CHAPTER 8

The United States in the World Economy

AMERICA HAS LONG LED THE WORLD in championing open trade and competition. The result has been an unprecedented period of worldwide growth in incomes and trade. The expansion of international trade that supported postwar growth in incomes has been accompanied by dramatic transformations in the economies of the United States and other countries. In 1960, trade—exports plus imports—was equivalent to just 9 percent of U.S. gross domestic product (GDP); that figure is now 23 percent. Twelve million American workers now owe their jobs to exports, and the opportunities for global sales represent a critical part of firms' investment, research and development, and hiring decisions. The importance of exports to the U.S. economy has been strikingly apparent in the last 3 years; U.S. exports of goods and services have grown by 20 percent, accounting for about one-third of real GDP growth.

Not only the size but also the geography of the international market has changed since the 1950s. Developing countries that adopted market-oriented policies grew significantly faster than those that clung to closed markets and statist policies. Now many of these successful emerging economies have become major markets. Whereas in 1970, 29 percent of U.S. exports went to developing countries, in 1995 these same countries absorbed 41 percent of U.S. exports. These will be the major growth markets into the next century and will generate huge demands for capital goods, infrastructure, and an increasing variety of consumer goods.

But a high-income, highly competitive economy poses challenges as well as opportunities. Technological change, business reorganization, and international competition have at times required painful adjustments of workers and firms. Critics of international trade often point to the trade deficit, "lost" domestic production due to imports, or expanding income differentials as evidence that foreign trade and investment are harmful to the United States.

Americans have legitimate concerns about job security and standards of living, and the Administration is strongly committed to fostering better jobs and greater economic security. But neither job security nor future income growth will be enhanced by closing the American economy to foreign competition. As the 21st century approaches, the Administration firmly believes that economic isolation would lead only to economic decline, and that the most promising way forward is to rise to the challenges of the international market. We can and must compete, not retreat, in the face of global competition.

The Administration has pursued an aggressive trade policy to open markets abroad. Despite historic reductions in trade barriers and the striking growth in U.S. exports, many countries still maintain formal trade barriers, or more subtle administrative or collusive barriers, that prevent other nations' firms from competing on an equal basis. This Administration has insisted that other countries live up to their obligations under international and bilateral agreements and has attacked remaining barriers that discriminate against U.S. exports.

This chapter explains why outward-looking, competitive policies remain the best choice for America and examines the Administration's record in promoting open competition across the globe. Special attention is given to the role of trade policy and to the proper measure of its success. This chapter also discusses the causes and consequences of the trade deficit and effective policy for reducing it.

THE BENEFITS OF OUTWARD-LOOKING, MARKET-OPENING POLICIES

Open, competitive trade promotes the economic welfare of all countries that engage in it, and does so in four ways. It secures the benefits of national comparative advantage, allowing each trading economy to devote more of its resources to producing those goods and services that it can produce most efficiently. It sharpens domestic competitive pressures, spurring productivity gains. It quickens the flow of technology and ideas, allowing countries to learn from each other. And it broadens the variety of inputs available to producers and final goods available to consumers, boosting efficiency and standards of living.

Nations that engage in trade benefit from the logic of comparative advantage, as each imports those goods that are produced more cheaply abroad, and exports those goods that are produced more cheaply at home. Box 8–1 offers a simple example that illustrates this traditional argument favoring free trade. Critics argue, however, that many industries of increasing importance in the world economy (including many high-technology industries) are characterized by economies of scale in production, and that these scale economies undermine the simple comparative advantage argument. But although economies of scale do complicate the story, they do not invalidate the principle of comparative advantage or lessen its importance, as Box 8–2 explains. Now more than ever, unimpeded access to a world market is crucial.

Box 8–1.—Comparative Advantage and Living Standards

The classic argument for free trade is based on the principle of comparative advantage. Suppose U.S. workers are much better at producing computer software and somewhat better at producing shoes than workers in Thailand. Comparative advantage states that trade between the two countries—with the United States exporting software and Thailand exporting shoes—can still boost living standards in both.

A simple analogy may help illustrate this abstract and seemingly implausible intuition. Imagine a lawyer who happens to be a very good typist—so good that she is somewhat faster than her secretary. Even though the lawyer is better than her secretary at both practicing law and typing, it makes sense for her to spend all her time on the law and leave the typing to her secretary. A greater combined total of lawyering and typing will get done in the same amount of time than if each did some or all of the other's work, and the incomes of both workers will be greater than they would otherwise.

Similarly, by allowing countries to focus their resources on what they do *relatively* well, international trade boosts living standards. Especially when an economy is near full employment, the primary impact of trade is on the allocation of jobs among industries rather than the overall number of jobs. Trade allows employment to be shifted into relatively more productive, better jobs. This effect is manifest in U.S. wage data: jobs in the United States supported by goods exports pay 13 percent more than the national average. This is not surprising, given that U.S. comparative advantage lies in highly specialized manufacturing and service activities, not in low-skill, low-wage sectors. Comparative advantage in high-skill industries, however, appears to provide only a partial explanation for the higher wages paid in export jobs. Even after plant size, location, industry, and skill category are controlled for, exporting plants seem to pay higher wages than nonexporting plants.

The second argument in favor of open competition is that exposure to the challenges of the international marketplace strengthens competitive pressures in the domestic economy, stimulating efficiency and growth. An open trade regime effectively increases the number of both actual and potential competitors in the domestic market by including those located beyond the Nation's borders. This encourages domestic producers to innovate and become more

Box 8–2.—The New Trade Theory

Over the past 15 years, economists have formalized new models of international trade that offer theoretical justifications for protectionism. These models, often referred to collectively as the "new trade theory," have prompted a reexamination of the costs and benefits of open trade.

The new trade theory assumes that certain industries enjoy increasing returns to scale or generate positive spillover benefits to society as a whole, for which the industry is not compensated. Increasing returns actually *raise* the gains from trade: they make it even more efficient to sell to a global market. But in some cases, unilateral protection can raise social welfare. Under the right conditions, for example, temporary protection can secure a permanent cost advantage for a domestic firm by discouraging foreign producers from entering the market. If the monopoly rents that then accrue to the domestic firm are large enough to offset the costs of capturing them, the nation as a whole benefits.

These sophisticated arguments for protectionism do not necessarily invalidate the case for free trade. Even with scale economies, if all countries adopt protectionist policies in the hope of making their national champion the global monopolist, the costs will be even higher than in the absence of increasing returns. With access to foreign markets blocked, all hope of any firm exploiting the increasing scale returns is lost; the traditional losses from protectionism (arising from ignoring comparative advantage) are then compounded by the failure to produce at efficient scale. In a sense, therefore, protectionism is even more costly with increasing returns than without them.

But perhaps the greatest challenge in the new trade theory sweepstakes is targeting only those industries and firms that best meet the theory's narrow conditions. In practice, selection would be complicated by political pressures from special interests, who are likely to exaggerate the positive spillovers their industries contribute. And the costs of an erroneous choice may prove counterproductive: granting protection in inappropriate cases may outweigh the benefits of granting it in appropriate ones. In sum, the new trade theories provide a possible theoretical justification for protectionist policies in some limited cases. But practical considerations suggest that the potential gains, if any, are likely to be small.

competitive. Consumers, both at home and abroad, reap the benefits.

