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13 Macroeconomic Policy and Trade Performance: International Implications of U.S. Budget Deficits

Rachel McCulloch

13.1 Introduction

As the trade ministers of 74 nations gathered in Punta del Este in September 1986 to launch the new "Uruguay Round" of multilateral negotiations, the U.S. Department of Commerce released numbers documenting still another record deficit in the nation's trade accounts. Even after a spectacular decline in the dollar relative to other major currencies, the U.S. merchandise trade deficit for 1986 was anticipated to reach $170 billion, a figure almost beyond imagining just a few years earlier. This seemingly inexorable growth of the trade imbalance intensified domestic political pressure for new protection, exacerbated trade disputes between the United States and its trading partners, and dimmed prospects for new multilateral action to maintain open international markets.

Despite ongoing discussion of the U.S. "competitiveness problem," most economic analysts and policymakers had long since agreed that macroeconomic developments in the United States and abroad were the root cause of the huge trade imbalance. However, recognition of the key role of macroeconomic forces in no way simplified policy choices on trade. Macroeconomic conditions continued to disrupt normal trading relationships, and the burden of dealing with the resulting imbalances continued to fall on those directly responsible for trade matters.

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Yet trade officials have little influence in determining macroeconomic policies at home—and none at all abroad. While finance ministers, central bankers, and heads of state prolonged the debate on appropriate macroeconomic remedies, the domestic political need to "do something" about trade virtually ensured new protectionist moves by the United States—and retaliatory action from trading partners.

13.2 The View from Washington

Early on, analysts had singled out the U.S. budget deficit as the primary factor underlying the sharp rise of the dollar that began in 1980, pricing most U.S. goods and services out of world markets. As this explanation gained wide acceptance in Washington, the need to cut the federal deficit enjoyed rare bipartisan appeal. But agreement ended abruptly at the question of how to do it without plunging the U.S. economy into recession, rekindling inflation, or both.

Congress faced the always unwelcome choice between cutting expenditures and raising taxes. With the 1986 elections looming ahead, they opted in the end to do neither. A one-time sale of federal assets satisfied the letter but not the spirit of the new Gramm-Rudman budget-balancing law. Administration officials sought ways to reduce the deficit without dismantling the fiscal incentives central to the "supply-side revolution" of the early 1980s. However, a major (purportedly revenue-neutral) reform of the U.S. tax system received top priority in administration efforts. Even without notable progress on the budget deficit, the dollar began a sustained decline in early 1985, but the already huge U.S. deficit on merchandise trade continued to climb.

Economists at first registered little surprise at the failure of the tamed dollar to produce an immediate reduction in the trade deficit. Even after 18 months of dollar decline with no sign of a turnaround, many remained confident that the lower exchange rate would eventually shrink the U.S. trade imbalance to manageable proportions. By late 1986, however, some analysts began to put forward theories of "hysteresis" in U.S. trade performance, arguing that the prolonged period of dollar overvaluation had caused U.S. markets to be lost permanently to new competitors.

Others noted that while the dollar had indeed fallen to near-record lows relative to the Japanese yen and the German mark, it had fallen very little or not at all relative to the currencies of Canada and some other important U.S. trading partners, such as the Asian newly-industrializing nations (NICs). Trade-weighted indexes of the dollar's value, usually based on historical rather than current trade shares, tended to overstate the dollar's actual decline.

But even if economists could afford to take the long view, Washington policy makers were understandably reluctant to risk their careers on the strength of arcane theories. Perhaps relief indeed lay just around the bend of the J-curve. Still, with elections only a few months away, the precise timing of the relevant lags became a matter of critical importance.

Given no assurance that the anticipated improvement in the trade numbers would arrive before the November 1986 elections, the U.S. House of Representatives sought to underscore concern about job losses in American manufacturing. In May, the House endorsed by an overwhelming majority an omnibus trade bill intended to whittle down large bilateral imbalances. House members called their bill "tough." President Reagan's assessment was "blatant protectionism" that risked retaliation from U.S. trading partners.

But the president's scorn for the omnibus trade bill and concerns about retaliatory action by no means signaled that the White House was abandoning the activist stance on trade issues championed by Treasury Secretary James Baker III. The administration's own 1986 initiatives on trade included new negotiated (coerced?) restraints on trade in steel, machine tools, and semiconductors. Administration officials also continued their highly visible seek-and-destroy missions aimed at allegedly unfair practices of U.S. trading partners, with increased emphasis on trade frictions with Europe.

Adopting rhetoric usually reserved for the Japanese, Secretary Baker claimed in April 1986 that U.S.–European Community disputes on agricultural trade posed "the biggest threat to the world's free trading system."[1] By fall, US-EC competition on agricultural export subsidies had escalated into a sectoral trade war. A draft agenda prepared by U.S. officials for the Uruguay Round of trade negotiations pushed for inclusion of the agricultural subsidies issue, a move sure to antagonize France.

