers far better.

## DOLLAR POLICY

Dollar decline is an almost inevitable byproduct of fiscal adjustment. Foreign direct investment and successful trade policy can lessen the need for gains in competitiveness but their scope will not be far-reaching enough to do away with the need for some improvement in the U.S. relative cost position.

Table 8 Hourly Compensation in Manufacturing
(1988 Wage in U.S. $, Index U.S. = 100)

| | | | |
|---|---|---|---|
| United States | 100 | Korea | 18 |
| Germany | 130 | Taiwan | 19 |
| Italy | 93 | Hong Kong | 17 |
| Japan | 95 | Singapore | 19 |
| France | 93 | Mexico | 12 |
| United Kingdom | 76 | Brazil | 11 |
| Spain | 63 | | |

Source: U.S. Bureau of Labor Statistics

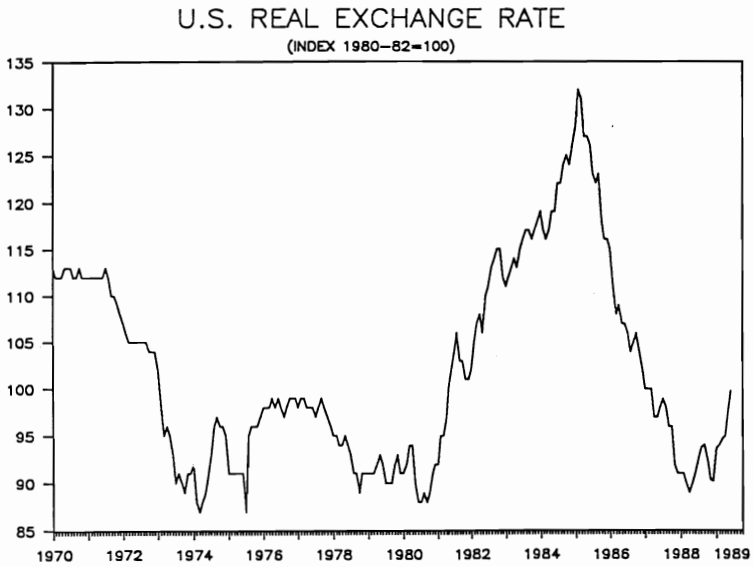
The argument that the dollar needs to decline further is often countered by the observation that the U.S. today is already a relatively low wage country, relative to Germany for example. But the fact is that German and U.S. labor have very different productivity. German labor produces high value added goods as for example a Mercedes while U.S. labor, in many branches literally competes with Mexico. Of course, there are industries that produce high-value-added goods, most obviously the aircraft industry, but there is an uncomfortable predominance of firms who cannot compete in the world market at current wages. Moreover, if the level of wages were the only consideration the UK should be highly competitive, yet it is common knowledge that Britain has a very serious competitiveness problem, just as the U.S.

The extent of dollar decline required to maintain full employment, once the fiscal adjustment occurs, depends on the behavior of world interest rates and world growth. It also depends critically on how many more years the U.S. pursues a policy of overspending which accumulates interest burdens that ultimately must be serviced by trade surpluses. It is difficult to believe that anything less than a 20% real depreciation from the levels of September 1989 would be enough.

Table 9 Real Exchange Rates
(Index 1980-82 = 100)

| | 1980 | 1985 | 1987 | Sept. 89 |
|---|---|---|---|---|
| U.S. | 91 | 123 | 96 | 96 |

Source: JP Morgan




The translation into nominal exchange rates suggests a 40-50 percent depreciation against the main European currencies and the Yen. The reason is that depreciation against Canada and Latin America (who absorb more than half of our trade) will be negligible. Thus, to achieve an average real depreciation of 20 percent, 40 percent are required for the other trading regions. To that we need to add the ongoing inflation differential. These considerations suggest a major realignment of exchange rates in the years ahead.

## THE POLTICAL ECONOMY OF ADJUSTMENT

The large dollar depreciation that lies ahead brings with it major tensions at home and in the world economy. In the world economy the U.S. will become relatively smaller. The formation of blocks abroad, and the dollar depreciation, will reduce the relative size of the U.S. appreciably. That cannot fail to change world politics. A tri-polar world will look very different and the transition opens a dangerous vacuum of which we see very little awareness on the party of U.S. leaders but an increasing consciousness abroad.