A third, related argument is that access to international markets stimulates the flow of information across borders. Domestic firms engaged in international competition assimilate new ideas about production methods, product design, organizational structure, and marketing strategy, allowing them to employ their resources more efficiently. Open competition thus boosts productivity.

Finally, trade expands the menu of goods and services available to both producers and consumers. Firms gain access to a wider variety of inputs, and consumers get to choose from a broader assortment of final goods and services. By expanding the choices available to all, trade boosts efficiency and improves living standards.

One can also gauge the benefits of open markets by assessing the cost of the alternative, namely, protectionism. It is impossible to protect all industries; protecting some inevitably distorts market signals and imposes higher costs on other industries and on domestic consumers. For example, extending protection to the steel industry imposes a cost on automobile manufacturers, who pay more for steel, and on consumers, who pay more for a new car than they would if steel were available at the lower world price. Because the impact of such restrictions is both indirect and spread over a large number of consumers, the total cost may be difficult to discern. But it is nevertheless quite real, and it is likely to grow over time. By raising the relative price of the protected sectors' output, and thus drawing capital and labor into those sectors and away from others, protectionist policies prevent the most efficient long-run use of an economy's resources. These distortions may be particularly harmful when restrictions are imposed on inputs used by industries that are characterized by economies of scale in production (that is, by lower average costs per unit at higher levels of output; Box 8–2).

Finally, every protectionist action invites retaliatory reaction. The costs of a tit-for-tat escalation are so high that in the long run all countries are likely to lose from the adoption of restrictive policies. The experience of the 1930s provides a grim demonstration: the major industrial countries responded to the onset of the Great Depression by raising trade barriers against each other, which provoked retaliation in kind and succeeded only in weakening their economies still further. A better strategy is for all to strive for a regime of open and fair competition, rather than to focus on any possible (and in any case usually illusory) short-term gains from protection.

Many of the same advantages that accrue from an open trade regime also accrue from international investment flows. Inward flows of foreign direct investment can boost efficiency and cross-border learning. Direct investment in the opposite direction—that by domestic firms in countries overseas—also promotes such learning and is closely linked to export expansion: approximately three-fifths of U.S. exports are sold by U.S. firms with operations abroad, and several recent studies have confirmed that foreign direct investment is more likely to increase trade than reduce it.

THE EVIDENCE ON OPEN ECONOMIES

Trade affects growth through various channels, but the cause-and-effect relationship is difficult to establish in practice: even if expanded trade is statistically associated with growth in income, does the expansion in trade *cause* the expansion in income, or vice versa? There can be no definitive answer, but careful studies generally conclude that trade liberalization establishes powerful direct linkages between the domestic and the world economy, unencumbering the flow of ideas and technology across borders, bolstering competitive pressures.

A recent economic analysis, which controlled for other national characteristics such as education, starting income, and political instability, found that the open economies in a sample of 79 countries grew by an average of 2.5 percentage points more per year (over a 20-year period) than did the closed economies. A comprehensive study of productivity across manufacturing industries in Germany, Japan, and the United States recently concluded that trade restrictions generally hurt productivity by reducing competitive pressures; productivity growth is the single most important factor underlying sustained increases in income. Other studies have found that protection of industries that produce intermediate inputs reduces growth. For example, one recent study found that, across a sample of over 70 countries, a 10-percentage-point increase in the tariffs on capital goods and intermediate products was associated with a decline in real growth of GDP per capita of 0.2 percentage point per year. For the United States, such a reduction in growth over the 10-year period through 1994 would have lowered GDP per capita by $500 from its actual 1994 level of $26,558.

Even when trade restrictions are used to curtail unfair foreign competition, they can still impose costs on consumers. The U.S. antidumping and countervailing duty laws, for example, are intended to offset the effects of unfair foreign competition: antidumping laws seek to counter unfair pricing by foreign firms, while countervailing duties seek to compensate for the anticompetitive effects of foreign government subsidies. The concern is a legitimate one: U.S. living standards could be diminished by certain types of predatory foreign behavior. But many analysts believe that many of the cases filed under these statutes have little to do with preventing unfair competition, and the duties make consumers and domestic businesses pay higher prices for imported goods and inputs. In any case, a recent study found that the net cost of the 163 antidumping duty orders and 76 countervailing duty orders in place in the United States in 1991 was $1.6 billion.

TRADE AND WAGE INEQUALITY

Over the past 15 years the real earnings of low-skilled U.S. workers have fallen sharply while those of highly skilled workers have risen: between 1980 and 1994, real average annual earnings for high school dropouts aged 25 to 34 fell by 18 percent, while those for college graduates rose by over 3 percent. Over the same period, imports have risen as a percentage of GDP. Are these two trends related? Is increased trade hurting low-skilled workers, and if so, is this an argument for protectionism?

In theory, increased trade could worsen inequalities in wages even while raising aggregate income. The U.S. economy has a relative abundance of skilled labor, and so U.S. comparative advantage is in producing skill-intensive goods. Traditional models of trade therefore suggest that the United States would tend to export goods requiring relatively large amounts of skilled labor and import goods requiring relatively large amounts of unskilled labor. International trade would in effect increase the supply of unskilled labor to the U.S. economy, lowering the wages of unskilled American workers relative to those of skilled workers, thus aggravating wage inequality.

Economic theory does not, however (except under extremely restrictive assumptions), tell us how great the resulting gap in wages will be. Moreover, careful examination of the channels through which trade should affect wages suggests that other factors bear a larger responsibility for the widening of wage differentials. Foreign workers do not compete with American workers directly, but rather through the products that they produce and sell. The argument that imports drive down wages for unskilled labor is predicated on a relationship between the relative prices of goods and the prices of inputs used to produce them. If competition from developing countries lowers the prices of goods requiring unskilled labor as their major input, the wages of unskilled workers will be driven down, widening income disparities. The problem with this argument is that there has been no such change in relative goods prices: over the 1980s the average relative price of goods that require substantial inputs of unskilled labor actually increased.

If trade, or factors such as immigration that affect the relative supply of workers, were the predominant cause of wage disparities, one would expect to see domestic producers taking advantage of the lower cost of unskilled workers by using more of them. Yet just the opposite has occurred. In almost all industries, employment of skilled workers has increased relative to that of unskilled workers, despite the higher cost of skilled workers. This suggests that factors affecting the demand for different kinds of workers, such as technological changes that have increased the demand for skilled workers, have been the more powerful force in influencing relative wages.

Yet even if the effect is small, trade may indeed have some adverse impact on wage inequality. In many ways the effects of trade are similar to those of technological advance: both raise national income but can worsen inequality. Yet just as a neo-Luddite crusade against technology is not the solution to increased inequality due to technological progress, neither is protectionism the answer to wage inequality resulting from expanded trade. Several recent studies show that protection can impose costs on the economy that far outweigh the targeted benefits. Moreover, import protection cannot promise continuing reductions in inequality over time. At best, a strategy of import protection would narrow the wage gap temporarily at the risk of slowing the rate of productivity and income growth generally.

Ultimately, the only lasting solution to the increase in wage inequality that results from increased trade is the same as that for wage inequality arising from any other source: better education and increased training, to allow low-income workers to take advantage of the technological changes that raise productivity. In addition, programs such as the earned income tax credit and the minimum wage can be effective in raising the after-tax wages of low-income workers.

