Integrating Forces In the World Economy:

How Have They Affected the Southeast?

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We in the Southeast have a long experience with international trade. In the 18th and 19th centuries, the Southeast was an exporter of agricultural products such as cotton, tobacco, indigo, and rice, and an importer of manufactured goods, trading primarily with Europe. Therefore, the region favored low tariffs, one of many points of contention leading to the Civil War. The relatively low cost of waterborne trade meant that transatlantic trade ties were often closer than national trade ties.

Transport costs fell dramatically over the next 100 years, but internal transport costs, by road and rail, fell even more dramatically than external transport costs. For these and other reasons, including relatively high tariffs up until World War II, the internal integration of the U.S. economy proceeded more rapidly than its integration with the rest of the world. Foreign trade's share in the U.S. economy, measured by the share of exports in gross national product, or GNP—which may have been as high as 12 percent in the colonial period—fluctuated between 5 and 10 percent, falling gradually to less than 4 percent in the 1950s and 1960s.

During the postwar period, the dollar gradually became overvalued, as the European and Japanese economies recovered their productivity. This kept the prices of traded goods, such as agriculture and manufactured products, low relative to the prices of nontraded goods such as services and construction. Increasing balance of payments problems led to the devaluation of the dollar in 1971 and the subsequent downward float in 1973. In the 1970s, the cheaper dollar stimulated exports, while rising oil prices pushed up the costs of imports. The share of foreign trade in the U.S. economy doubled from 6 percent to 12 percent between 1970 and 1980.

Declining transport and communication costs have contributed to these trends, as documented in a recent paper by Richard Cooper.[1] Transatlantic and transpacific air fares today are roughly one-tenth of what they were in 1939 in dollars of constant purchasing power. Freight transportation costs have fallen as well. Communication costs have declined even more dramatically, with satellites providing virtually instantaneous worldwide communication by television or telephone

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at a fraction of the cost formerly required by cable.

Capital Movements

In recent years, foreign capital again has begun to play an important role in U.S. economic growth. From 1980 to 1982, plant and equipment expenditures by direct foreign investors accounted for 11 percent of plant and equipment investment by nonfinancial corporate businesses, excluding farms.[2] These funds act as a source of jobs coming into the economy and are particularly focused in the Sunbelt, especially the Southeast.

On the other side of the ledger, direct investment abroad by U.S. corporations fell in 1984 to only one-third of the level of foreign direct investment in this country. This may reflect the increasing difficulty American firms have had selling abroad with the strong dollar. At the same time, the substantial foreign investment in the U.S. economy reflects the strong markets foreign firms have been finding here for their goods, as well as a desire to forestall protectionist pressures by producing goods here.

Migration

The U.S. economy has been built on immigration. Current problems relate to difficulties in absorbing large numbers in specific areas such as south Florida, exploitation of illegal immigrants by unscrupulous employers, and the general issue of whether we can hope to control our borders, especially in light of a population explosion in Mexico.

Simple economics tells us that to maintain our standard of living we need to have some limits on immigration, while common sense tells us that maintaining our culture also implies some limits. Clearly, the irresistible force of a higher income is what pulls people into our country. The evidence shows that most immigrants soon become net contributors to the economy, so the economic limits on immigration presumably are rather high. But there seem to be socio-cultural limits as well, although I do not feel qualified to discuss them.

Costs and Benefits of Integration

Trade as a Shock-Absorber. Through trade, we absorb foreign shocks such as oil price fluctuations, swings in other commodity prices, and the troubles of our Mexican and Central American neighbors. At the same time, foreigners absorb shocks from our economy, the world's largest. As the Canadians frequently remind us, this is like sleeping with an elephant. Foreign trade acts as an automatic stabilizer to our economy. When a boom pulls in imports, it holds down inflation. And when imports fall in a slump, part of the burden of falling demand is met by foreign suppliers.

Wider Choices. Trade brings us more types of goods at lower cost, which improves consumer welfare and raises what economists call X-efficiency in domestic production. This X-efficiency is what the British don't have and what the Japanese do—that is, the most efficient operation of a plant with given human and technical resources.