The more striking implications of the adjustments to come are at home. First there is the internationalization of the U.S. economy. Traded-goods prices will rise relative to domestic prices, international activities (both in manufacturing and in services such as tourism) will become relatively profitable. Foreign ownership will become far more pervasive in the U.S. as dollar depreciation puts U.S. assets within easy reach of European and Asian firms or households. In this respect it may be instructive to observe what happened in the UK in the period since the 1960s.

Along with the internationalization of the U.S. economy there will also emerge a major political tension centered on the real income issue. In the past 20 years real family incomes have increased as a result of increased labor force participation of women - more people in the family worked, but real hourly earnings have not advanced. There is already the perception of a "middle class squeeze". But that squeeze is felt at a time where the U.S. is spending more than its income and is at full employment.

Table 10 The U.S. Middle Class Squeeze
(Percent per year)

| | 50-59 | 60-69 | 70-79 | 80-88 |
|---|---|---|---|---|
| Real Per Capita Disposable Income | 1.6 | 3.0 | 2.1 | 1.8 |
| Real Hourly Earnings[a] | 2.5 | 1.7 | 0.2 | 0.0 |

[a]Private nonfarm business sector
Source: Economic Report of the President

In the years to come there may be full employment, but employment growth will be far slower and growth in real wages is unlikely to be even zero. Productivity growth is too low and the gain in competitiveness that is required therefore must come out of a fall in the standard of living. The political survival instinct of Washington will be to

deny, as long as possible, this extraordinary tension. As a result the need for adjustment will be far larger. There is a genuine risk of economic populism which, of course, would make matters far worse.

The right answer is to raise dramatically the national saving rate and shift resources and commitment to eduation and innovation. There is enough optimism in the world that if the U.S. did take that direction unlimited credit and faith would support the move. Unfortunately there is little indication of a determination to adjust while the conditions are favorable.

It is easy to paint a gloomy scenario for the U.S., but there is an important countervailing trend. The world economy has never been more prosperous. The dramatic innovation and technology in the pipeline to commercialization are changing the world faster than at virtually any time before. There is enough prosperity around to be shared by all; perhaps the realization of the excitement of participating actively in these extraordinary prospects (most clearly apparent in the Pacific Rim) will be the driving force to change U.S. culture to resume excellence and leadership.

FOOTNOTES

1 The first formulation highlighting demographic issues is von Furstenberg (1980).

2 See Krugman (1985), Frankel and Froot (1986, 1987), Ito (1988) and Dornbusch and Frankel (1989).

3 See G. Meier (1964) and Haberler (1988).

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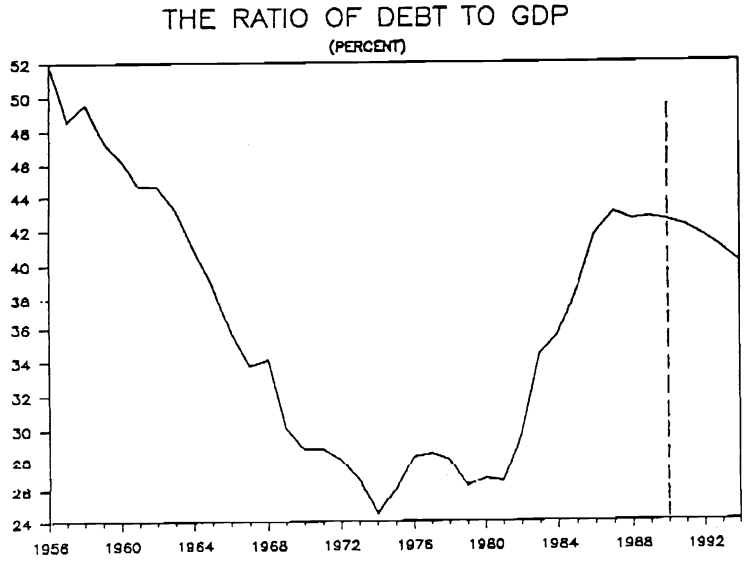


