CHOICES FOR U.S.

Why Our Trade Deficit Is More Worrisome Than Our Budget

by Lester C. Thurow

Americans talk about two deficits. Most of the concern goes to the federal budget deficit, but I want to draw attention to the other one—the $150 billion balance of trade deficit. Within the next year or two Americans will discover that this deficit is much more important and is, in fact, the deficit that we must deal with.

Inflation and the No-Crisis Syndrome

Let me explain why I believe that to be true. What is wrong with running a $200 billion federal budget deficit? Two things, the first being inflation and the second being negative savings. If you are a Keynesian economist and you are pumping $200 billion of Keynesian steam into the system, that is perfectly appropriate in 1933, when you are trying to get out of the Great Depression. It is also perfectly appropriate in 1982, when you are trying to get out of a maxi-recession—the worst since the Great Depression. That procedure, however, becomes less and less appropriate as the economy crawls back to full employment. Sooner or later, it will create inflation.

There is a big difference, however, between this kind of overstimulation—aggregate demand inflation—and a supply shock like a food or oil shock. If an oil or food shock hits the American economy, it comes in one sector: prices rise substantially and inflation roars up in a hurry. We have seen that over the last ten years. But excess aggregate demand inflation is a very different commodity. It spreads a cross the entire economy, but it is very slow and very pervasive.

Think about the period from 1965 to 1970, which is the last time we made this mistake. We had too much aggregate demand being pumped into the economy by the government because of the Vietnam War, but inflation did not occur rapidly. In 1965, the U.S. inflation rate was 2.2 percent. In 1970, it was 5.4 percent. It took 5 years to raise the inflation rate by 3 points, despite major economic mistakes. I think somebody in all honesty could go to the President today and say, "Look, you are making a mistake if you run that kind of a deficit over the next 4 or 5 years. You will be pumping Keynesian steam into the system and generate inflation, but it will not get out of hand until 1989. It will never show up as a crisis on any particular Monday morning. It will be very pervasive, but very slow."

If you believe that democracies have the most trouble dealing with very slow pervasive problems that never appear as a crisis, then this is precisely that kind of a problem. It is not a situation where someone can say on a particular day that if we do not do something, then the world falls apart. It just is not true.

The second thing wrong with the big federal deficit is that it is negative savings. We are subtracting 5-1/2 percent of the gross national product from the pool of savings and investments and using it to finance public consumption. That will lead to a little lower growth rate, it will make us a little less competitive in world markets and our standard of living will fall relative to those countries that are investing in saving a lot more.

But that also is a very slow process. We do not even know it has occurred for 3 years because there is a big data lag: we fall at the rate of 1 percent a year, relative to the rest of the world, and in no particular year is that a disaster.

Think about Great Britain. In the 19th century, the British had the world's best economy. They had the highest level of GNP per capita, they were the productivity leaders and they invented the Bessemer steel process and all the new high technologies. We caught up with them about 1900; we were growing about one-half percent faster per year than were the British. But where are we today? We have productivity twice that of Great Britain. The British could not deal with that very slow, very pervasive falling behind: it was never a crisis.

But think about it as a society. When 1939 came along and the British did face a crisis, they pulled up their political and military and economic socks like very few societies ever have in all of human history. They could handle a crisis, but they could not deal with the slow economic rot in their economy.

In 1983, the British were passed by the East Germans in terms of GNP per capita. Not the West Germans, the East Germans. Think about it: the Germans can make communism work better

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than the British can make whatever they have work. But it never happened rapidly. There was no day when a disaster occurred. The same thing is true in the United States. No disaster is associated with the budget deficit problem at all; it is a slow, pervasive disaster, and as a result it is very difficult to deal with.

It also is very difficult to deal with because of some simple mathematics. Suppose I am a budget cutter that makes David Stockman look as if he is still in diapers. I am going to cut $200 billion out of the federal budget, starting with Defense. Since the whole Defense Department establishment annually spends about $300 billion, and I am going to cut $200 billion out of it, that means I must cut it by two-thirds. Not slow down the rate of growth, but cut it by two-thirds. But our President says maybe you can slow the rate of growth a little bit, but you cannot cut Defense.