Added Uncertainty. Along with the breadth of choice come foreign sources of shocks including, in today's environment, fluctuating exchange rates and commodity prices. This increased uncertainty bears costs for risk-averse consumers and managers.

Higher Standard of Living. Without foreign trade, we would be a lot poorer on average. Productivity, the source of our standard of living, is substantially higher in our export industries than in our import-competing industries. Data from the 1981 Annual Survey of Manufactures suggest that an industry with a 20 percent higher export share pays 5.34 percent higher wages on average.[3] Data on 1978 import penetration ratios in manufacturing industries, calculated by William Cline, suggest that an industry with a 20 percent higher import penetration ratio pays 3.3 percent lower wages on average.[4] Transferring labor from low-wage, low-skilled jobs in import-competing industries into higher-wage, higher-skilled jobs in export industries is the process through which increased foreign trade raises the standard of living. The Southeast, as a low-income region to start with, cannot afford to close off such an important source of increased productivity.

Social Costs of Change. The difficulty is that transforming low-productivity workers into higher-productivity workers requires expensive investments in education and training, particularly in the younger generation of workers coming up through school. Southeastern states seem to be realizing this and investing more in their public education systems in recent years, but this has been a long-neglected problem in the region.

The older generation is more difficult to retrain. This requires a reasonable program of adjustment assistance to trade-displaced workers, focused on moving them into new employment.

Failure to make these investments in our human capital brings inevitable pressure to resist change by resorting to protectionism, thus locking us into a low-level equilibrium trap.

Constraints on Economic Policies

Macroeconomic Policies. In the halcyon days of the early 1970s, floating exchange rates appeared to release domestic monetary policy from the "external constraint" in countries like West Germany and the United Kingdom, leaving more freedom to pursue domestic macroeconomic objectives. The United States also acted with more freedom from balance-of-payments worries after the 1971 devaluation and the floating of the dollar in 1973.

In retrospect, all this extra freedom resulted in what might be pronounced a mixed blessing, as policymakers seemed to feel it allowed them more freedom than was actually the case. Even with floating rates, it is necessary to convince foreigners to lend us the excess of our imports over our exports. Neglecting such elementary truths, policymakers placed too much of a burden on exchange-rate fluctuations to restore external payments imbalances during the 1970s. And the effect of domestic policies that such nations as the United States and the United Kingdom followed with this new freedom were not particularly admirable. It's not so easy to escape from the external constraint.

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Microeconomic Policies. Economic integration with the rest of the world means tax policies and regulatory policies need to be harmonized to some extent, or else trade is distorted by differences in taxes or regulations. Of course it is possible that the differences simply reflect varying preferences for pollution or safety or for the quality of public services. In that case, a familiar public finance theory called the Tiebout model predicts that people will simply move to the jurisdiction that provides the environment they prefer.

Internationally, it seems more likely that the firms will move, instead of the people, leading to the problem of policy competition. When countries compete for industries by lowering taxes or pollution standards, they may wind up with the same industries as before but with fewer public services and lower standards than they would have preferred if they could have negotiated an international cooperative agreement on harmonized policies. The same phenomenon affects international banking and lies behind the Eurocurrency markets.

Avoiding Conflict. Trade is a great harbinger of civilization, while warfare is its destruction. The European Economic Community was not created simply because it might promote intra-European trade, but because a community that bound together both France and Germany offered the best guarantee against a renewal of ancient hostilities that had torn Europe apart three times in 100 years. Americans should remember that hard-won wisdom and avoid cutting off the few commercial ties we retain with the Soviet Union. We also should remember it as we consider whether it is more important to try to isolate those with whom we disagree than to continue trading with them.

I seem to be concluding here that trade is foreign policy. For the purpose of this conference, it might be more useful to conclude that trade is domestic policy. I believe my arguments also would support that statement. A healthy domestic economy requires a healthy foreign trade.

But our foreign trade today is anything but healthy. The current account deficit, $101 billion in 1984, is expected to reach $120 billion this year, or about 3 percent of GNP. Some look on this with equanimity, and accuse us Cassandras of being mercantilists. They argue that the United States can sustain capital inflows amounting to 3 percent of GNP indefinitely, and that this country is now a natural capital importer. But the domestic counterpart of that capital inflow is the federal government deficit, now running about 5 percent of GNP. Few believe the federal deficit is sustainable at that level.

