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The United States in the World Economy: Introduction

Martin Feldstein

Until the decade of the 1980s it was common for Americans to ignore the international role of our economy. Imports and exports accounted for less than 10 percent of our gross national product, trade was approximately in balance, and international capital flows financed a very small portion of the net investment in the United States. In this environment, government officials, businessmen, and academic economists could safely think about the American economy with little attention to its international linkages.

The events of the 1980s changed all of that. The dollar rose more than 75 percent between 1980 and 1985, leading to a massive trade deficit and a correspondingly large capital inflow. By 1986, the trade deficit exceeded \$170 billion or 4 percent of GNP and was inflicting substantial pain on those firms that exported to the rest of the world or that competed with imports from abroad. In addition, the international debt crisis that began in the fall of 1982 drew attention to the links between U.S. banks and the performance of foreign debtor nations. It was no longer possible to ignore the international environment within which the U.S. economy operated.

The NBER conference presented in this volume was held in March 1987. By then the dollar had been declining from its peak for two years and was back within 10 percent of its initial trade-weighted real value. There was, however, no clear evidence that the U.S. trade deficit had begun to shrink. Although the Commerce Department had recently estimated a small decline in the real trade deficit in the final quarter of 1986, the volume of imports was still rising. Congress was debating new trade legislation that would close American markets to foreign products, and the finance ministers of the major industrial countries were discussing ways to stabilize the exchange rates.

Despite the very slow adjustment of the U.S. trade deficit, most economists believed that the reversal of the dollar's rise would soon cause a significant rise in exports and decline in imports. I and several others had predicted that the dollar would go on declining and would fall enough so that the United States would actually have a trade surplus by the early 1990s. This shift from massive trade deficit to trade surplus will occur because the world financial markets will not finance the flow of capital to the United States that would be required if the United States continued to have a trade deficit.

More specifically, past experience implies that if the dollar remained at its level of early 1987, the U.S. trade deficit would shrink from $170 billion to about $90 billion but would then stop declining. Financing that trade deficit would therefore require a capital inflow of $90 billion a year from the rest of the world. But in addition to this capital inflow, the United States would also require additional credit from the rest of the world to finance the interest and dividends that accrued on the foreign investments in the United States. By the end of 1986, the net foreign investment in the United States was $200 billion. That total was growing at an annual rate of $140 billion and could be expected to exceed $800 billion within five years. The interest and dividends on this amount would be about $60 billion. Thus the total capital inflow required by the early 1990s would be $150 billion a year and rising.

Foreign investors are very unlikely to be willing to devote so much of their own saving to investments in U.S. assets. Even if they are willing to go on lending the full amount of the interest and dividends that accrues each year, the United States would still have to export an amount equal to our imports, that is, to be in trade balance. If foreign investors want to provide less credit and get some net interest and dividend income on the funds that they have already provided, the United States will have to run a trade surplus. Indeed, a shift to trade surplus must eventually begin since otherwise the United States will have enjoyed a monumental capital inflow without ever giving anything in return. (For a more complete but nontechnical discussion, see Feldstein 1987.)

The challenge to the United States is to achieve this rebalancing of trade without a reduction in net investment in the United States and without a recession. The current level of U.S. investment in plant and equipment and in housing has been sustained by the capital inflow from the rest of the world. As the trade deficit and the current account deficit shrink, the capital inflow from the rest of the world will also decline. Unless saving in the United States increases substantially, our domestic investment will inevitably fall.

The key to increasing the national saving rate is to reduce the deficit in the federal budget. A government budget deficit in 1987 of $180 billion would absorb about half of all the net saving of households, businesses, and state and local governments. If the capital inflow from the rest of the world declines without a corresponding fall in government borrowing, real interest rates in the United States would have to rise to induce a substantial enough fall in net investment in plant and equipment and in housing. The fact that real long-term interest rates are currently nearly twice their historic average reflects the market's concern that this clash between the government's borrowing needs and private investment demand will soon be exacerbated by a decline in the inflow of foreign capital.

The requirement for avoiding a decline in domestic investment while the economy returns to a trade balance is easier to specify than it is to achieve politically. The goal of shrinking the budget deficit has been accepted by both political parties since the beginning of the decade, but they have not been able to find a consensus on the composition of the deficit reduction.