The proliferation of specific get-tough trade measures was perhaps intended to mask the inability of policy makers to deal effectively with the more basic macroeconomic issues. The general proposition that fiscal and monetary policy can exert a powerful impact on trade, and the specific proposition that a reduced U.S. budget deficit was a necessary first step in restoring "normal" conditions in the international economy, had gained nearly universal acceptance, but further implications of this linkage for national policy in the United States and abroad remained a potent source of controversy.

If the dollar was clearly overvalued in early and even late 1985, by mid-1986 it had reached a range relative to the German mark and the Japanese yen where opinions could—and did—differ. In Europe and

Japan, the weaker dollar was already translating into trouble for producers of tradables and slower growth overall. The central question was no longer merely whether the United States could reverse a five-year trend of deterioration in its trade position, but whether this could be achieved without throwing the world economy into recession—thereby exporting rather than extinguishing Washington's protectionist fires.

While clearly delighted with the dollar's decline in value, U.S. officials stressed the importance of stimulative policies abroad as an alternative means to promote international adjustment. As the dollar sank to new lows, Secretary Baker appeared to threaten still further dollar declines in the absence of adequate stimulative policies by West Germany and Japan. Putting essentially the same view in a more positive way, Chairman Paul Volcker of the Federal Reserve Board told the House Ways and Means Committee that further declines in the dollar would not be necessary if Germany and Japan took steps to accelerate growth and absorb more of the world's imports. But Germany remained adamant in its resistance to the U.S. call for further cuts in interest rates, and the European central banks intervened to raise the value of the dollar from its five-year low relative to the German mark.

If the source of the problem had been correctly identified, why was it so hard for policy makers to agree on what ought to have been mutually beneficial steps to correct it? Of course, even beneficial policies create winners and losers and, thus, political and social obstacles to implementation. However, a more fundamental reason in this specific case was failure to reach consensus on the underlying mechanisms that link macroeconomic policies, exchange rates, and trade performance. The remainder of this paper provides an outline of the basic linkages and indicates how alternative views of these linkages gave rise to conflicting policy prescriptions, stalemate on macroeconomic adjustment, and escalating trade conflict.

13.3 How Macroeconomic Policy Affects Trade: A Generic Explanation

The fundamental link between domestic macroeconomic policy and the balance of payments arises from an accounting identity: the excess of domestic investment over national saving equals net foreign borrowing, the nation's deficit on the capital account. This basic identity indicates that macroeconomic policy can influence international payments through direct and indirect effects on production, saving, and investment (both financial investment and increases in productive capacity).

The nation's current account, comprised of the merchandise trade balance, the balance of trade on services (including net payments generated by past foreign lending and borrowing), and net unilateral transfers (including official development assistance and private remittances), is equal in size but opposite in sign to the capital account. The excess of national saving over domestic investment is therefore equal to the nation's current-account balance. An equivalent restatement in the traditional language of balance-of-payments theory is that the current-account balance is equal to the gap between the nation's current production and net absorption—the latter denoting all domestic spending for goods and services, including private consumption, domestic investment, and government.

While the basic identities apply to every nation under all conditions, the adjustment mechanisms that produce equality need not be the same across nations or for the same nation at different times. Thus, plans for spending in excess of production may be reconciled by means of a current-account deficit, higher domestic prices, higher domestic interest rates, or a combination of these.

By itself, the basic identity offers no information on the direction of causation. This can be determined only from behavioral relationships among the relevant variables. Still, the identity provides a useful check on the consistency of proposals to improve trade performance. Specifically, a policy can succeed in improving the nation's balance on current account only if it raises domestic saving relative to domestic investment, or, equivalently, increases national production of goods and services relative to national absorption. Many of the proposed remedies for the growing U.S. trade deficit fail this test; others pass, but only at the cost of reduced incentives for domestic capital formation and a lower rate of growth of productive capacity.

13.4 How Macroeconomic Policy Affects Trade: The U.S. Budget Deficit

To many observers, the emergence of unprecedented U.S. deficits on merchandise trade and the current account signaled the long-term decline of the nation's industrial competitiveness, an inevitable sequel to loss of U.S. leadership in science and technology. Others attributed the precipitous decline in U.S. trade performance to the effects of pervasive trade barriers abroad and insufficiently aggressive actions on the part of the United States in protecting its rightful access to markets. Both views spawned detailed programs intended to reverse the decline through such diverse measures as R & D subsidies, relaxed antitrust laws, improvements in education, tax reform, and reciprocity legislation aimed at prying open foreign markets. As elaborated elsewhere,

this approach largely ignores the balance-of-payments identities that constrain movements in the U.S. current account (McCulloch and Richardson 1986).

An alternative analysis portrayed the rapid growth of the U.S. trade deficit and the appreciation of the dollar as the predictable results of largely macroeconomic forces, especially growth in the U.S. federal deficit (Branson 1985). Under this interpretation, declining technological leadership and a less-than-level playing field may reduce U.S. national well-being and the gains from trade, but they are not the primary factors responsible for ever-increasing trade deficits.