The other side of non-sustainability is the trade deficit's inexorable pressure on domestic industry and agriculture. Import-competing industries like textiles and footwear have mounted impressive campaigns for protection, although their problem is the dollar's high value, accounting for the lion's share of the increase in our trade deficit since 1980.

Domestic industry eventually will obtain a protectionist response from Congress unless something else relieves the unsustainable pressure on the balance of payments. That something is a decline in the value of the dollar.

Why Is the Dollar High?

Between 1980 and its peak last February, the dollar's value rose over 80 percent relative to the currencies of 10 industrial countries in the Federal Reserve Board's trade-weighted index. By mid-September the dollar had gradually declined some 12 percent from the peak, and by October 1 it had fallen another 6 percent. What led the dollar to rise so much and then to decline?

The primary reason for the dollar's strength, in my view, is the decline in inflation that began in 1980 in response to changes in monetary policy put into place in 1979 and confirmed by the election of 1980. During the 1977-1979 period in which the dollar fell, the U.S. inflation rate rose above the average foreign rate for the first time in post-war history. The crucial 1981 reversal of that ominous trend and the continuation of low inflation ever since has inspired renewed confidence in the future value of the dollar.

However, the dollar has risen much more than can be accounted for by differences in inflation alone. This is made clear by the fact that the real or inflation-adjusted value of the dollar rose over 70 percent between 1980 and February 1985. The explanation lies partially in expectations of future inflation rates, which also have ebbed dramatically from 1980. But the 1981 shift in the mix of monetary and fiscal policy is another major factor.

For better or worse, until 1981 monetary and fiscal policy in the United States generally worked in tandem, expansionary together or contractive together. Beginning with the 1981 tax reduction and the ensuing buildup in defense spending cuts, U.S. fiscal policy has become steadily more expansionary, as measured by changes in the cyclically adjusted budget deficit. By contrast, monetary policy began its anti-inflationary course in 1981, pushing the economy deep into recession in 1982 after interest rates soared.

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The combination of expansionary fiscal policy and contractive monetary policy has kept real interest rates high in the United States, as the federal government required an increasing share of the total funds in credit markets to finance its deficit.

With floating exchange rates, the normal response to this increased demand for credit has been to encourage capital inflow from abroad, putting upward pressure on the value of the dollar. The counterpart of the capital inflow in the balance of payments is a current account deficit made possible in large part by appreciation of the dollar.

Of course, other factors also have been at work. Tax reductions and a low-inflation climate have induced a sharp rise in foreign direct investment in the United States. Foreign fears of protectionist legislation can also help explain this fact, however, since protectionism has been rising along with the dollar. U.S. investment abroad, and bank lending to foreigners in particular, have been reduced sharply because of debt-repayment problems in the developing countries. The debt crisis itself began in 1982, brought on by the strong dollar and declining oil and commodity prices. Capital flight from debtor countries has swelled the capital inflow further, continuing the dollar's appreciation. Finally, in the exchange market as in other asset markets, everybody loves a winner. The expectation of a rising dollar undoubtedly has been significant in bringing capital into dollar assets.

When Will The Dollar Fall?

The dollar's 12 percent decline from February to mid-September can be explained largely by declining U.S. interest rates as the economic expansion has slowed sharply, reducing the private sector's demand for credit. Commercial and industrial loans at large commercial banks that report statistics weekly have declined 2.7 percent from March through August. Credit market borrowing by the nonfarm corporate sector fell 30 percent in the first half of 1985 from its 1984 level.

If a recession strikes, both interest rates and the dollar can be expected to skid farther as private credit demands fall even more sharply, allowing interest rates to fall and the capital inflow to shrink. At the same time, the current account should improve as imports decline.

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A preferable scenario for a decline in the dollar relates to a shift in the mix of monetary and fiscal policy. Some have argued that expansionary fiscal policy combined with tight monetary policy was a major reason for the dollar's strength, and reversing that combination should require smaller capital inflow and weaken the dollar, even without a recession. However, the possibility of gradually reducing the government budget deficit without throwing the economy into recession probably escaped us a year or two ago.