U.S. TRADE POLICY IN THE 1990s

Governments play a decisive role in determining the rules of competition in international markets. Just as governments must be responsible for regulating domestic markets, they must also be responsible for the rules that govern international trade and investment. This is a responsibility that cannot be shirked—even the absence of a formal trade policy is itself a policy. The objective is therefore to structure government involvement so as to help, not hurt economic performance.

The United States has led international efforts to liberalize world trade and investment, and this Administration has actively sought to eliminate foreign market barriers to U.S. exports. Regardless of their effects on the overall trade balance, these market-opening policies raise U.S. incomes by securing the gains from international trade. As already noted, the expansion of market opportunities is especially important in industries characterized by economies of scale (e.g., those with high fixed costs). The opportunity to sell in a larger market allows these fixed costs to be spread over a larger number of units, reducing average cost.

Opening up markets to U.S. exports also increases world demand for our products by removing artificial barriers to their consumption by foreigners. Stronger demand raises the prices that our products command on world markets, and so improves our terms of trade with the rest of the world. The terms of trade (defined as the ratio of the average price of our exports to that of our imports) affects U.S. real incomes. An increase in the terms of trade means that, for any given volume of exports, Americans can purchase more foreign goods. Even a small change in the terms of trade can have a huge effect: a 1 percent rise in the terms of trade corresponds to a real increase in income of more than $7 billion.

Open markets benefit all participants in international trade, even those whose own national markets are closed to foreign competition. Open markets are a public good, the benefits of which are available to all. As with any public good, countries have some incentive to "free ride"—to seize a share of the benefits without assuming any of the costs (the case of trade may be special, however, in that every country may have an incentive to adopt open trade policies regardless of what other countries do). The negotiators in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) recognized the importance of ensuring every nation's participation in lowering trade barriers: in almost all respects, membership in the new World Trade Organization (WTO), created under the 1994 Uruguay Round agreement, requires adherence to all of its rules. Indeed this is one of the reasons why the Administration strongly supported the Uruguay Round agreement.

Even those nations that have adopted the general rules of the trading system often come under pressure to intervene in particular instances—to protect industries going through difficult adjustments to foreign competition, to skew the rules in favor of domestic companies, or to try to influence foreigners to purchase from domestic firms. An aggressive policy to protect American interests from such practices abroad helps ensure that U.S. firms do not lose out, and that foreign governments are less inclined to try to bend the rules. The strengthened dispute settlement process within the WTO, together with the United States' own Section 301 legislation, which addresses unfair or unjustified foreign practices, are the most important tools that the United States uses to enforce our rights in the trade and investment arenas.

THE ADMINISTRATION'S TRADE STRATEGY

This Administration has embraced an outward-oriented, protrade, progrowth economic strategy. In its first 3 years in office, this Administration has concluded over 200 trade agreements and done more to promote trade and open markets abroad than any previous Administration (Box 8–3). We are using all the tools available to us—multilateral, regional, and bilateral—to advance our protrade agenda. This multilevel approach to trade policy has become particularly important as the nontraditional aspects of trade policy have assumed increasing importance (Box 8–4), and as global trade patterns have shifted toward emerging markets. Recognizing that success is measured not by the number of agreements signed, but by concrete results, the Administration has taken great pains not only to reach mutually beneficial agreements with our trading partners, but also to follow through in implementing, monitoring, and enforcing those agreements.

In assessing the results of the Administration's trade policies to date, it is important to recognize what trade policy can and cannot do. Trade policy can raise U.S. income and productivity, but it cannot significantly affect the overall trade balance. That is determined by domestic saving and investment and by government fiscal policy. Although the overall trade *balance* may not change, trade policy can alter the composition (both the sectoral breakdown of products traded and the shares of individual trading partners) and the overall *level* of trade. But U.S. trade policy should not be judged by whether our trade is in balance in any particular product or with any particular country. Even if our overall trade were balanced, there is simply no reason to expect (or desire) that our imports of cabbages or computers will match our exports of cabbages or computers, or that our sales to Japan or Zambia will cancel out our purchases from those countries, in any given year or even over an extended period. As we have already seen, it is precisely the ability to specialize, to concentrate on what we produce most efficiently, and to sell it in those markets that offer the highest returns, that is the fundamental source of the gains from international trade.

Multilateral Initiatives

The Uruguay Round trade agreement was signed in April 1994. The agreement went into force on January 1, 1995, with some provisions phased in over a 10-year period. The 1995 *Economic Report of the President* describes the agreement in detail.

Over nearly five decades, a series of GATT negotiating rounds has developed basic principles for the international trading system, which have guided trade negotiations in other spheres and have informed (and been informed by) U.S. trade policy. These principles include nondiscrimination, transparency, and reciprocity. Nondiscrimination is defined by two precepts: the most-favored-nation (MFN) precept requires that the most favorable concessions that a country gives to any trade partner be applied to all its trade part-

Box 8–3.—The Administration's Trade Achievements

Over the last 3 years the Administration has:

- Brought the Uruguay Round of multilateral trade negotiations to a successful close after 7 years. The Uruguay Round agreement cuts global tariffs by an average of 40 percent and extends international trade rules to agriculture, services, and intellectual property rights. The United States will eventually gain an estimated additional $100 billion to $200 billion in income per year from the agreement.
- Through the North American Free Trade Agreement (NAFTA), created a free-trade area encompassing our largest and third-largest trading partners. NAFTA has helped maintain and indeed increase U.S. exports to Mexico despite a financial crisis and recession there.
- Reached agreement with 33 other countries—including some of the world's biggest emerging markets—to seek a Free Trade Area of the Americas by 2005. Trade with countries in the hemisphere already accounts for roughly 40 percent of U.S. exports.
- Articulated a vision for achieving free trade and investment by 2020 in the fastest-growing region of the world: the Asia-Pacific. At the 1995 Asia-Pacific Economic Cooperation summit in Osaka, Japan, the leaders of the 18 member countries detailed the steps they will take to make this vision a reality.
- Negotiated 20 bilateral trade agreements with Japan. In those goods sectors covered by these agreements for which precise data are available, U.S. exports to Japan have grown nearly 80 percent since this Administration took office.
- Established a National Export Strategy under the leadership of the Trade Promotion Coordinating Committee, which for the first time coordinates the Federal Government's efforts to assist U.S. exporters through advocacy, export financing, and business counseling.
- Promoted macroeconomic and trade policies that have contributed to strong export growth. Exports of goods and services have grown 20 percent in real terms since the Administration took office.

Box 8–4.—Trade and Intellectual Property Rights

A major nontariff barrier to U.S. exports is the lack of adequate protection for intellectual property rights (IPR) in certain countries. The nature of intellectual property has always made it vulnerable to piracy: theft of intellectual property costs U.S. exporters billions of dollars in lost sales and royalties annually. Many of the top U.S. export earners—including copyrighted products such as films, sound recordings, and computer software, and patented products such as new pharmaceuticals—are among the most vulnerable. Piracy not only reduces U.S. export earnings but also discourages the development of new products by lowering the returns to innovation. Efforts to establish strong IPR protection abroad have therefore been an essential element of this Administration's trade policy, advanced through multilateral, regional, and bilateral mechanisms.