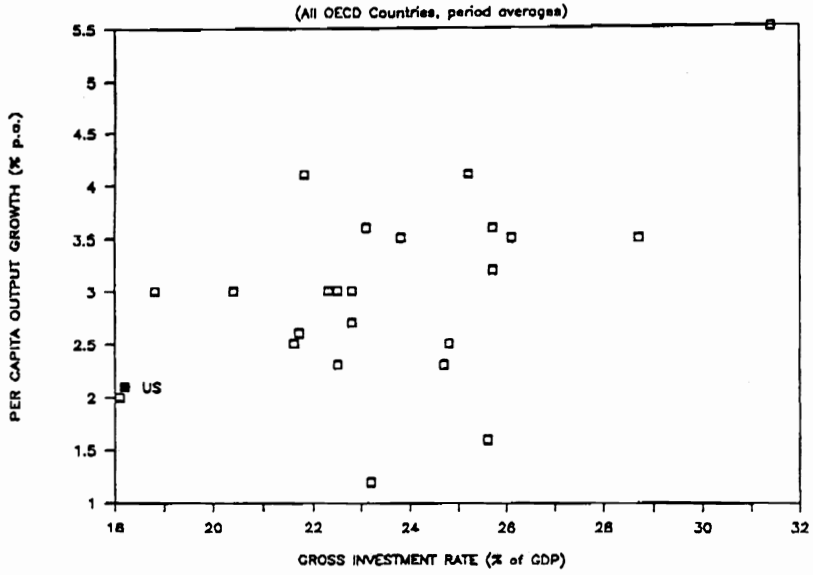

US Federal Budget and Debt
(Percent of GNP, fiscal year)

| Period | Budget | Debt | Period | Budget | Debt |
|---|---|---|---|---|---|
| 1946-49 | 2.4 | 96.0 | 1980-84 | -3.7 | 30.3 |
| 1950-59 | 0.0 | 59.1 | 1985-89 | -3.8 | 41.5 |
| 1960-69 | -0.4 | 47.8 | 1989* | -3.1 | 42.7 |
| 1970-79 | -1.1 | 27.5 | 1994* | -2.6 | 42.8 |

*Estimate by CBO

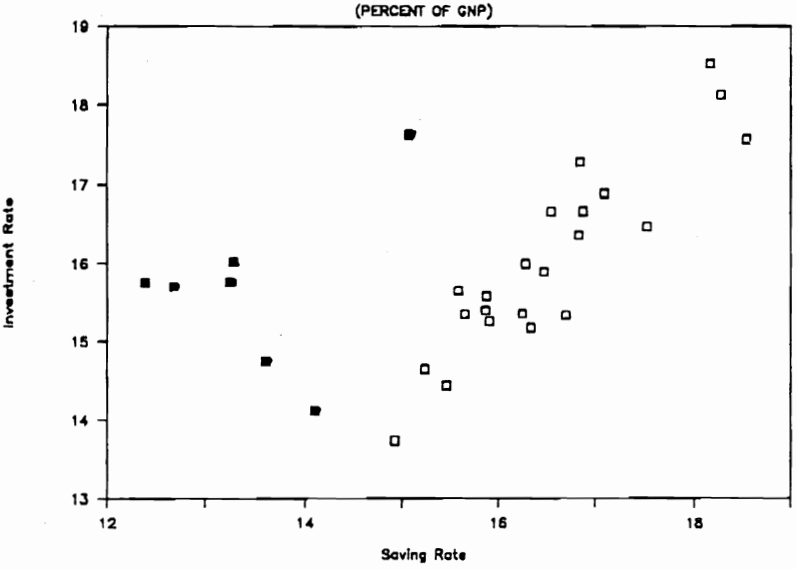
## INVESTMENT AND GROWTH: 1960–87

(All OECD Countries, period averages)