The challenge of avoiding a recession while the United States returns to a trade balance is equally difficult, but the problem is technical as well as political because it is not clear what steps, if any, need to be taken. The most obvious direct effect of the decline in the trade deficit is expansionary since exports rise and imports fall. But the decline in the trade deficit also brings with it contractionary side effects: the rise in interest rates and fall in investment, the decline in the fiscal stimulus if the budget deficit is reduced in order to limit the interest rate increase, and the fall in consumption that occurs because American households become poorer as the decline in the dollar reduces their purchasing power in world markets and therefore reduces the real income that they have to spend at home. No one can know the relative speeds with which these positive and negative forces will affect overall demand and production in the United States. If the direct effect on net exports comes sooner and is stronger, a recession will automatically be avoided. But if the adverse effects on investment and consumption occur sooner, the economy could fall into a temporary recession.

A monetary policy aimed at stabilizing nominal GNP might dampen these effects but could not be certain to prevent a recession. A more expansionary monetary policy could lead to rising inflation that would create even greater problems in the future. And discretionary fiscal policies aimed at offsetting a potential but uncertain economic downturn could actually exacerbate cyclical instability if the timing of their effects are inappropriate. The risk of an economic downturn in the process of returning to a trade balance is the price that the American economy must pay for not dealing sooner with the fiscal imbalances that caused the trade deficit.

Changes Abroad

The shift of the United States from a massive trade deficit to a trade surplus will bring substantial gains to many American firms and their employees. But the nature and magnitude of those gains will depend on developments in the rest of the world. Much of the conference dealt with the potential for such changes abroad.

A central issue in this context is the extent to which foreign countries will give American firms greater access to their markets. Although the financial forces in world capital markets will eventually cause the dollar to decline by enough to lead to a U.S. trade surplus regardless of whether or not foreign markets are opened, the gains for both Americans and foreigners will be greater if foreign markets are more open as this occurs. If foreign markets are open, U.S. firms will be able to produce those products and services in which we are relatively more efficient. This allows American workers and firms to benefit from doing more of what they do best and permits foreign buyers to take advantage of the relatively low cost of U.S. production.

If however foreign markets are closed to an increased volume of American products, the shift from the current trade deficit to a trade surplus will be achieved by reducing imports into the United States. This reduction in imports could be obtained by either an even greater fall in the dollar than would otherwise be necessary or by explicit protectionist policies of quotas and tariffs. The fall in the dollar would be the least harmful of these while the quotas would be the most harmful. In either case, American firms and workers would lose the opportunity to sell more of the products in which they have a comparative advantage. Moreover, American consumers would be denied the opportunity to buy the foreign goods that they would have been able to purchase if foreigners were buying more of U.S. products.

There is a clear risk that the falling dollar will lead the major trading partners of the United States to become more protectionist in order to avoid competition at home from American producers. This would not stop the shifting trade balance but it would hurt foreign consumers and foreign exporters and would encourage protectionist retaliation by the United States.

It is not surprising, therefore, that the problem of access to foreign markets came up repeatedly in the conference. Much of this discussion focused on the special problems of access to the markets of Japan and the newly industrialized countries of the Asian Pacific rim. There was also substantial attention to the problem of selling in Latin America now that the international debt situation has required those countries to reduce their imports.

Access to foreign markets involves access for the sale of services and for investments as well as for the sale of goods. This point was emphasized in two of the sessions of the conference and has been recognized in the new round of GATT negotiations. Access for services is more complex in many ways than access for goods since access for services generally involves being able to produce the service in the foreign country as well as to sell it there. Effective access means providing the same "national" treatment to foreign suppliers of a service as to domestic suppliers so that the two can compete equally. Because there are so many special features in the markets for services and in foreign investment, it appears that progress will be slow and will have to be made on a bilateral case-by-case basis as well as under the umbrella of an expanded multilateral GATT (General Agreement on Tariffs and Trade).

Restricting the imports of goods and services and excluding foreign investment are not the only barriers to free international commerce. The other major problem discussed at the conference was the provision of government subsidies to exports and to domestic producers. This has been a problem in a number of industries but has been particularly acute in agriculture.

The dramatic reduction of U.S. agricultural exports in recent years can also be traced to technological changes abroad, to trends in foreign income and population, and to the introduction of effective production incentives in China, Latin America, and elsewhere. But the growing volume of agricultural subsidies in Europe, Japan, and the United States is extremely wasteful. They cause a serious misallocation of productive resources to low-value activities, contribute significantly to government budget deficits, and raise the cost of food to European and Japanese consumers.

Latin American Debtors

The increased agricultural exports from Latin America have helped those countries adjust to the drying up of new foreign capital after 1982. The sessions at the conference on Latin America and on the international debt problem emphasized the progress being made in those countries as well as the seriousness of the current situation for both the debtors and the creditor institutions.

