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U.S. BUDGET DEFICITS AND
THE EUROPEAN ECONOMIES:
RESOLVING THE POLITICAL
ECONOMY PUZZLE

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ABSTRACT

This paper, prepared for the annual meetings of the American Economic Association, discusses how the increases in the U.S. budget deficits since 1980 have affected the economies of Western Europe. The analysis emphasizes that U.S. deficits have not only affected these economies directly but have also induced them to adopt more restrictive monetary and fiscal policies than they would otherwise have chosen. This induced shift in domestic policies is the primary reason why European governments have pressed for a reduction in the U.S. budget deficits despite the favorable impact of those deficits on European trade surpluses.

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The experience of the past five years has dramatically underscored the international consequences of U.S. fiscal policy. The massive current and projected budget deficits were the primary cause of the sharp 60-plus percent rise in the real trade-weighted value of the dollar between 1980 and the end of 1984. The dollar's rise was in turn the major reason that the U.S. current account shifted from a surplus in 1981 to an unprecedented deficit that currently exceeds 3 percent of GNP.¹

During the past four years, the exploding trade deficit has generated calls in the United States to adopt protectionist policies and to abandon our basic system of floating exchange rates. At the same time, European policy officials have been unanimous in calling upon the United States to reduce its budget deficit and to cooperate in intervention to lower the dollar's value.

The anguished cries from American exporters and from American firms and employees that compete with imports from abroad are easy to understand. But why have European officials been critical of our fiscal policy and eager to see the dollar decline? Hasn't the U.S. trade deficit meant a substantial

*Professor of Economics, Harvard University and President of the National Bureau of Economic Research. This paper will be presented at the annual meetings of the American Economic Association on December 29, 1985 in the session on The International Dimensions of Fiscal Policies. I am grateful to Rudiger Dornbusch, Jeffrey Frankel, Paul Krugman and Jeffrey Sachs for conversations on this subject over the past several years in both Washington and Cambridge. A more complete discussion of the impact of U.S. deficits on German unemployment will appear in Feldstein and Bacchetta (1986). Earlier comments along these lines were published in Feldstein (1985).

¹For a discussion of the links between the budget deficit, the dollar and the trade deficit, see Chapter 3 of the 1983 and 1984 editions of the Economic Report of the President.

improvement in the European trade balances? And shouldn't that have been the mechanism by which the U.S. "locomotive" (to use a currently unpopular phrase) pulled the European economies out of their recession? The European complaints about U.S. fiscal policy and about the resulting strong dollar are a political economy puzzle that deserves to be addressed.

There is no doubt that the European trade balances have improved. For the European Economic Community (EEC) as a whole, the trade balance with the rest of the world improved by more than \$50 billion between 1980 and 1984. Exports rose sharply. French and German exports both increased about 17 percent between 1980 and 1984 and have continued to expand rapidly in 1985. Nevertheless, during the past four years, growth in the European community languished at an average annual rate of less than one percent and the unemployment rate has doubled.

It is of course possible that the rise in European unemployment and the slow growth in Europe would have been even worse without the strong U.S. dollar and our resulting trade deficit. If so, the vociferous complaints of European officials are simply the normal behaviour of politicians seeking to shift the blame for domestic policy failures to a convenient scapegoat. But I think that there is a more serious and legitimate reason why the Europeans have been critical of our fiscal policy.

In considering the impact of recent U.S. fiscal policy on the European economies, it is important to bear three things in mind. First, budget policy is only one aspect of the change in U.S. economic policy that has occurred since 1980. The increased budget deficits were accompanied by a monetary policy that caused U.S. inflation to decline from 9 percent in 1980 and 1981 to 4 percent in each year since 1982. Thus a sound monetary policy and the

expectation that such a policy would persist prevented the massive budget deficits from leading to concurrent inflation or to a widespread expectation of future inflation.² In addition, business tax rules were changed in 1981 in a way that reinforced the effect of the budget deficits on real interest rates.³

Second, U.S. policies affect the European economies not only directly through trade and financial markets but also by inducing changes in the policies of European governments. These induced policy changes have been particularly important in the past few years and go a long way toward explaining why European officials believe that their countries have been hurt by U.S. fiscal policies despite the favorable effects on European exports.

Third, although it is possible to generalize considerably about the impact of U.S. policy on the European economies, it is also important to recognize that the situation differs among the major countries. I will focus my comments on the situation in Germany, not only because Germany is the largest of the European nations, with nearly 30 percent of the EEC's total GDP, but because it is also the dominant nation in the European Monetary System and the primary trading partner of the other European nations. The impact of the U.S. deficits on the German economy and particularly on German economic policy therefore had profound effects elsewhere in Europe.