The Uruguay Round Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) makes significant progress in securing stronger protection for IPR worldwide. It is the first international agreement to protect a full range of intellectual property and to provide for the establishment of the legal and judicial structures needed to enforce IPR protection. The TRIPs agreement requires all WTO members to set improved rules for the protection of copyrights, integrated circuits, patents, trademarks, trade secrets, and designs. The new rules will then be subject to the WTO's improved dispute settlement system.

ners; national treatment requires that a country's laws and regulations treat foreign products no differently from domestic products. Transparency ensures that the rules governing trade are explicit and that due process is followed in applying them, and reciprocity refers to the balancing of concessions from different countries. In addition, the GATT process has endorsed the use of safeguards—escape clauses and other forms of temporary relief from import surges—to protect against job dislocation during transitions.

The Uruguay Round agreement called for negotiations in three service sectors to be extended beyond the Round's conclusion: financial services, telecommunications, and maritime transport. The WTO's major negotiating effort in 1995 focused on the first of these. As the extended negotiating period for financial services drew to a close, the United States concluded that many offers—especially those from several emerging economies—provided inadequate new market access or did not formally protect even existing market access. The United States therefore announced that it would take an MFN exemption (that is, that it would not apply MFN treatment to all WTO members), allowing the United States to grant differential market access for new entrants and the new activities of foreign financial services suppliers. The United States also indicated that, while reserving its legal right to do so, it had no intention of imposing new restrictions on foreign firms. The participants in the negotiations nonetheless reached an interim agreement on July 28, to be reconsidered by the end of 1997. The United States is a party to the agreement and is entitled to all the commitments made by all participants.

WTO negotiations on telecommunications liberalization were initiated at the meeting of trade ministers of the WTO member countries in Marrakesh in April 1994. The talks are scheduled to conclude by April 30, 1996. As of January 1996 there were 48 WTO members participating, 33 of which had submitted offers detailing the liberalization they are prepared to undertake. The telecommunications negotiations are taking place at a critical point in the evolution of the global telecommunications industry. As Chapter 6 has described, the telecommunications sector was long considered a natural monopoly and has been heavily regulated or state owned in most countries. In recent years, however, technological change has greatly increased the scope for entry and competition. At the same time, systems of regulation and public ownership that were designed to protect consumers have in many cases become obstacles to competition and further progress, from both domestic and foreign firms. Thus deregulation and trade liberalization are closely intertwined, and the outcome of the trade negotiations depends on legislative reform in the major participating countries.

The goals of the United States in these negotiations are to ensure market access and national treatment for U.S. telecommunications firms abroad and to secure agreement on procompetitive regulatory principles in the participating countries. Competition in this sector requires that all entrants be able to connect to existing networks on equal terms. It also requires safeguards to ensure competition and the independence of regulators from the operating companies they oversee. The United States has indicated that if there is a critical mass of high-quality offers from industrial and developing countries, it will be willing to lift restrictions on foreign ownership in the U.S. telecommunications industry and to guarantee national treatment for foreign firms operating in the United States. However, if offers of sufficient quality are not forthcoming, the United States has reserved the right to amend or withdraw its existing offer or to take an exemption to the MFN requirement, as it did in financial services.

Regional Initiatives

The Administration has promoted the creation of regional trade agreements as stepping stones toward global free trade. The Administration has set ambitious goals for free trade in the two most dynamic markets of the world: the Asia-Pacific and Latin America. The combination of rapid growth and unprecedented liberalization is likely to make export and investment opportunities in these markets a key engine of growth for the U.S. economy over the next decade, and developing countries already account for over 40 percent of U.S. exports.

Regional initiatives founded on the principles of openness and inclusivity serve to strengthen the multilateral trading system. The principle of inclusivity encourages members of a regional agreement to pursue additional liberalization with nonmembers, including possible accession to the agreement. Regional free-trade agreements that do not raise external barriers and that welcome new members can set off a virtuous cycle of liberalization. As the market encompassed by a free-trade area expands and becomes increasingly dynamic, other countries become more interested in joining.

The GATT has always recognized the "desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties [sic] to such agreements" (Article XXIV), as long as such agreements do not result in an increase in the parties' external barriers. This restriction helps to ensure that preferential regional agreements create more trade among the participants (and others) than they divert from nonparticipants. In general, cheaper imports improve the well-being of the member countries and create trade. But regional liberalization *may* reduce trade with nonmember countries, since imports from such countries do not benefit from the reduction of trade barriers. Trade diversion arises when countries within a regional agreement switch from importing goods from the lowest-cost nonmember to importing from other members. Minimizing such distortionary trade diversion is a key objective in well-designed regional agreements.

Regional agreements often achieve deeper and broader economic integration than multilateral agreements because, as neighbors, members have substantial interests in common. Such agreements therefore often become models for future multilateral liberalization in new areas such as services, investment, and environmental and labor standards. The expansion of regional free-trade areas has also encouraged nations to find more common ground in multilateral negotiations. The U.S. regional initiatives in North America and the Asia-Pacific, for example, were an impetus for the successful conclusion of the Uruguay Round.

The North American Free Trade Agreement. NAFTA liberalizes trade with our two closest neighbors—who are also our largest and third-largest trade partners—over a period of 10 to 15 years. The impact of NAFTA on bilateral trade flows is difficult to isolate because Mexico experienced a severe financial crisis during 1995 (Box 8–5). In NAFTA's first year U.S. merchandise exports to Mexico and Canada grew by 16 percent—over twice as fast as U.S. exports to the rest of the world. Although U.S. exports to Mexico fell as Mexico entered recession, they remained higher during 1995 than they had been in 1993, before NAFTA. And despite the recession Mexico continued to honor its commitments to the United States, cutting tariffs on U.S. products in accordance with NAFTA's provisions—even as it increased tariffs on many goods from non-NAFTA partners by 15 percentage points. In part because of this, the U.S. share of Mexico's imports has grown from 69 percent in the first 9 months of 1994 to 74 percent over the same period in 1995. The performance of U.S. exports to Mexico in 1995 stands in sharp contrast to what happened after the previous Mexican financial crisis, in 1982, when the Mexican Government imposed 100 percent duties and import permit requirements on products from the United States and other countries. U.S. exports to Mexico were cut in half during that episode, and it took 6 years for U.S. exporters to recover their pre-1982 position. In contrast, U.S. exports to Mexico during the current episode fell by less than 10 percent and remain higher than before NAFTA.

In some instances, expanded trade with Mexico and Canada has displaced workers in the United States. Consequently, the President made it a priority to include a strong transitional program of trade adjustment assistance as part of the legislation implementing NAFTA. This program provides support to displaced workers in industries experiencing large increases in imports from, or whose plants have relocated to, Mexico or Canada, regardless of whether the job losses are directly related to NAFTA. In addition, the Department of Commerce's Economic Development Administration, through its Trade Adjustment Assistance program (which predates NAFTA), has provided assistance to a significant number of firms adversely affected by increased imports from Mexico and Canada.