So I march off to the second biggest program in the Federal Government, which is Social Security and Medicare. Since together they spend about $250 billion, a $200 billion slice out of Social Security means reducing every pension check in America by 75 percent. Our President tells me he promised not to do that. The Democrats love Social Security, and 29 million elderly people vote.

I then move on to the third biggest program in the federal budget, the roughly $150 billion interest on the national debt. But before I cut a penny, a lawyer at the Justice Department reminds me that it is a national legal obligation and I cannot cut interest on the national debt.

So I cannot cut Defense, I cannot cut Social Security and Medicare, and I cannot cut interest on the national debt. That leaves me with the other social programs, but how much do they spend? Just $200 billion. We would have to close down the interstate highways, close the Agriculture Department, close the Supreme Court, the President and Congress (you might like that). Every single other thing the Federal Government does would have to end. This clearly is very difficult to do. It is exactly what Gramm-Rudman promises we will do.

Boosting Taxes

Now suppose I am a tax increaser that makes George McGovern look like a piker. Suppose I set out to raise the current federal income tax to get $200 billion in new revenue. What would the surtax have to be on April 15 to do that? Since the whole federal income tax raises only $300 billion, it would not be a 5 percent or even a 10 percent surtax; it would have to be a 66-2/3 percent surtax. That puts the numbers in the context in which they really are, and if you ask yourself when could a democracy do those kinds of things—cut Social Security by two-thirds, raise taxes by two-thirds—the answer is "only in a crisis."

But in early 1986 the economy is not going broke; it is doing well. It is still growing, unemployment is not rising and inflation is under control. Why would anyone do all of those difficult things in that kind of context? "If it ain't broke, don't fix it."

Let me use an illustration from agriculture to show what is needed if we really are going to be serious about dealing with the budget crisis. To begin, the agricultural industry is a tax scam. In 1982 the Department of Agriculture said net farm income was $20 billion. But what was reported to the Internal Revenue Service? If you check with the IRS you will find that a little fewer than 1 million farmers reported about $10 billion worth of net income. Another million and a half reported $15 billion worth of farm losses. So net farm income reported to IRS was minus $5 billion.

We would have raised tax revenue in the United States if we had lowered taxes on farmers to zero, so farming could not be used as a shelter for urban income! But imagine if we got rid of all those shelter characteristics of agriculture: what would happen to agricultural land values? To ask the question is to answer it: they would be even lower.

"The agricultural industry is a tax scam."

We have industries in the United States that pay positive taxes up around the 33 and 34 percent level. We have other industries that pay taxes down around the level of minus 10 percent, and agriculture is one of them. If anybody thought about having a more equitable tax code, they would be talking about doing major things to raise the taxes on farmers, because agriculture pays no taxes; agriculture is a tax shelter, a tax scam—just like real estate. But when big changes in the tax laws come up, we all protect our self-interests. And, of course, that is multiplied many times across the economy.

How is the President, who campaigned on the grounds that everything was going well, suddenly going to stand up and say the whole system is broke and we have to do all of these incredibly difficult things to put it back together? I would suggest that there will be lots of sound and fury—if I can use the terminology of the Bible, tinkling of glass and banging of cymbals—but when it is all over and the dust settles down, nothing will have changed. The deficit still will be approximately $200 billion, because we cannot deal with that kind of problem without the aid of a perception that something major is wrong. In reality something major is not wrong, and second, that certainly is not the perception.

The only reason to do something soon is, that if you believe all those economists who told you that if you do nothing, there will be a disaster. Buy why would anyone ever believe them? President Reagan's economists have not given him a good forecast in 4 years; why should he start believing them now?

When he came into office in 1981 they told him there was going to be a boom; there was a recession. In 1982, they told him there was going to be a recovery; there was a maxi-recession. In 1983, they said slow recovery; there was a boom. In 1984, they saw the boom petering out in the first part of the year, and there was another boom. If you were the President, having had that set of information flowing through your door, and they now march in and say "disaster" if you do not do something about the federal budget, why would you believe them?

And there is another piece of history to keep in mind: The United States has never had a major tax increase without the active leadership of the President. Congress is not about to raise taxes. The President cannot just sign on to something that Congress already has agreed on: he must take the leadership and he must come to the conclusion that a major tax increase is what needs to be done. Gramm-Rudman is an attempt to force the President to support a tax increase or force cuts in his beloved Defense budget. But will he? At least based on his campaign statements, there is no reason to think that he believes that a tax increase is necessary.