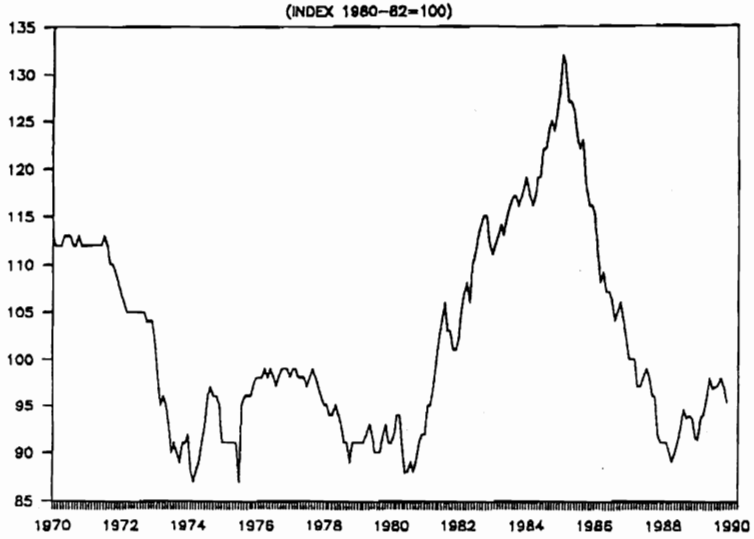

## US SAVING AND INVESTMENT RATIOS

(PERCENT OF GNP)

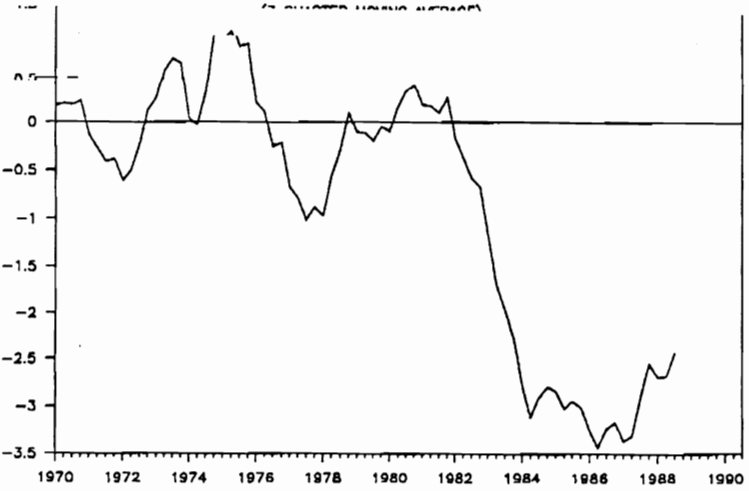


US:THE REAL EXCHANGE RATE

(INDEX 1980-82=100)

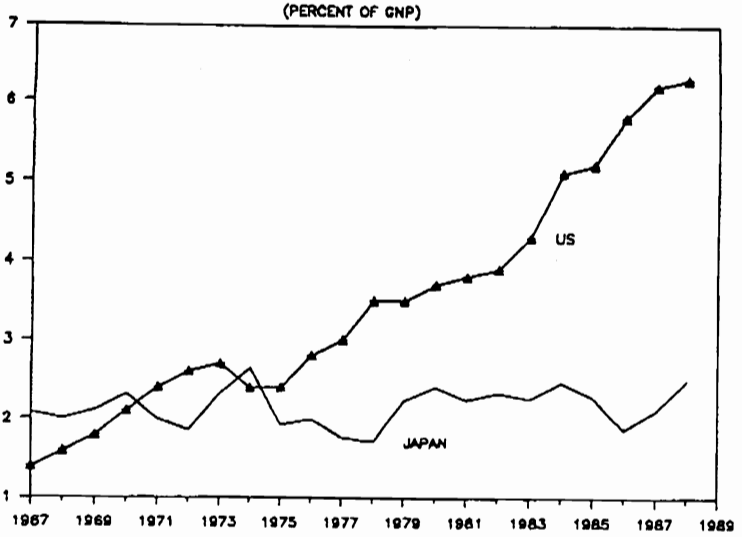



US CURRENT ACCOUNT/GNP RATIO



## MANUFACTURES IMPORTS

(PERCENT OF GNP)




## NET EXTERNAL ASSETS

(PERCENT OF GDP)