NAFTA will serve both as a model for future multilateral liberalization in areas such as investment and as a vehicle for further regional liberalization. The Administration is committed to conducting negotiations with Chile on accession to NAFTA. Since Chile's population is only about one-seventh the size of Mexico's, the economic impact on the United States from Chile's accession is likely to be comparatively small. But Chile's accession will provide opportunities for American businesses to expand operations in this fast-growing market (which has grown by 7 percent per year on average

Box 8–5.—Mexico's Financial Stabilization

In December 1994 Mexico faced a balance of payments crisis. Investors lost confidence in Mexico's ability to maintain the exchange rate of the peso within its trading band, in part because of Mexico's large current account deficit, which had reached almost 8 percent of GDP in 1994. Intense pressure on the peso in foreign exchange markets threatened to exhaust Mexico's international reserves, compelling the Mexican Government to float the peso.

The President responded swiftly to Mexico's crisis, leading a $50 billion multilateral effort to assist in Mexico's stabilization and making available $20 billion in U.S. credit. This effort helped attenuate the impact of the crisis on other emerging markets. At the same time, the newly inaugurated Mexican President took the difficult steps essential to restoring stability and growth in Mexico. Government spending was cut, resulting in a budget surplus of 1.5 percent of GDP in the first three quarters of 1995. The Mexican Government also implemented a tight monetary policy, and because a lack of timely information was seen as having contributed to the crisis, Mexico took steps to make key financial and economic data more transparent and more widely available to investors.

Together these measures have begun to work, setting the stage for a return to growth. Nearly all of the $29 billion stock of *tesobonos*—short-term, dollar-denominated government debt—has been retired. Mexico's international reserves have risen from $6 billion at the beginning of 1995 to $16 billion at year's end. Monthly inflation has fallen to 2 to 3 percent from a high of 8 percent. As of mid-January 1996 the peso had stabilized, after an additional sharp decline in November, and the stock market had staged a partial recovery. Interest rates have declined from over 80 percent at the height of the crisis to below 40 percent. In addition, Mexico appears to have largely regained access to the international capital markets after only 7 months—far less than the 7 years it took Mexico to regain the trust of foreign investors after the debt crisis of 1982.

The financial crisis engendered a severe recession in Mexico, leading to a contraction of 7 percent in the first three quarters of 1995. But U.S. support, Mexico's tough stabilization policies, and the strong economic foundation that had been laid by the preceding 7 years of structural reform in Mexico should accelerate a return to sustainable growth.

since 1988), help encourage sound economic policies in the region, and serve as an important step on the road to creating a Free Trade Area of the Americas.

The Free Trade Area of the Americas (FTAA). In December 1994 in Miami, leaders from 33 Western Hemisphere countries joined with the President in embracing the goal of achieving free trade in the Western Hemisphere by 2005. Even though the FTAA will take years to achieve, by securing a commitment to work toward a hemispheric free-trade area now, hemispheric leaders set a high standard for the region, ensuring that subregional trade agreements will evolve in a manner consistent with the FTAA and the multilateral system.

The United States should reap significant benefits from establishment of the FTAA. It will create a market of over 850 million consumers with a combined income of roughly $13 trillion. Latin America is one of the fastest-growing regions in the world. Total exports of countries in the hemisphere grew nearly 17 percent on a year-over-year basis in the first half of 1995. Import growth was also strong at over 18 percent. Total trade flows in the hemisphere are estimated to have reached over $2 trillion in 1995. The FTAA will also level the playing field for U.S. exporters, reducing Latin American trade barriers that are currently three times higher on average than U.S. barriers. The increase in growth and improved access to new ideas that freer trade will bring should also promote U.S. goals of development and democracy in the region.

Trade ministers from throughout the hemisphere met in Denver in June 1995 to lay out a road map for achieving the leaders' vision of regional free trade. They agreed that trade liberalization should be consistent with WTO principles and comprehensive in scope. The Denver Ministerial established working groups in seven important areas: tariffs and nontariff barriers, customs procedures and rules of origin, investment, standards and technical barriers, sanitary and phytosanitary measures, antidumping and countervailing duties, and smaller economies. Each working group is responsible for compiling an inventory of regulations and regimes in its assigned area and undertaking a variety of other projects to prepare the foundations for the negotiated dismantling of trade and investment barriers. In March, trade ministers will meet again in Cartagena, Colombia. At the Cartagena Ministerial four additional working groups will be established, covering government procurement, IPR, services, and competition policy.

Asia-Pacific Economic Cooperation (APEC). The 18 members of APEC include some of the largest and most dynamic economies in the world today. Indeed, APEC is a unique combination of some of the world's most important established markets and some of its most important emerging markets. With a combined population of

2.1 billion and $13 trillion in combined annual income (over half of world income), the members make up the largest consumer market in the world. More than 30 percent of global trade takes place between APEC countries. The Asia-Pacific region continues to grow at a faster pace than any other region in the world: in 1994 China grew by 12 percent in real terms, Singapore by 10 percent, and South Korea, Malaysia, and Thailand by more than 8 percent. Over the next decade the developing East Asian economies are projected to invest between $1.2 trillion and $1.5 trillion in infrastructure, generating enormous opportunities for sales of American goods and services. Already APEC accounts for over 60 percent of U.S. merchandise exports, and these exports have grown 35 percent since the beginning of the Administration. U.S. exports to the Asian countries of APEC have grown 55 percent since the beginning of this Administration.

APEC was formed in 1989 as an informal group of 12 nations focused on increasing economic cooperation in the region. Initially only the members' designated APEC ministers attended the group's meetings. In November 1993, however, the President hosted the first summit of the leaders of the APEC countries. At that meeting, held at Blake Island in Washington State, the Asia-Pacific leaders embraced the President's vision of a Pacific community based on shared strength, peace, and prosperity, as well as his determination to make APEC relevant to the everyday problems of businesses throughout the region. Having set their course in 1993, APEC leaders again met in Bogor, Indonesia, in 1994, where they made a momentous commitment. The Bogor Declaration set a goal of achieving free trade and investment between the member economies over the next 25 years. For the industrialized countries in APEC the benefits come even sooner: full implementation is scheduled to occur within 15 years.

This year at Osaka, Japan, the APEC leaders put in place a work program and a liberalization process to make the vision of freer and fairer trade a reality, and meanwhile to deliver some concrete measures of immediate value to business. The leaders adopted an Action Agenda for implementing free trade and investment in the region by 2020 (Box 8–6). The Action Agenda covers 15 broad areas for liberalization and sets out 135 specific actions that members should take to open their markets and reduce the costs of doing business. The agenda's broad scope covers market access issues such as tariffs, quotas, and services. It also includes new areas that are the source of some of the most pernicious market barriers in Asia, such as IPR protection and investment, and other issues of growing importance to the region such as competition policy and deregulation. In each of these areas the Action Agenda sets out key objectives, benchmarks, time frames, and specific actions. The principles embodied in the Action Agenda ensure that liberalization in each country will be comprehensive, covering all products, services, and investment, and require each country to achieve results that are balanced and comparable to those of other APEC members. In the coming months, each member will detail the specific steps it will take to begin implementing the Action Agenda, to be presented at the next meeting of the APEC leaders in Manila in 1996. Implementation could begin as early as January 1997—only 2 years after APEC leaders made the commitment to achieve free trade.

The Transatlantic Trade and Investment Initiative. The U.S.-European relationship is one of the oldest and most durable in international affairs. To further strengthen this partnership, the United States and the European Union initiated a Joint Action Plan at their Madrid summit in December 1995. The summit declaration included the commitment to foster a Transatlantic Marketplace. As part of this effort, the United States and the European Union have pledged to seek agreements on mutual recognition of testing data and standards certification, to cooperate and assist each other on customs procedures, to begin work on a comprehensive agreement on cooperation in science and technology, and to initiate a joint study on market barriers confronting transatlantic trade. The two sides will draw heavily on the advice of the private sector. Their cooperation will also extend to environmental and labor issues.