And in some sense, there is no reason why he should believe it. Being an economist, I believe the economists are right, for the two reasons I mentioned, and that it is important to do something about the federal deficit. But I can understand why President Reagan does not believe us.

The Trade Deficit: A Crunch Is Inevitable

President Reagan perhaps may finesse the federal deficit and let his successor handle that problem. But the other debt problem he will not finesse: the $150 billion trade deficit will show up on his doorstep a long time before he leaves office. It really is very simple: no country can forever run a deficit in its balance of payments; that is the equivalent of the law of gravity.

The problem is that, when people seemingly see water running uphill for a long enough period of time, everybody starts saying, "Well, I don't know how it happened, but somebody repealed the law of gravity." That is the stage we are in at the moment. In October, 1984, Business Week ran an article saying the dollar can stay high for the next 10 years. That is the same thing as saying the United States can have a trade deficit for the next 10 years. If you believe that, you will believe anything.

Let us do a little arithmetic (MIT professors love arithmetic. It's what made us great). In fiscal 1983 the United States had a $69 billion trade deficit. That was the biggest trade deficit any country ever has had, by a factor of two. This year we have a $150 billion trade deficit, or four times the previous high that any country ever had in all of human history. The deficit has been doubling every year.

But let us be conservative. If we have a $150 billion deficit, we have to borrow $150 billion to finance it. Assume the deficit only goes up by $30 billion a year—a very modest assumption. Next year the deficit is $180 billion, so we have to borrow $180 billion, but we also have to borrow $15.3 billion to pay interest on last year's borrowed $150 billion. The year after next it is $210 billion, but we have to borrow, in addition to the $210 billion, $18 billion to pay interest on last year, $15 billion to pay interest on the year before that, and $1.5 billion to pay interest on the interest.

Once you get out there two or three years—a long time before 1989 rolls around—you are talking about numbers so large that the rest of the world neither has that amount of money nor any willingness to lend it to us. If you were to ask me precisely when the crunch will come, I would say I do not know the magic number, but it is finite.

If you had asked me how much money Mexico could borrow in June, 1982, I would have given you the same answer. But by late August, 1982, I knew the answer. When the world discovered that it had lent Mexico $85 billion, it threw up its hands in horror and said "No more." The United States is much bigger and much wealthier than Mexico and we can borrow a lot more than $85 billion, but the number still is finite. On or about May, 1985 we went from being a net creditor country to a net debtor country. From now on the balance of payments deficit is going to be bigger than the balance of trade deficit, because the difference between the two basically is interest payments. Up until now we have been getting more interest than we have been paying; now we will be paying more interest than we will be getting, and the whole compound interest problem moves against us very, very rapidly. Given that arithmetic, how can people believe the dollar is going to stay high forever?

Tulips and Bubbles

Since agricultural policies are our point of reference, I want to review a little agricultural history. In Amsterdam in 1633, for some strange reason people got interested in tulip bulbs—a good agricultural commodity. The Dutch always were smart: everybody in Holland knew the price of tulip bulbs in the long run could not exceed the cost of growing them (in modern terminology, in terms of the balance of payments, that is called purchasing-power parity). But the price of tulips went above that magic level.

The economists then confidently predicted, "tulip prices will come down." But in 1634 they went up. The economists then were even more confident that tulip prices would go down, but in fact they went up again in 1635. With the economists discredited and very quiet, Amsterdam in 1636 was full of people with pseudological reasons why tulip prices could stay high forever and, of course, in 1637 the price crashed and everybody was wiped out. But for 4 years, tulips were impossibly high: this kind of binge sometimes lasts not for 3 weeks, but for a long time.

Another bit of history—the beginning of the famous South Sea Bubble in 1713. The British chartered the South Seas Company to slave and fish despite the fact that everybody understood that there were no fish and very few people in the South Seas to be made into slaves. The price of shares nevertheless went up for 7 straight years. Among the shareholders was Sir Isaac Newton, probably the world's smartest man.