Monetary policy already has become more expansionary in 1985 as the fiscal stimulus now almost entirely leaks abroad. It is hard to imagine phasing a further step-up in monetary growth so carefully in conjunction with gradual fiscal contraction that it will allow the effects on the economy to offset each other. That requires fine-tuning beyond the practices of the 1960s.

Standing in contrast to that kind of fine-tuning is the bill recently passed into law that would require arbitrary reductions to bring the deficit down to zero by fiscal 1991. This proposal, as I understand it, would punish the economy with spending cuts and tax increases in the likely event of a rise in the budget deficit induced by a slowdown in growth.

A more appropriate policy stance would be to seek a gradual reduction in the cyclically adjusted budget deficit, allowing the automatic stabilizers to play their role as needed. This undoubtedly would require attacking some of the budgetary sacred cows that got us into this mess in the first place. With a stable medium-term path for fiscal policy, monetary policy could then play an appropriate counter-cyclical supporting role.

The Group of Five Statement on Intervention. On September 22, the finance ministers of the five largest industrial countries met in New York and agreed to cooperate in actions to "encourage" what was called "orderly appreciation of the main non-dollar currencies against the dollar"—in other words, depreciation of the dollar. The announced reason was that "exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case."

For the U.S. government, this is a major change from the policy in place since early 1981. The previous policy was based on the assumption that the market was almost always right. When the loose-fiscal, tight-monetary policy mix pushed the dollar up and strangled domestic industry, the Reagan administration found itself hoisted with its own petard. After four years of vainly fighting off protectionism and refusing to change the monetary-fiscal mix that had led to the problem, the administration suddenly decided the market may not always be right after all.

As one who believes that intervention can play a useful role in a floating exchange rate policy, I welcome this battlefield conversion. But before they climb into the same foxhole I'm in, I'd like to be sure we're on the same side. According to my line of argument, the dollar has been high primarily because of fundamental factors such as the administration's fiscal policy, no doubt with some bandwagon effects and other factors added on.

A change in intervention policy without a change in the fundamental factors keeping the

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dollar up is what I call using intervention as a substitute for monetary and fiscal policy. We may have gone from an intervention policy that is "do nothing" to one that tries to "do everything." I doubt that sterilized intervention alone can produce a lasting, significant fall in the dollar unless it is accompanied by either a recession or a significant change in fiscal policy. By this late date, it may not be possible without the recession.

If the administration continues to pretend that its budgetary cows are sacred when everybody else's are going to be made into hamburger, I don't believe markets will accept that the fundamental factors really have changed. In that case, the markets will wait until the U.S. economy has run out of gas before letting the dollar drop of its own accord. While the dollar dropped a noticeable 6 percent by October 1, it didn't move much in the next month on a trade-weighted basis.

To conclude, I welcome the change in intervention policy as a refreshing switch from dogmatism to pragmatism. But I fear it may be used as a temporary palliative to avoid more fundamental policy changes that could lead to a healthier trade picture. The evils of protectionism can be fought only with real weapons, not with mirrors.

NOTES

[1]Richard N. Cooper, "Growing American Interdependence; An Overview," prepared for a conference at the Federal Reserve Bank of St. Louis, October 11-12, 1985.

[2]Lois Stekler and Peter Isard, "U.S. International Capital Flows and the Dollar: Recent Developments and Concerns," Board of Governors of the Federal Reserve System, April 11, 1985.

[3]Data on average hourly wages w_i and exports as a percent of shipments x_i for 20 industries yields a regression of $w_i = 5.86 + 0.175\ x_i$ with an elasticity of 0.267 at the mean. Data from 1981 *Annual Survey of Manufactures* (Washington D.C.: U.S. Government Printing Office).

[4]Data on import penetration m_i and average hourly wages w_i yields a regression of $w_i = 9.31 - 0.1334\ m_i$ with an elasticity of −0.1647 at the mean. Import penetration data from William R. Cline, *Exports of Manufactures from Developing Countries* (Washington D.C.: The Brookings Institution, 1984), Table A-5.