The OECD Multilateral Agreement on Investment. After 4 years of intensive work, the ministers of the member countries of the Organization for Economic Cooperation and Development (OECD) agreed in May 1995 to launch negotiations toward a multilateral agreement on investment. The aim is to conclude negotiations by 1997. At the negotiators' first meeting in September 1995, broad consensus was reached on ensuring a high standard of principles (including full national and MFN treatment of investment). Exceptions to such treatment will be limited in number and narrowly drawn. In future negotiations the United States hopes to establish international legal standards governing expropriation, freedom from performance requirements (such as the requirement that a foreign subsidiary's products contain at least a specified minimum local content, or that a specified minimum quantity be exported), guaranteed access to binding international arbitration of disputes between private investors and national governments, and the right to unrestricted investment-related transfers across borders. If these principles are adopted, the multilateral agreement on investment would establish a high standard for future work on investment issues in Asia.

Bilateral Initiatives

Disputes and negotiations between one country and another are inevitable in international trade relations. The United States ac-

Box 8–6.—The APEC Action Agenda

The Action Agenda details steps that APEC members will take to dismantle key trade barriers that currently impede foreign businesses. Examples include:

- *Tariffs:* According to one estimate, automobile sales to Indonesia, Malaysia, and Thailand combined could equal U.S. auto sales to Canada and Mexico combined by 2000. Under NAFTA, U.S. car exports to Canada face no tariffs; those to Mexico face a 10 percent tariff, which will be eliminated by 2003. But tariffs on U.S. car exports to Indonesia, Malaysia, and Thailand range between 30 and 60 percent. The Action Agenda stipulates that members will progressively lower these tariffs. Some members will start reducing tariffs as early as January 1997.
- *Air transport:* Demand for air transport services in Asia is projected to grow by 8.5 percent annually through the end of the decade. This is a key opportunity for U.S. carriers, whose costs per passenger-mile are half those of their Japanese competitors. Yet barriers are high. APEC has commissioned a group of experts to develop options to lower barriers to competition in this fast-growing market.

The Action Agenda also contains a variety of measures that will reduce the cost of doing business in the region:

- *Infrastructure database:* APEC is assembling an infrastructure opportunity database, which will provide information on the Internet—in English—on all government procurement open to foreign bidding. APEC has already launched a pilot home page on the World Wide Web that includes projects from Hong Kong, the United States, Japan, and Australia.
- *Customs harmonization:* APEC is working to promote uniform customs classifications and procedures and to establish common forms for manifests, travel documents, and the electronic transmission of business documents. Businesses can look forward to the day when a single customs form is accepted in all APEC countries.
- *Standards harmonization:* APEC is developing so-called mutual recognition agreements in toys and some food products, which will enable companies to sell their products throughout the APEC countries after a single laboratory test.

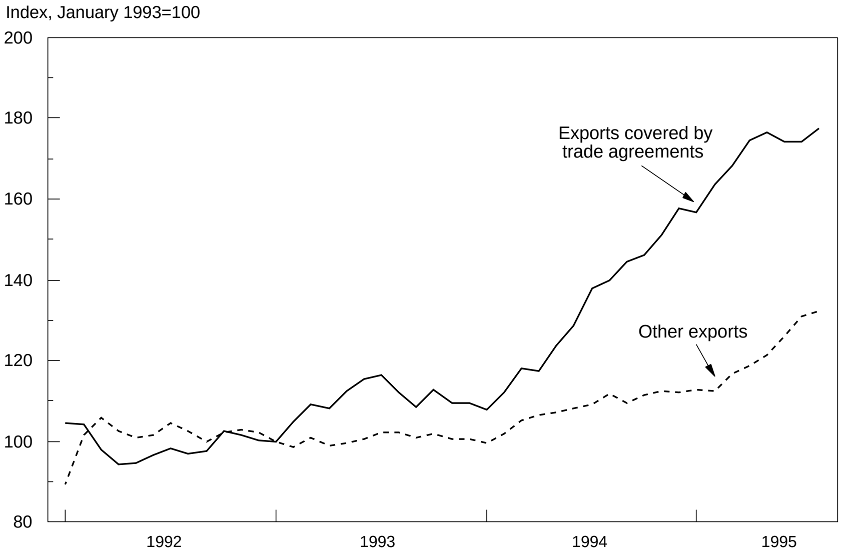
tively engages in bilateral consultations, negotiations, and dispute settlement procedures to defend U.S. commercial interests and to ensure that trade agreements are implemented, market access is expanded, and offending foreign practices are addressed. The focus of U.S. bilateral agreements is to open foreign markets to producers from all countries, not just those from the United States. These agreements are designed to support a more open, less distorted world trade regime. This Administration has also insisted on agreements that lead to tangible market opening, not simply agreements in form. The Administration's trade agreements specify qualitative and quantitative indicators of progress, agreed to by both countries, and the Administration has actively reviewed and monitored the agreements it has reached, comparing actual progress made against these indicators.

Japan. Japan remains among the most important of our economic partners. The Administration's goals in our relationship with Japan are to increase both access for and sales by non-Japanese firms in the Japanese market, to stimulate demand-led growth in the Japanese economy, and to raise standards of living in both Japan and the United States. To these ends, in 1993 the Administration signed the Framework for a New Economic Partnership with Japan. The Framework laid out macroeconomic goals and identified areas for sector-specific and structural negotiations. In the past year alone the Administration has signed new agreements under the Framework in automobiles and auto parts (discussed below), financial services, and investment. These agreements bring to 20 the number of trade agreements that the Administration has concluded with Japan.

The sectoral agreements with Japan are beginning to produce results. The Framework set up mechanisms, including qualitative and quantitative criteria, for both countries to use in reviewing the progress made on these agreements. Although it is still too early to judge the effects of the 1995 agreements, the results from the agreements concluded in 1993 and 1994 have generally been positive. By any measure, growth of U.S. exports to Japan has been striking, especially given that country's continuing economic stagnation. Overall U.S. exports to Japan were 20 percent higher in the period from January through November 1995 than in the previous year, and 47 percent higher than when the Administration took office. Growth of U.S. exports to Japan has been even stronger in those goods sectors covered by the Administration's trade agreements with Japan (Chart 8–1).

After 2 years of negotiations to open Japan's markets in automobiles and auto parts to U.S. and other foreign suppliers, an agreement was reached in the summer of 1995 to increase Japanese purchases of foreign automobiles and parts. Under the agree-

Chart 8-1 **Merchandise Exports to Japan**
Exports in goods sectors covered by Administration trade agreements with Japan have increased at a faster rate than other U.S. exports to Japan since 1993.



Note: Data are 6-month moving averages.
Sources: Department of Commerce and Council of Economic Advisers.

ment, Japan promised to improve foreign automakers' access to Japanese dealerships. U.S. industry expectations are for access to 1,000 new outlets and the annual export of 300,000 U.S.-made vehicles to Japan by 2000. Also in connection with the agreement, the Japanese Big Five automakers announced plans for their U.S. assembly plants that are expected to increase those plants' purchases of North American auto parts by $6.75 billion by 1998. Japan also agreed to deregulate the repair and replacement market for auto parts in Japan, which will make it much easier for foreign firms to sell auto parts in the Japanese aftermarket. Finally, the Japanese Government will increase the budget of the Japan Fair Trade Commission and consider U.S. suggestions for improved antitrust enforcement.