²This gives a bit too much credit to monetary policy for the decline in U.S. inflation. The interaction of monetary and budget policy, by raising the exchange value of the dollar, was an important cause of reduced inflation. See Sachs (1985).

³See Feldstein (1976, 1980) for an early discussion of the likely impact of such tax reform on real interest rates and Feldstein (1986) for evidence that the enlarged budget deficits had a much bigger impact on interest rates than the change in tax rules.

I. The Direct Impact of U.S. Fiscal Policy

The strong U.S. economic recovery and the surge in the U.S. dollar undoubtedly contributed to a significant rise in European exports to the United States. Since 1980, U.S. imports from Western Europe increased more than 50 percent while the value of our exports to those countries has actually declined. But the importance of this to Europe should not be exaggerated. The U.S. represents less than 10 percent of the imports and exports of the EEC countries; even when intra-EEC trade is eliminated, the U.S. is only one-sixth of EEC trade. In fact, the total volume of exports of the EEC rose only 14 percent between 1980 and 1984, about one-third less than the increase in the two previous four-year periods.

The sharp rise in the dollar relative to the European currencies also had two unfavorable direct effects. It caused a decline in the terms of trade with the United States (and with other countries whose currencies followed the dollar more closely than the ECU) and it put upward pressure on domestic inflation in Europe. The German mark fell 45 percent in real terms relative to the dollar between 1980 and the end of 1984, implying that German exports to the U.S. bought 45 percent less in U.S. goods in 1984 than they did in 1980. Since U.S. trade represents 8 percent of Germany's GDP, this corresponds to a real income fall of about 3 percent.

The impact of the dollar's rise on European inflation is more difficult to judge because of the induced policy response to which I will turn in a moment. But a simple mechanical pass-through of the increased import costs associated with the 70 percent nominal rise in the dollar-DM ratio between 1980 and the end of 1984 would imply a 6 percent increase in the German price

level or about one-third of the actual price rise over that 4 year period. This cost pass-through calculation is very crude. It understates the inflationary effect to the extent that it ignores imports priced in dollars that do not come from the United States and because it ignores the impact of rising import prices on domestic prices and wages.

The increase in U.S. real long-term interest rates raised not only the value of the dollar but also the level of real long-term interest rates in Europe. This increase in interest rates reflected in part the policy response of the Bundesbank and other central banks that I will discuss in a moment. But even with no change in European economic policy, the behavior of private investors would have caused the real long-term interest rates on DM and other long-term bonds to move in the same direction as the real interest rate on dollar bonds. The rise in the real long-term interest rate in Germany reduced spending on construction and on investment in plant and equipment, industries in which the decline in activity and increase in unemployment have been particularly severe.

This impact of U.S. long-term rates on European investment can also be expressed in terms of the shift in the capital flow with the rest of the world. Germany, which was importing capital to finance a current account deficit in 1980, had a current account surplus in 1984 equal to more than 5 percent of gross fixed investment. For 1985, the current account surplus and associated capital outflow is expected to reach more than 10 percent of gross fixed investment. Europeans complain that this not only represents a fall in activity in the investment sector but also, by keeping the capital stock smaller than it would otherwise have been, retards the growth of productivity

and therefore exacerbates the classical unemployment problem caused by wage demands in excess of full-employment productivity.

It is difficult to be confident about the net impact on employment and output of the several direct effects of the U.S. fiscal deficits. The positive impact of the expanded exports may, but need not, exceed the adverse effects of the higher real interest rates and capital outflow. But these direct effects are only part of the total impact of U.S. fiscal policy. The large and persistent U.S. budget deficits also caused the European countries to alter their monetary and budget policies in a contractionary way. To understand the impact of U.S. deficits on European economic activity, it is important to examine the nature of these induced changes in economic policy.

II. The Induced Policy Response

Inflation was a principal problem on the minds of policy officials everywhere in Europe as the 1980s began. The rise in the inflation rate after the 1973 oil shock had just been slowly but painfully reversed when the 1979 oil shock restarted the inflation process. Inflation in the EEC as a whole rose from 6.9 percent for 1978 to 12.4 percent for 1980. The Germans saw inflation rise from 2.6 percent for 1978 to 5.3 percent for 1980. The German government was determined to reverse this inflation, even if it meant temporarily slower growth and increased unemployment.