In the spring of 1720, Newton sold his shares for a 5,000 pound profit, say-

"The Federal Reserve Board may care a little bit about farmers, but it really cares about banks."

ing, and this is a literal quote, "I can predict the motion of the heavenly planets, but not the madness of human beings." The price continued to go up, however, and the world's smartest man was seduced back into the market. He bought more shares and lost 20,000 pounds when it all crashed later in 1720.

Or take the Great Depression. We had a farm recession or depression in 1925 and the GNP quit growing in 1928, but the stock market continued up for another year and a half before it crashed. The problem with these binges is that nobody can predict the day when they turn around. The stock market could have crashed in March, 1930, rather than October, 1929. Nothing was magic about October 29, and nothing was magic about 1637 or 1720, but the end eventually comes.

Dollar Won't Stay High

The problem with the dollar is that it will indeed show up as a crisis that will get everybody's attention, a crisis that does a whole set of things that all of us need to think about. A $150 billion trade deficit means that the United States has lost 4 million jobs. If we had a balance in our balance of trade, three million Americans today would be working who are not working.

Although no one can tell us the day when it becomes a crisis, we do know two things. First, we knew that the dollar would not stay high forever.

Second, we knew that when the dollar started moving, it would move very rapidly. History tells us that and so does logic. Suppose I am a German multinational treasurer, and I have moved 300 million marks into the United States when the mark is three to the dollar, which is what it is at the beginning of 1985. I now have 100 million dollars. Now suppose I have to move it back to Germany at two marks to the dollar: I have just lost one third of my capital.

What keeps tulips going, or the dollar going, or the South Sea Bubble going, is the combination of greed and hubris. The greed is, although you know it is crazy, you can make money on the way up; the hubris is you think you will be out one day before everybody is out. But, of course, you will not.

After The Fall

As the dollar falls, jobs shift in America's favor, but something else goes against America. To the question, "will the falling dollar be good for American agriculture?" the answer is yes. It makes American agricultural products cheaper on world markets, we sell more of them than with a high-value dollar, and it rescues Caterpillar and other American corporations that are noncompetitive at the current price of the dollar. That is the good news.

The bad news is in a different area. We Americans import 13 percent of our GNP. The econometricians and statisticians tell us that the dollar will have to fall 30 percent to get back to a balance in the balance of payments. That means the price of everything we buy from abroad goes up 30 percent. If we have a 30 percent fall in the value of the dollar and we import 13 percent of the GNP, that means 3.9 percentage points of inflation. Add that to a basic inflation rate of about 4-1/2 percent and we are up near the 8 percent level.

But that is not the end of the story. Those are the direct effects—what about the indirect effects? The indirect effects are the people who now have good price behavior because they compete with imports. What does General Motors do to the price of cars if Toyota has to go up $2,000 because of a falling dollar? Again, to ask the question is to answer it. And more inflation usually stems from that indirect effect than from the primary effect. Put them together and we are right back to double-digit inflation.

What does the Federal Reserve Board do when we have double-digit inflation? What do central banks always do when there is a flight from the currency? They raise interest rates; that is the standard solution. The problem with the standard solution is a weak banking structure. When the Federal Reserve Board raised interest rates in 1984 by just one percentage point from January to July, it collapsed two of the 15 largest U.S. banks—Continental Illinois and American Savings.

Because of bad loans in the rest of the world and bad loans to farmers, the American banking system is very weak. If the Fed did anything really fundamental on interest rates, it would be in danger of pushing not just a lot of farmers into bankruptcy, but a lot of banks with them. The Federal Reserve Board may care a little bit about farmers, but it really cares about banks. The Fed is much less willing to see a lot of banks go broke, especially big ones, than it is to see farmers do so, whether they are big or small.

That is the context. Somewhere out there in a finite number of months the falling dollar will have a set of positive and negative effects on the economy—it will be good for employment and good for sales but bad for inflation. The question is: how are we going to deal with it?

The World Has Changed

When people say the American economy has died and been replaced by a world economy, that is precisely correct. As I noted, we import 13 percent of the GNP; in 1984, we also exported 13 percent of the GNP. The Japanese export 17 percent of their GNP. In short, we depend almost as much on international trade as do the Japanese. If you exclude trade among European countries, our export and import percentages are just about the same as those of the Common Market. We are now fully integrated in the world economy.