Barely two years into the first Reagan term, the Council of Economic Advisers had linked growth of the trade deficit to large projected U.S. budget deficits. To the immense displeasure of Donald Regan, then secretary of the treasury, and other top administration officials, the 1983 *Economic Report of the President* announced that "the main sources of the U.S. trade deficit are to be found not in Paris or in Tokyo, but in Washington" (p. 67). . . . "The competitiveness of U.S. business as a whole—as opposed to that of particular sectors—and the balance of payments are macroeconomic phenomena" (p. 70). The Council's primary recommendation to restore U.S. international competitiveness: bring budget deficits under control. In numerous public appearances, Chairman Martin Feldstein reiterated the Council's analysis and policy prescription.

Initially ridiculed by Regan and other administration officials, the "Feldstein doctrine" that U.S. budget deficits were the primary force underlying dismal U.S. trade performance was soon widely and somewhat uncritically accepted by policy makers and economists. The basic insight was that the sharp increase in the U.S. budget deficit translated into a major reduction in the nation's total saving (private plus public). Although usually stated in terms of the U.S. budget deficit, the crucial element in the hypothesis was actually the implied rise in total demand for currently produced goods and services, i.e., the rise in government spending plus private spending—absorption—relative to domestic production.

If current or anticipated future taxes had reduced private spending enough to keep total absorption unchanged, or if national output had risen by the same amount as total spending, the larger budget deficits would have had no effect on the nation's international payments. Because in the U.S. case domestic absorption *did* rise relative to output, a deterioration in the current account was the inevitable outcome.

But acceptance of this explanation raised a host of new questions. The underlying logic was itself far from new.[2] Yet few would accept the general proposition that large increases in deficit spending tend to raise the international value of a nation's currency; based on the history

of many nations and many government spending sprees, the betting would surely go in the opposite direction. If U.S. fiscal policy was indeed the culprit behind the dollar's climb, there remained to be explained why the process of adjustment was so different in this case from what seemed to be the global norm.

13.5 Alternative Adjustment Mechanisms

To restate the fundamental identity in a slightly different form, national saving must equal domestic investment plus net foreign investment. If the U.S. economy were closed to foreign borrowing and lending, any rise in government spending would have to be met through reductions in other domestic spending—lower private consumption (increased private saving) and reduced domestic investment. To some extent, anticipation of future tax liability could boost current private saving. The remaining necessary adjustment would be brought about by increased prices of goods and services, increased interest rates, or a combination of the two.

With no foreign borrowing or lending and the tight monetary policy the United States actually adopted during the early 1980s, a rise in interest rates would have been the main mechanism for adjustment. In fact, early opponents of the increased budget deficits predicted precisely this outcome. A rise in interest rates would reduce private investment—the conventional "crowding-out" effect of government expenditures.[3] It would also hold down interest-sensitive consumption expenditures as well as bond-financed state and local government expenditures. Through these responses, the higher interest rates would reduce total absorption of goods and services to restore equality with production.

For an economy open to capital market transactions, borrowing from abroad becomes an additional avenue of reconciliation. Depending on the elasticity of supply of foreign funds to domestic capital markets, the adjustment could rely more on capital inflows and less on a rise in domestic interest rates. Any crowding-out of investment would thus be spread over a number of countries, as the increased demand for funds pulled up interest rates abroad along with those at home.[4]

The resulting surplus on capital account must be matched by an equal deficit on current account. Higher total spending by itself means higher demand for tradable goods, reducing the trade balance. Further adjustments may be produced by means of changes in the relative prices of domestic and foreign goods. Higher demand at home tends to push domestic prices upward. But if, as in the U.S. case, the fiscal stimulus is accompanied by tight money, most of the burden for raising domestic relative to foreign prices rests on the exchange rate. Currency appre-

ciation shifts demand toward foreign goods and services, thus producing the current-account deficit needed to match the surplus on capital account.[5]

13.6 U.S. Capital Inflows: Demand and Supply

A rise in planned spending relative to production can be viewed as an outward shift in the nation's net demand for foreign borrowing. As with any demand shift, the outcome depends critically on conditions of supply, in this instance the foreign supply of loanable funds to the nation.[6] The typical effect of a large increase in government spending (however financed) is to shift the relevant supply curve *inward*. In part this occurs because potential lenders revise upward their estimates of the nation's future rate of inflation. This in turn reduces the expected real return associated with any given nominal interest rate. If the higher spending is viewed as unsustainable in the longer run, another concern is possible recessionary consequences of future budget cuts. And many investors doubt that big government and high taxes favor sustained growth.