The two countries also signed an investment agreement in July 1995. Despite the abolition of most formal barriers to foreign direct investment in Japan, Japan has absorbed only 1 percent of world foreign direct investment—remarkably little for an economy that accounts for about 16 percent of world output. A tangible market presence is increasingly important for overseas sales in many industries, and for many service industries it is indispensable for conducting business. Efforts to facilitate foreign direct investment in Japan were therefore an important part of the Framework negotiations. Under the United States-Japan Investment Arrangement, Japan will review the few remaining restrictions on foreign investment, make foreign investors eligible for low-interest loans from the Japan Development Bank, and ensure that foreign-owned firms are eligible for government-funded employment programs. Japan has also pledged to make land available to foreign investors in designated foreign access zones, and the Keidanren (Japan's major business organization) has pledged to facilitate foreign contacts with its members.

China. China is an increasingly important player in the world economy. China's share of world trade has tripled since market reforms were launched in the late 1970s, making it the world's 10th-largest exporter. The Chinese economy has recently recorded some of the fastest growth rates in the world (12 percent in 1994 and roughly 10 percent in 1995). Already the world's most populous country, China may have the world's largest economy by early in the next century. U.S. exports to China continue to grow quickly, as incomes, and hence demand for high-quality U.S. goods, increase. This Administration is committed to encouraging further economic liberalization and to integrating China more fully into the world economy. Success at these efforts will support U.S. foreign policy objectives of democratization, economic reform, and development in China. Although great progress has been made on these fronts, there is still a long way to go.

China's accession to the WTO is an important goal for both the United States and China, with negotiations under way since 1988. The United States and other WTO members have stipulated that China must join the organization on commercial terms. Every country that has joined the GATT in the past has agreed to adhere to the basic principles of the multilateral trading regime, such as transparency of the trade regime and uniform application of trade rules. The United States is working with China to reach these world trade standards in a variety of forums, including bilateral trade initiatives on market access, protection of intellectual property, and services.

In February 1995 the United States reached a bilateral agreement with China on IPR protection. The new agreement lays out specific enforcement measures for China to undertake, and consultations between China and the United States have been occurring frequently to ensure that these measures are being carried out. In addition to creating a new enforcement structure, the agreement increases market access for U.S. audiovisual products, software, books, and periodicals by placing a ban on quotas and by allowing U.S. companies to set up joint ventures in several urban areas around the country.

Chinese pirating of U.S. software and audiovisual materials and infringements of U.S. trademarks and patents had become a concern to the United States as exports of pirated goods began turning up in Southeast Asia, Latin America, and even Canada and the United States. China has more than 29 factories with the capacity to produce 75 million compact discs annually—in a domestic market that, according to estimates, can absorb only 5 million. Under the new agreement, task forces have been set up to raid illegal retail and manufacturing establishments as well as to provide border control. As of the end of 1995, implementation of the agreement has been mixed. Although China has attacked piracy at the retail level, massive production, distribution, and export of pirated materials continue. In particular, China has yet to halt production of pirated CDs.

Korea. Although Korea is the fifth-largest manufacturer and a rapidly growing exporter of automobiles, a variety of barriers have effectively closed the Korean automobile market to imports. These barriers include onerous standards and certification procedures, limits on consumer financing and advertising by foreign firms, and excise and registration taxes that fall disproportionately on the medium-sized and larger models that U.S. automakers produce. Until recently, Koreans were required to report the automobiles that they owned on their income tax returns, and owners of foreign cars feared tax audits. These barriers, which help explain why the foreign share of Korea's automobile market is only 0.3 percent, were serious enough to warrant active consideration as a "priority foreign country practice" in the U.S. Super 301 process this past year.

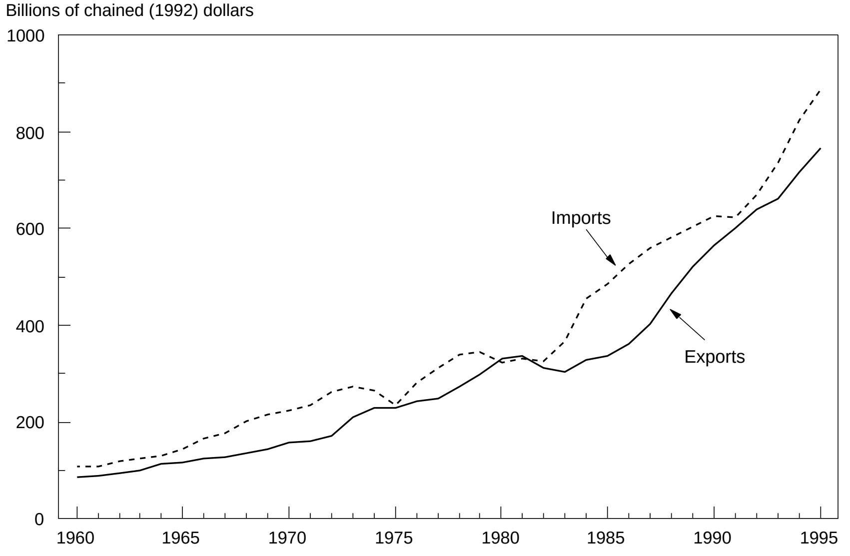
Negotiations led to the signing of a memorandum of understanding with Korea on September 27, 1995. The Korean Government agreed to reduce significantly the tax burden on larger automobiles and to affirm that foreign car ownership would not subject Koreans to tax audit or other harassment. In addition, Korea will substantially reduce the documentation required to secure safety approval and will allow testing for a new noise standard to be done outside Korea. Foreign firms will be able to establish or acquire automobile finance companies and will be given equal access to television advertising time.

Monitoring foreign practices. One of the principal objectives of U.S. trade policy has been the identification and elimination of unfair foreign trade barriers. The Administration has placed a high priority on enforcing U.S. trade agreements and on ensuring that other countries do not engage in practices that violate trade agreements they have signed with the United States. The U.S. Trade Representative, in close consultation with U.S. firms, its private sector advisory committees, and other interested parties, monitors the trade practices of other countries and their compliance with U.S. trade agreements and is responsible for addressing those practices identified as unfair.

MEASURING THE SUCCESS OF TRADE POLICY

The Administration's protrade policies have been associated with rapid export growth. Real exports of goods and services have grown by 20 percent since the first quarter of 1993 (Chart 8–2). Real export growth has risen: from 3.3 percent in 1993 to 8.3 percent in 1994 and 9.0 percent through the third quarter of 1995 (on a year-over-year basis). The United States is once again the largest merchandise exporter in the world, accounting for roughly 12 percent of global exports. Moreover, the U.S. share of industrial-country merchandise exports has grown to 18 percent, from 15 percent in 1986, and now exceeds the shares of Germany and Japan (at 15 and 14 percent, respectively).

Chart 8-2 **Export and Import Volumes**
Exports have grown vigorously in recent years, but, with imports also rising, the trade balance remains in deficit.