That does not mean, by the way—despite its stature as popular myth—

that American agriculture is much more efficient than the rest of the world. In some areas that is true and in other areas it is not, but it certainly is not true on average for American agriculture. The productivity growth rate in French farming, for example, is way above American agriculture productivity growth rates at the moment. European agriculture on average probably still is behind American agriculture, but it is catching up very, very fast and in some areas—dairy products is one—it probably is not behind American agriculture at all.

If you really had free trade in agriculture the European dairy farmers would put a lot of American dairy farmers out of business. That sounds less attractive than American wheat farmers—because they are more efficient—putting European wheat farmers out of business. Moreover, the Green Revolution has transformed much of the Third World. Those developing countries are not going to be importing a lot of American agricultural products.

Simply stated, the world has changed. One hears suggestions, for example, that we "lay it to the Brazilians" because of Brazil's threat to U.S. soybean farmers or whatever. Well, we are not going to lay anything to the Brazilians, because if we do they might default on their debt. Who would be there lobbying against the farm community in Washington if you really tried to lay it to the Brazilians? Every bank in America.

Who has the most clout when it comes to finance—the farmers or the Citibanks of the world? There will be no agreement in the United States that we should lay it to the Brazilians because they are doing X, Y, or Z, because the whole thing is interconnected; you lay it to the Brazilians, they lay it to the American banks, and the whole pressure cooker blows up.

Lord Keynes' most famous dictum is, "In the long run we all are dead." The second most famous is that "if you borrow 100,000 pounds from the bank and cannot pay it back, you have a problem. But if you borrow 10 million pounds from the bank and cannot pay it back, the bank has a problem." And in this case the United States has the problem, not the countries that borrowed the money. That is why there is a vested interest in keeping every agricultural commodity one can imagine flowing out of those developing countries.

Losing The Edge

Not only are we embedded in the world economy, but we now have technologically equal competitors, and this once was not true. Both American agriculture and industry used to have what I would call "effortless superiority": we were just technically way ahead of the rest of the world. But it is not true anymore—not in agriculture and not in manufacturing.

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The following numbers from American manufacturing were generated by Data Resources, an economic consulting firm. In 1982, expressed in 1975 prices, American productivity and manufacturing was \$11.20 per hour of work. In Germany, it was \$12.39; in France, \$11.96; in Italy, \$11.29. Essentially every country in Northern Europe and some in Southern Europe now have manufacturing productivity slightly above the American level.

It is not really true to say that they are significantly above us, but it is true that we now have peers—people who are just as good as we are. We no longer can sell anything that Americans make on the grounds that it is technologically superior because we do not anymore have that kind of edge.

How is America doing on the leading edges of the competitive world economy as opposed to its back edges? Consider the leading new consumer electronics product—video recorders. This year the Japanese will be making 20 million video recorders, racking up billions of dollars in sales, and creating hundreds of thousands of jobs. How many video recorders will be made in America? The answer is zero; they are 100 percent imported. When was the last time we saw a brand new product never made in America?

Machine tools? Robots? At the moment we have one-thirteenth as many programmable robots in the American economy relative to the size of the work force as the Swedes, one-seventh as many as the Japanese. We are way behind when it comes to robotization of the American economy.

Personal computers? How many people know that more than half of the value added of the IBM Personal Computer is made abroad? That is not an American product, just an American label; if we cannot be competitive on television sets, we cannot make the video screen. If we are not competitive on extruding plastics, then we make the keyboard abroad, and so forth. Only the microprocessor in the IBM Personal Computer is really an American product.

Telecommunications? We put up for competitive bidding the laying of the glass optic fiber from New York to Washington, D.C. The lowest bid by 50 percent came from a foreign firm, which we then rejected on the grounds of national security, despite the fact that the country involved is one of our allies. And while it does not rank high in terms of cosmic significance, did you notice who made the clothes for the American Olympic ski team in Sarajevo? They were made by a company called Descente. That sounds Italian but, like everything else, it's Japanese. We had a world-class ski team, but it was not backed up by a world-class economy.

Our competition is all across the board, and nowhere is this more true than in agriculture. American agriculture is competing in world agricultural markets, and it is not competing with the enormous effortless technological superiority that it had in the past. That is a lesson that we all are going to learn in America, and I expect it will be a little painful.