The case of the United States was unusual because the rise in spending was accompanied by an *outward* shift in the supply of foreign funds. For reasons both related and unrelated to U.S. macroeconomic policies, the United States became a relatively more attractive borrower at the very time that the nation's demand for foreign capital expanded.[7] Financial and industrial deregulation, enhanced fiscal incentives for capital formation, and a credible commitment to reducing the rate of inflation were positive factors directly linked to post-1980 economic policies in the United States. Actual and anticipated increases in U.S. trade barriers provided incentives for inward direct foreign investments. This was true particularly for Japanese firms; Japanese exports were the overwhelming target of U.S. selective protection. During the same period, the United States also repealed the withholding tax on earnings from U.S. assets held by foreigners.

Abroad, the Japanese liberalized restrictions on capital outflows. Although this liberalization was part of a longer-term policy trend in Japan, the United States instigated an acceleration of its pace, as one element of the dollar-yen accord engineered by Treasury Secretary Regan in 1984. Capital flight and debt crises of the developing nations and "Eurosclerosis" were further supply factors contributing to the vast flow of funds into U.S. capital markets.[8] And once in motion, the process was reinforced by expected capital gains from the rise in the dollar that was needed to pull the current-account deficit into equality with the burgeoning capital-account surplus.[9]

The sharp increase in U.S. capital inflows reflected both one-time adjustments of international portfolios and ongoing effects on the placement of new additions to those portfolios. Thus, even without a reduction in the U.S. government deficit, the implied rate of capital inflows and the associated value of the dollar would have been expected to fall over time once stock adjustments to new conditions were complete. Moreover, increased foreign holdings of U.S. assets would gradually raise the debt-service component of the current-account deficit, putting downward pressure on the deficit on merchandise trade (and the value of the dollar required to produce it) even with the capital-account surplus unchanged.[10]

If U.S. capital inflows in the early 1980s reflected important supply effects as well as the increased demand associated with the U.S. federal budget deficits, one implication is that in qualitative terms events in the international economy might have looked much the same even without the large increase in the budget deficit.[11] In particular, the dollar appreciation and declining U.S. international competitiveness could have been produced, albeit less dramatically, without the budget deficits that have taken most of the blame. A further implication is that a balanced U.S. budget, whatever its other political or economic virtues, ensures neither balanced U.S. trade nor an "appropriate" exchange rate for the dollar.

13.7 The Impact Abroad of U.S. Policy

By 1983, European and Japanese leaders were persistently urging the United States to correct its trade position by bringing down the budget deficit, sometimes to the extent of making U.S. deficit reduction a precondition for their participation in negotiations on economic issues of common concern. On occasion, foreign officials referred sneeringly to the "American disease" of deficit-financed growth in government spending. While it is self-evident why U.S. policies generated vocal opposition at home, the roots of foreign criticism were more complex. After all, the record $150 billion U.S. trade deficit for 1985 translated into record surpluses abroad.

Although the implications for any specific nation of the dollar's rise (and subsequent decline) and of a growing U.S. trade imbalance were shaped by that nation's own distinctive economic and political conditions, the overall effects abroad can be summarized in terms of four important types of spillovers. Of these, two were the direct contemporaneous effects of U.S. expansion and the strong dollar, while the remaining two reflected the perceived unsustainability in the long term of ever-increasing U.S. current-account deficits.

The first direct effect was the obvious positive impact on domestic demand via trade with the United States. Japan accounted for the lion's share of the 1985 U.S. global deficit on merchandise trade, $49.7 billion or about 30 percent of the total. But relative to gross national product, Canada's bilateral surplus with the United States of $22.2 billion was even larger. These figures are not surprising, given that Canada and Japan are the most important trading partners of the United States. For the European Community as a whole, the bilateral trade surplus in 1985 was $22.5 billion, slightly larger than Canada's, with Germany accounting for about one-third of the total. Other countries with sizable 1985 bilateral surpluses included Taiwan (about 9 percent), Mexico (5 percent), Brazil (5 percent), Hong Kong (5 percent), Korea (3 percent), and Italy (3 percent).

However, whether the large trade surpluses with the United States provided a welcome stimulus for exporting nations or merely complicated an already difficult task of macroeconomic management depended critically on underlying conditions in the affected countries. Specifically, for countries where high unemployment resulted from structural factors that raise the natural rate rather than from insufficient aggregate demand, increased demand would expand employment only temporarily, and at the cost of increased inflation.

Moreover, exchange-rate movements also have a direct impact on domestic price levels. While the rise of the dollar's value enhanced the effectiveness of anti-inflationary policies in the United States, the fall in the value of foreign currencies translated into unwelcome inflationary pressures abroad. In response to concerns about inflation, Germany and France may have adopted fiscal and monetary policies more contractionary than would otherwise have been chosen.[12]

The second direct effect stemmed from the other side of improved trade balance—matching capital outflows and associated upward pressure on interest rates. With sluggish growth and high unemployment already major problems throughout Europe, the higher interest rates held down demand in interest-sensitive sectors such as construction and discouraged domestic investment. The latter further darkened the region's prospects for expansion of productive capacity. In contrast, Japan found itself in nearly the best of all possible worlds, since a shift from domestic "capital-deepening" to increased investment abroad had become a matter of national policy.