The sharp rise in the dollar that began in 1980 brought with it an additional inflationary impulse: a 20 percent decline in the mark between 1980 and 1981. To limit the future decline in the mark, the Bundesbank slowed the growth of money and raised short-term interest rates. The German money supply

actually declined between 1980 and 1981. The mark nevertheless continued to fall. To offset the resulting inflationary pressure, the Bundesbank appears to have continued to manage monetary policy in a way that maintained greater slack in the German economy than they would otherwise have preferred. Money supply growth from 1980 to 1983 was approximately half of what it had been in the three preceding three-year periods and real GNP grew at an average annual rate of less than one percent. This contraction of German monetary policy in reaction to the rise of the dollar caused by U.S. budget deficits was an important source of continued high unemployment in Germany and elsewhere in Europe.

All of this can be restated more formally as follows: the decline in the mark that resulted from the rising U.S. budget deficits was a negative supply shock to the German economy that shifted its short-run Phillips curve to the right. The Bundesbank pursued a tight money policy aimed at limiting this shift and, to the extent that the shift could not be prevented, at moving along the Phillips curve to achieve lower inflation than would otherwise occur but at the cost of higher unemployment.

The enlarged U.S. budget deficits also appear to have caused German fiscal policy to become more contractionary. This occurred for several reasons. When the combination of high German interest rates and a slack economy automatically enlarged the budget deficit, the German government sought to counter this by cutting spending and allowing tax receipts to rise as a share of income. It was also argued that shrinking the German budget deficit would reduce inflationary pressure in Germany, would lower real interest rates (including those paid by the government), and would free up

funds to offset the capital outflow.

These remarks are not meant as either praise or criticism of German monetary and fiscal policy since 1980. I want only to indicate how the enlarged U.S. budget deficits, by raising real U.S. interest rates and thereby reducing European currency values, induced the German government to adopt contractionary monetary and fiscal policies. Because of Germany's dominant position in the European Monetary System, the other countries of Europe had to follow Germany's tight money policy.⁴ Moreover, because half of European trade is within the EEC and Germany is the largest EEC market for each of the other member countries, the slowdown in German economic activity was immediately transferred throughout Europe.

III. The Falling Dollar

The fall of the dollar that began in March 1985 opened new opportunities for Germany and the other European countries. The dollar fell from 3.4 marks at its peak to 2.8 marks in September (before the G-5 announcement on coordinated intervention) and to less than 2.6 marks by the beginning of December. Parallel shifts occurred in the values of the other EMS currencies.

The preceding analysis suggests that Germany and the other EEC countries would respond to this dollar decline by easing monetary policy. That is exactly what occurred. Although German money market rates were at essentially the same level in March 1985 as they had been at the start of 1984 (despite a 100 basis point decline in comparable U.S. rates and a significant decline in

⁴This induced shift of national monetary policies in response to U.S. fiscal deficits is the explanation of the rise in world-wide interest rates that puzzled Summers and Blanchard (1984). Knight and Masson (1985) indicate that a substantial rise in world-wide interest rates can also be ascribed to the net fiscal expansion that occurred in the world economy as U.S. deficits increased by more than European deficits declined. The fall in the OPEC surplus reinforced this net decline in world-wide savings.

German inflation), during the six months after the dollar began to decline German interest rates came down 150 basis points, widening the gap with U.S. rates. The response was similar in other EMS countries: money market rates have declined 150 basis points in France and Italy. Longer term rates have also generally declined.

The G-5 decision to try to bring the dollar down by coordinated intervention has started yet another new phase. Although the Japanese have strengthened the yen more than 15 percent by a sharp tightening of monetary policy and by increasing the likelihood of fiscal expansion, the Germans and other key European governments have only engaged in limited intervention without any noticeable shift in monetary or fiscal policies. The more modest strengthening of their currencies relative to the dollar since September has reflected a continuation of the trend started earlier in the year, accelerated by the market's fear of possible intervention and perhaps by the growing recognition that the dollar remains too high to decline only at a rate equal to the international interest differential (Krugman, 1985).

The strengthening of the European currencies relative to the dollar replaces imported inflation with imported disinflation. In this environment, the European governments can more easily pursue expansionary monetary policies. This opportunity will be reinforced if prospective U.S. budget deficits and long-term interest rates continue to decline. Although such an easing of European monetary policy cannot be a substitute for dealing with the more fundamental problems that prevent a return to full employment in Europe, it can help to reduce the current exceptionally high levels of European unemployment.

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