The fundamental problem in achieving the successful management of the debt problem in the major middle-income debtor countries is achieving a cooperation between creditors and debtors that neither has a compelling incentive to offer. The debtors need to limit their debt service payments in order to achieve an acceptable rate of economic growth, while the creditors need to limit their exposure in order to raise funds at a cost that permits them to compete in world credit markets. It is tempting, therefore, for each side to unilaterally abandon the effort at a cooperative solution.

Fortunately, it is in principle possible to permit the debt to grow at a rate that is fast enough to support acceptable growth in the debtor countries while still shrinking the ratio of the debt to the GNPs and exports of those countries and to the overall size of the banks' capital and earnings. The problem is to convince both creditors and debtors that such a cooperative solution is more in their interest than a de facto unilateral repudiation of debt by the debtors or an unwillingness to provide any additional credit by the creditors. And as the conference presentations emphasized, any additional credit will be more effective if it is combined with reforms in the debtor countries that lead to higher growth and better resource use.

Changing World Capital Markets

The dramatic fluctuations in the relative value of the dollar and the unprecedented growth in the size of the U.S. trade deficit captured the headlines in the 1980s. But the more fundamental and persistent changes in the world economy that happened during those years were the structural innovations in international financial markets. New technologies and regulatory reforms have combined to create global financial markets that did not exist a decade ago. The pace of change was accelerated when the sharp fluctuations in exchange rates and interest rates spurred the demand for new instruments that could protect investors from unwanted speculation.

The new financial instruments and their new uses have permitted individual investors to achieve a better allocation of credit and of risks around the world. But while protecting individual investors, they may also have increased the overall risks to the banking and financial systems. Neither the banks and other financial institutions that use the new domestic and international instruments nor the government agencies that regulate those banks can be fully confident that they know the effects of the new instruments and new investment strategies. Only substantially more study and time will tell the significance of their increasing role.

The conference discussion highlighted some of the risks of the changing financial marketplace and the impact of international competition as a driving force in this change. Moreover, because American investors and borrowers can use foreign capital markets and foreign institutions that do business in the United States, the traditional bank regulations may significantly reduce the competitiveness of American banks and weaken the American banking system. This is accelerating the deterioration of the old role of banks and hastening their shift to the development of new and riskier products and services.

In an integrated world capital market, regulatory provisions must be uniform across countries and competing institutions in order to avoid weakening those institutions and markets that are more tightly regulated. Some steps have already been taken by the Federal Reserve and the Bank of England to coordinate bank capital requirements. Over time, this type of coordination of banking rules is likely to spread to other countries and other issues. Ultimately it may become a principal that extends to other financial service industries.

The impact of our integrated world capital markets may reach much further. If long-term capital comes to flow very freely among major industrial countries, it will no longer be possible to develop tax systems without taking such capital flows into account. A country with higher tax rates will drive away profitable businesses, while a country with generous investment allowances will attract more investments in plant and equipment. At the level of macroeconomic policy, the availability of foreign capital postponed the rise in U.S. interest rates and may therefore have given U.S. officials the political luxury of ignoring the deficit for a longer time than would otherwise have been possible. Similarly, the current fall in the dollar and corresponding rise in interest rates may force political action to reduce the deficit sooner than would otherwise have happened.

The falling dollar may also have an important impact on national security decisions and American strategic policies. The substantial decline of the dollar makes it more expensive for the United States to maintain troops abroad, to provide foreign aid, and to do anything that requires purchasing goods and services in foreign markets. The government may respond to this higher price by cutting back on such overseas activities, changing the volume and nature of the American presence abroad.

In the years ahead the role of the United States in the world economy is likely to change fundamentally as foreign companies play a larger direct role inside the American economy. The United States is of course fundamentally attractive to foreign investors because of its massive $5 trillion market place, its political stability, its continuing flow of technological and product innovations, and its relatively flexible labor and product markets. The recent tax changes increase the appeal of location in the United States to businesses that produce substantial taxable profits or high professional incomes. The sharp decline in the dollar also makes American assets more attractive to foreign buyers and lowers the relative cost of production in the United States. The next decade is therefore likely to see an increase in the volume and range of foreign businesses investing in American facilities.

The papers in this volume indicate the diversity of the ways in which the American economy influences and is influenced by economic events and conditions around the world. The experience of the 1980s has dramatically demonstrated the power and extent of this interdependence. American businessmen must become increasingly global in their activities and in their vision of the market environment within which they operate. Policy officials in the United States must recognize that the response of the American economy to changes in American economic policies is very much influenced by the impact of those policies on trade and capital flows. This conference and the resulting book will have been a success if they increase the awareness of corporate leaders, policymakers, and economic analysts to this changing role of the United States in the world economy.

Reference

Feldstein, Martin. 1987. Correcting the trade deficit. *Foreign Affairs*, Spring.