Thus, the net direct effect of U.S. macroeconomic policies must be seen as the sum of two opposing components, increased demand for tradables and higher interest rates. Whether this added up to a net stimulus depended on the particular situation of each country, but, perhaps more important, it is a pattern that necessarily produced do-

mestic losers as well as winners. Even if the net effect in a given country were positive, major sectors would be adversely affected; any induced moves toward more restrictive macroeconomic policies would expand the set of domestic interest groups adversely affected by U.S. policies.

13.8 Unsustainability: What Goes Up Must Come Down

While the U.S. external imbalance created real problems of macroeconomic management for Europe and perhaps also for some developing nations, part of the uneasiness abroad reflected not current but anticipated future impacts. The unsustainable size and rate of growth of the U.S. external imbalance inevitably raised questions about how the imbalance would eventually be corrected. Here the two most important concerns were induced protectionism in the United States and a possible "hard landing" for the U.S. dollar.

The prolonged period of dollar appreciation unquestionably eroded already thin commitment in the U.S. Congress to liberal trade policies, even in the context of steadily declining unemployment and considerable net job creation. Indeed, the nation's gigantic external imbalance by itself became a politically potent argument in favor of a more aggressive U.S. stance on trade, while the pressure of foreign competition on U.S. manufacturing compounded the national debate about "deindustrialization" of the American economy. Thus, major beneficiaries abroad of the U.S. trade imbalance faced the threat of abrupt losses of export markets through induced U.S. moves toward protectionism.

The fears associated with a hard landing were perhaps overblown. Despite the rapid descent of the dollar from its record heights of early 1985, investors abroad continued to acquire U.S. securities in record amounts. With the dollar no longer clearly overvalued, dollar-denominated bonds may have actually increased in relative attractiveness, and through late 1986, the Japanese continued to purchase large volumes of U.S. assets.[13]

But if the dollar's fall had failed to reverse the growth of U.S. capital inflows, there was ample evidence of its impact on European and Japanese exporters. To some extent, the higher value of their currencies simply translated into higher dollar prices and reduced export volumes. However, because market-expansion opportunities based mainly on the strong dollar had been perceived as temporary, some exporters had chosen to take part of the earlier appreciation of the dollar in the form of higher profits instead of further increases in market share achieved through still-lower dollar prices. Reversing the process, U.S. prices of such imports moved much less than the decline in the dollar's value, squeezing export profits more than export volume. Negative effects

on exporters' sales and profits were important enough to trigger currency intervention by the Bundesbank and the Bank of Japan. The Japanese also devised a new credit program to cushion the blow to smaller exporting firms.

Further trade impacts from the dollar's fall reflected associated movements in other relative currency values. The Canadian dollar actually fell relative to the U.S. dollar, while a number of newly-industrializing nations including Taiwan and Korea kept their currencies roughly in line with the new, lower value of the U.S. dollar. Even within the European Monetary System, the Italian lira and the French franc both moved downward. Thus, German and Japanese exporters lost markets not only to U.S. producers, but also to competitors in a number of other nations.

Another complicating factor was the sharp fall in (dollar) oil prices that began in 1985.[14] Throughout the industrialized world, lower oil prices were expected to provide a significant macroeconomic stimulus, notwithstanding depressed conditions in domestic energy sectors. Moreover, the fall in oil prices was expected to further dampen chronic fears of inflation in Germany and thereby increase German willingness to pursue stimulative policies. In the United States, where the fall in the dollar and rapid monetary growth might have revived inflation, increases in wholesale prices remained small. The decline in oil prices thus produced needed breathing space in the U.S. adjustment to a lower international value of the dollar.[15] But lower oil prices put additional pressure on nations such as Mexico, where a revival of U.S. exports depended critically on resolution of debt issues.

13.9 What Comes Next

The meeting of the Group of Five in September 1985 at the Plaza Hotel in New York was seen by many as a watershed for U.S. policy toward the international economy. A year later, economic prospects for the United States and the global economy were much altered, yet the same basic questions remained unanswered—and in some cases even unasked.

U.S. policy had moved in an appropriate direction, but only at a glacial pace. Moreover, while policy makers were agreed on the need to cut the budget deficit, the underlying reasons for the need remained poorly understood. The U.S. current-account deficit can fall only if U.S. absorption falls relative to production. Will a tax increase ensure this outcome? And what about U.S. monetary policy? Some feared inflationary pressures associated with the dollar's decline, especially after the full effect of lower oil prices was dissipated. But given fiscal tightening and a marked slowdown in some industrial sectors, others

emphasized the need for monetary stimulus to keep the economy growing.

The best policy course for the United States depended, as always, on what was happening abroad. U.S. policy makers had long recognized that expansion in Europe and Japan could ease the adjustment process at home. However, the responses to U.S. suggestions had, by September 1986, been largely disappointing. The U.S. external imbalance continued to be viewed abroad as fundamentally a U.S. problem, its correction fundamentally a U.S. responsibility. Foreign attitudes were reinforced by the apparent inability of the United States to carry out its own role in the macroeconomic plan laid out at the Plaza Hotel meeting, reducing the federal budget deficit.

With economic and political problems of their own to contend with, foreign leaders were reluctant to give high priority to what were perceived to be U.S. needs. But the U.S. capital-account surpluses were effects of foreign supply as well as U.S. demand. A return to a more normal pattern of international transactions, presumably with the United States again a net supplier of capital internationally, could not be achieved without significant policy alterations on the part of all major industrial nations.

13.10 U.S. Initiatives

As the November 1986 elections approached, the big question in Washington remained how to bring the federal budget deficit under control. Unfortunately, this was not exactly the central issue, at least with respect to improving U.S. trade performance. The right question was how to raise production relative to absorption or, equivalently, how to raise saving relative to domestic investment. The answer was far from obvious because spending cuts and tax increases have both direct and indirect effects on the relevant totals.

While the details are complex, the principles are simple. Cuts in federal spending are likely to trigger offsetting increases in government programs at the state or local level as well as in private spending. Tax increases typically alter private economic incentives for saving and investment in the short run and influence the growth of national output in the longer run. In brief, moving toward a balanced federal budget need not reduce the gap between production and absorption and, thus, need not have the desired effect of cutting U.S. capital inflows and the associated current-account deficit.[16]

The uncertainty associated with outcomes suggested putting the emphasis on spending cuts rather than higher tax revenues. Even though some cuts would simply shift the locus of decision making and spending to state or city units or to the private sector, this at least would force

a reassessment (to some observers, much overdue) of how much government should do, and at what cost. But spending cuts were unlikely to come prior to the 1986 election.

A second question concerned appropriate monetary policy. Once greater fiscal restraint was achieved, should easy money take up the slack? Although Reagan administration supply-siders clearly favored a less-restrictive U.S. monetary policy, Federal Reserve Board Chairman Paul Volcker urged a relatively conservative course. Volcker, who presided over the successful U.S. fight to bring inflation down, repeatedly stressed the potential inflationary impact of the falling dollar.

Since the one clear message of recent monetary history is that it is far easier to start an inflation than to end one, Chairman Volcker's conservatism regarding monetary growth may have been well founded. Rapid financial innovation has in any case further obscured the links between the money supply (however defined) and the economy, so that it is harder than ever to determine when the Fed oversteps the boundary between "not enough" and "too much." Given the nation's highly developed networks of financial intermediation, ensuring predictable growth of an aggregate the Fed can actually control may be more productive than attempts at monetary fine-tuning.

13.11 Expansion Abroad

By late 1986, U.S. officials had become increasingly frustrated by the cautious approach of their West German and Japanese counterparts toward adopting more expansionary fiscal and monetary policies. Through their direct effects on demand, such policies could reduce the required role of exchange-rate movements in restoring acceptable U.S. trade performance—a link stressed repeatedly by Secretary Baker.[17] U.S. officials also emphasized the potential for mutual gains. In Europe, unemployment continued at or near double-digit rates. In Japan, the unemployment figures remained low, but so (to Western eyes) was the living standard, given the nation's current wealth.

As already noted, the issue in Europe hinged crucially on the underlying causes of unemployment, and the potential for reigniting inflation. Even prior to the favorable impacts of currency appreciation and lower oil prices that began in 1985, Tobin (1984) saw the inflationary threat as remote. By 1986, with prices actually moving downward and the loss of markets due to currency realignments depressing industrial output, the case for fiscal or monetary stimulation was presumably even stronger. But others stressed institutional factors that have raised the natural rate of unemployment in Europe.[18]

Leaving aside continuing controversy with regard to the factual validity of the underlying hypothesis, a higher natural unemployment rate does not in any case mean that policy is impotent. If anything, there

may be a *larger* potential role for policy than in the case of simple inadequate demand, as action is also required to restore appropriate incentives at the microeconomic level. While by 1986 the harmful effects of direct labor-market policies including minimum wages, payroll taxes, and various types of worker protection were already widely appreciated by European policymakers, the equally important task of restoring incentives for investment and especially entrepreneurial activity had only begun to receive attention (see Sachs and Wyplosz 1986 and the following discussion). But the required microeconomic policy improvements could not be implemented with the same speed as the interest-rate cuts favored by Secretary Baker, and, perhaps more important, the mere fact that a European supply-side revolution would facilitate U.S. adjustment did not have much bearing on its domestic political appeal in West Germany or France.

In the case of Japan, the central issue was not unemployment but a production structure oriented toward export growth. Japanese current-account surpluses and corresponding capital exports reflect high national savings not completely absorbed by domestic capital formation—the reverse situation to that of the United States. Increased incentives for consumption or for domestic investment could therefore alter the "structural" tendency toward trade surpluses and thereby facilitate U.S. adjustment. Although concrete proposals have tended to bog down in fruitless discussions of real and imagined import barriers and of unique cultural factors, modest alterations in tax-based incentives could redirect some Japanese production toward satisfying domestic needs, particularly but not exclusively in the area of housing.

13.12 A Role for Policy Coordination

The idea that a system of flexible exchange rates would provide insulation from policy mistakes abroad has clearly failed the test of experience. While the current monetary system (or nonsystem) imposes no constraints at all on the macroeconomic policies of member nations, there has been increasing support for the view that international policy coordination could achieve important mutual gains.

The meeting of the Group of Five (G-5)[19] in September 1985 following several months of secret negotiations marked the shift in the Reagan administration's official position from a go-it-alone posture of (mostly) benign neglect of the international economy. Engineered by Treasury Secretary Baker, the G-5 agreement was the centerpiece of the administration's new stance on trade problems and placed considerable emphasis on the potential role of international policy coordination.[20]

Exactly what the G-5 actually accomplished remains hazy. The most immediate and tangible component of the September 1985 agreement was coordinated intervention in foreign-exchange markets. However,

the agreement to intervene followed a six-month period of gradual decline in the market-determined value of the dollar from the peaks reached in early 1985, and the path of the dollar's subsequent descent showed no evidence that intervention affected the process in an important way. Likewise, the subsequent coordinated reductions in official discount rates followed rather than led movements in financial markets.

Of potentially greater long-term importance was the commitment to enhanced consistency in macroeconomic policy making. Predictably, concrete steps in this area were slow in coming. The participants in the Plaza Hotel meeting promised changes in basic macroeconomic policy (budget cuts for the United States, expansion abroad) that, a year later, had failed to materialize. Indeed, it was probably unrealistic to expect considerations of impact abroad to outweigh political concerns at home. But the explicit recognition that "domestic" policies can have significant international implications was itself a step forward, even if a modest one.

13.13 Conclusions

This paper provides an analytic framework for considering the impacts of macroeconomic policies at home and abroad on patterns of international trade and investment. The most important theme is that aggregate trade performance, as measured by the current account or the merchandise trade balance, is determined by national saving and domestic investment, or, equivalently, production and domestic absorption. Accordingly, policies aimed at trade performance can achieve their goals only if they move these aggregates in the right direction. Likewise, changes in macroeconomic policies can produce unintended effects on trade and thereby add to protectionist pressures, as in the recent experience of the United States.

With respect to the current U.S. external imbalance, efforts to reduce the U.S. federal deficit can help, but only if they succeed in reducing domestic absorption relative to production. Moving toward a balanced budget will not necessarily have this effect. As has been widely recognized, stimulative policies abroad might also facilitate the adjustment. In terms of the analysis presented here, such policies work only if they raise absorption abroad relative to production and thereby redirect capital flows away from U.S. markets.

It is perhaps worth emphasizing that this paper is mainly about the impact of macroeconomic policies on the current account and has relatively less to say about exchange-rate movements. Although the analysis links the rise in the value of the dollar to U.S. capital inflows, it is agnostic on the generic issue of exchange-rate determinants, especially in the short run.

Notes

1. The administration may have recognized, somewhat belatedly, that further trade concessions from Japan were unlikely before the elections there. On the policy roots of U.S.-European trade frictions in agriculture, see Hayes and Schmitz (1986).

2. In the classic Mundell-Fleming analysis, a bond-financed increase in government spending pulls in capital from abroad but has an ambiguous effect on the exchange rate. The direction of the induced exchange-rate movement depends on the IS-LM parameters, the degree of international capital mobility, and the relative size of the country. For a recent treatment, see Corden (1986).

3. The crowding-out of investment is the consequence of competing demands for current production rather than the mode of financing of government expenditure. The usual claim that deficit-financed government spending crowds out investment while tax-financed spending does not rests on the assumption that the taxes produce a larger fall in consumption than an equal volume of government borrowing. The issue hinges on the extent that anticipation of future tax liabilities affects intertemporal optimization of consumption by taxpayers. The same point arises below in assessing the effects of increased taxes on the trade balance.

4. Treasury Secretary Regan countered claims that the federal budget deficit was responsible for high real interest rates by noting that interest rates abroad were just as high as in the United States. But in an integrated international capital market, U.S. federal deficits would raise rates globally, with international differences remaining small. Hooper (1985) has reported mixed evidence on the actual linkage of foreign interest rates to U.S. rates for the period from 1981 to 1984. According to Hooper, Canadian rates were closely tied to U.S. rates, while movements of Japanese and U.K. rates were opposite to those of U.S. rates for much of the period. The behavior of German rates fell between these extremes.

5. The mechanism described here is a variant of the familiar "transfer problem" analysis in the balance-of-payments literature. The extent of foreign lending is the transfer to be effected. Induced spending on foreign goods could in principle "over-effect" the transfer, so that currency depreciation rather than appreciation would be required to restore equilibrium. In light of the apparent unresponsiveness of the U.S. trade position to movements in exchange rates, it is worth underscoring the role of expenditure effects. Dollar depreciation without reversal of capital inflows can eliminate "switching" effects on trade flows but does nothing to alter expenditure effects. The latter would include loss of U.S. export markets in debt-ridden developing nations.

6. In this discussion I largely ignore the diversity of international asset transactions summarized by the sharp reversal of the U.S. capital account. In fact, U.S. "borrowing" from abroad included increases in every category of capital inflow, from investments in "real" assets such as land and buildings through establishment of foreign subsidiaries and joint ventures, and portfolio investments in equities, corporate bonds, and short- and long-term government securities. Also included were substantial reductions in the foreign loans of U.S. financial institutions, particularly to Latin America.

7. An interesting comparison is with the process by which petrodollars were recycled during the 1970s. In that case supply and demand also expanded simultaneously. But both the borrowers and the lenders of petrodollars were reacting to the same exogenous shock, higher oil prices. In the petrodollar case, the increase in supply was predictable, while the large increase in demand

for the funds materialized in a fashion not initially anticipated by analysts. For the case of the United States in the 1980s, the increase in demand has been emphasized but supply factors abroad largely ignored.

8. Some might argue that the relative unattractiveness of investing in Europe or the developing nations was also influenced by U.S. macroeconomic policies. As discussed below, Feldstein (1986) believes that U.S. deficits induced European economies to adopt more restrictive monetary and fiscal policies than they would have otherwise chosen. Likewise, Cline (1985) attributes some of the debt problems of developing nations to the high interest rates produced by U.S. deficits and the increased U.S. protectionism that accompanied the deterioration of the U.S. trade position.

9. See McCulloch and Richardson (1986) for a more complete analysis of the factors determining relative returns on investments across countries.

10. See Krugman (1985). In practice, these effects were offset in part by the downward trend in nominal interest rates worldwide and the effect of the dollar's decline on timing of profit repatriation by U.S.-based multinationals.

11. To make the point that the capital inflows reflected both supply and demand factors, I have overstated the extent to which the two categories can be separated neatly. Some aspects of Reagan administration policies had important direct effects on both, as in the case of lower taxes on income from many types of investments.

12. For example, see Feldstein (1986), who argues that the second oil shock of 1979 had rekindled inflation in Europe just as the dollar began its rapid rise. Japan also cut its budget deficit during the same period, but domestic politics rather than imported inflation provided the apparent motive in the Japanese case.

13. An interesting question is how foreign investors fared after February 1985 with their portfolios of U.S. assets. A large portion of these were long-term government securities denominated in dollars. The fall in the dollar of course pulled down the foreign-currency value of the principal. But the large accompanying fall in long-term interest rates generated dollar capital gains on those same issues. Dollar prices of most U.S. equities likewise appreciated by more than enough to offset the change in currency values. Some U.S. corporate bond issues were denominated in foreign currencies rather than dollars; for these, the fall in interest rates produced an unambiguous capital gain. Still other foreign holdings were "real" assets, claims on dollar-denominated streams of future profits in a variety of U.S. sectors. For these, the effects on rates of return are more complicated, but it is reasonable to assume such investments were desired at least partly to enhance international diversification of asset holdings.

14. Prices of most other primary commodities also fell far below their peaks of the mid-1970s. Although none are as important to the global economy as oil, this was an additional source of downward pressure on export earnings of some less-developed debtor nations.

15. By itself, a lower value of the dollar would typically mean a short-term worsening of the nation's terms of trade. That effect on current real incomes in the United States was also moderated by the concurrent reduction in the price of oil, thus minimizing political fallout from the dollar's descent.

16. On the international effects of tax increases, see Aschauer (1986) and Summers (1985).

17. However, just as with fiscal remedies in the United States, expansionary policy abroad could, but would not necessarily, operate to increase absorption

relative to production and thus provide the desired effect on current-account balances.

18. The traditional and somewhat discredited notion of a natural rate of unemployment, below which there exists an employment-inflation tradeoff, has reemerged in updated form as the non-accelerating-inflation-rate of unemployment, or NAIRU (Sachs 1986; Sachs and Wyplosz 1986). The fundamental concept remains the same, i.e., the limits on the usefulness of demand management in maintaining full employment.

19. Charter members of the group were the United States, West Germany, Japan, the United Kingdom, and France. The group was expanded in May 1986 from G-5 to G-7 with the addition of Italy and Canada. It is ironic that Canada, the most important trading partner of the United States and the nation with the second largest bilateral surplus on trade with the United States in 1985, was excluded from the original group.

20. Given Secretary Baker's renown as a political analyst and his slender credentials as an economic analyst, the call for international coordination might be viewed by a cynic as the administration's attempt to spread the blame for U.S. trade problems. Baker's subsequent efforts to push the dollar down without tackling directly the causes of massive capital inflows suggest an incomplete understanding of U.S. trade problems. Unlike efforts to manipulate exchange rates, the "Baker Plan" to relieve debt problems of developing nations would attack a basic cause of the U.S. trade deficit.

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