Note: Data are for goods and services; data for 1995 are estimates.
Sources: Department of Commerce and Council of Economic Advisers.

Although U.S. exporters are once again extremely competitive on world markets, the U.S. trade balance remains in deficit. The next section explains why the trade deficit is a misleading measure of the success of U.S. trade policies and the strength of the U.S. economy. Fundamentally, the trade deficit is caused by macroeconomic factors, not trade policy, which is capable of making only marginal changes in the overall deficit. Eliminating or substantially reducing the trade deficit will require macroeconomic policy measures, such as the elimination of the Federal budget deficit.

CAUSES AND CONSEQUENCES OF THE TRADE DEFICIT

International trade and competition make a vital contribution to the growth and well-being of the United States, and U.S. firms and workers have proved themselves successful in that competition. Yet despite the rapid growth of U.S. exports and export-related jobs, public commentary often focuses on the overall trade balance, which shows a large and seemingly intractable deficit. Many critics point to the trade deficit as evidence that the United States is not competing successfully and that international trade is detrimental to the health of the economy. Therefore, they argue, the United States should modify its longstanding policy of encouraging open markets and liberal trade.

This focus is unfortunate, because the trade balance is a deceptive indicator of the Nation's economic performance and of the benefit that the United States derives from trade. Trade policy is neither responsible for, nor capable of significantly changing, the overall trade balance. As noted above, trade policy can have a substantial impact on the sectoral and geographic composition of trade, but the aggregate trade balance is determined by larger macroeconomic factors. Persistent external deficits do entail costs, but effective policies to reduce these costs by narrowing the external deficit are beyond the realm of trade policy.

SOURCES OF THE U.S. TRADE DEFICIT

The trade balance is simply the difference between the value of goods and services sold by U.S. residents to foreigners and the value of goods and services that U.S. residents buy from foreigners. Most of what the United States produces (89 percent in 1995) is sold to residents of the United States; the rest is exported. And most of what the United States buys (88 percent in 1995) is produced here; the rest is imported. When we compare total production and total expenditure, those goods and services that we purchase from ourselves net out, and the difference is exports minus imports, or the trade balance. A trade deficit thus results when the Nation's expenditure exceeds its production.

Trade is by far the largest source of foreign income and foreign payments, but there are other external income flows: the main ones are interest and other investment earnings, aid grants, and transfers. Adding these other current flows to the trade balance produces the current account balance, which is the net income that the United States receives from the rest of the world. The current account balance thus represents the bottom line on the income statement of the United States. If it is positive, the United States is spending less than its total income and accumulating asset claims on the rest of the world. If it is negative, as it has been in most recent years, our expenditure exceeds our income, and we are borrowing from the rest of the world.

The net borrowing of the Nation can be expressed as the sum of the net borrowing by each of the principal sectors of the economy: government (Federal, State, and local), firms, and households. In other words, the current account deficit (CAD) is equal to the government's budget deficit (G − T, or net borrowing by the public sector) plus the difference between private sector investment and private sector saving (I − S, or net borrowing by the private sector):

$$\underset{\text{Government deficit}}{(G - T)} + (\underset{\text{Private investment}}{I} - \underset{\text{Private saving}}{S}) = \underset{\text{Current account deficit}}{CAD}$$

The crucial insight of this identity is that the current account deficit is a macroeconomic phenomenon: it reflects an imbalance between national saving and national investment. The fact that the relationship is an identity and always holds true also means that any effective policy to reduce the current account deficit must, in the end, narrow the gap between U.S. saving and U.S. investment.

Economic Performance and the Current Account

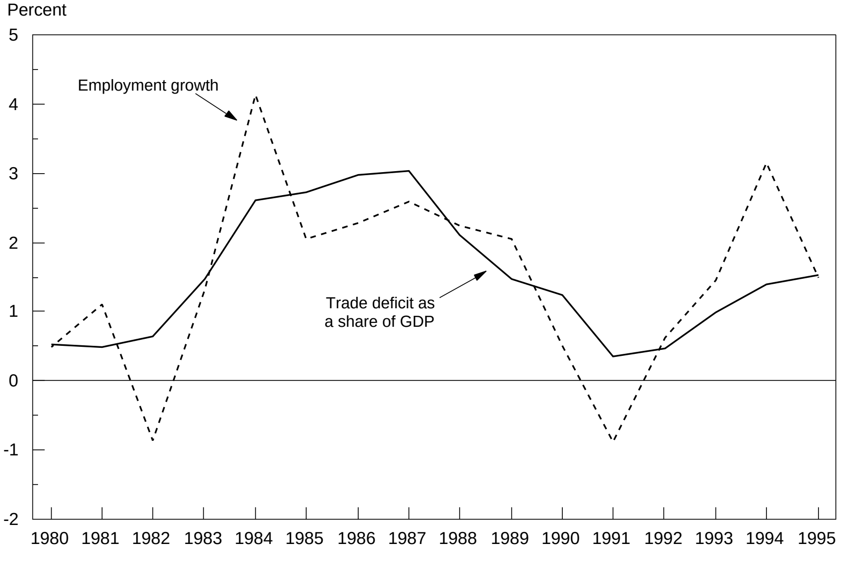
If the current account deficit has little to do with trade policy, neither does it necessarily indicate poor economic performance. In fact, in the short run it may indicate precisely the opposite. Consider two situations: one in which the economy is operating with fully employed resources, and one in which the economy is operating with excess capacity.

When resources are fully employed, a current account deficit does not constrain the level of economic activity and thus cannot represent "lost" production. The U.S. economy in the past 2 years provides a good example, since it has been very close to full employment and production capacity. During 1994 and the first three quarters of 1995, total U.S. production of goods and services (GDP) averaged $7.1 trillion per year. Total U.S. expenditure was $7.2 trillion. The difference, just over $100 billion worth of goods and services per year, came from overseas, as reflected in the trade deficit.

It would have been very difficult to have produced those extra goods and services ourselves and thus eliminated the trade deficit. The monthly unemployment rate in 1994 and 1995 averaged 5.8 percent and twice fell to 5.4 percent, very near the point at which economists believe inflation begins to accelerate. Both labor force participation and overtime in manufacturing were at postwar highs. In such a tight labor market, any attempt to close the trade deficit in 1994 or 1995 by producing more domestically would undoubtedly have been frustrated by rising prices, or by an increase in interest rates that would have reduced output in other sectors. In sum, when the economy is near full employment, the trade deficit does not affect the level of economic activity and therefore provides no insight into how well or poorly the economy is performing.

The second case to consider is an economy operating at less than full employment. Here trade outcomes can affect the level of economic activity. Rates of foreign economic growth and the exchange rate of the dollar have a strong influence on U.S. export sales, and therefore on the level of U.S. production. And unlike in the case of full employment, the expansionary impact from export sales in this situation is not necessarily fully offset. At the same time, the cyclical state of the U.S. economy exerts a strong influence on the demand for imports. In practice, this channel is so strong that the trade and current account deficits have tended to increase when the U.S. economy is growing rapidly, as it has in the last 3 years, and to diminish when the U.S. economy is weak. An increasing trade deficit is therefore usually the result of a strong economy, not the cause of a weak one. Over the past 15 years, U.S. employment growth has tended to be highest when the trade deficit was large, not when it was small (Chart 8–3).

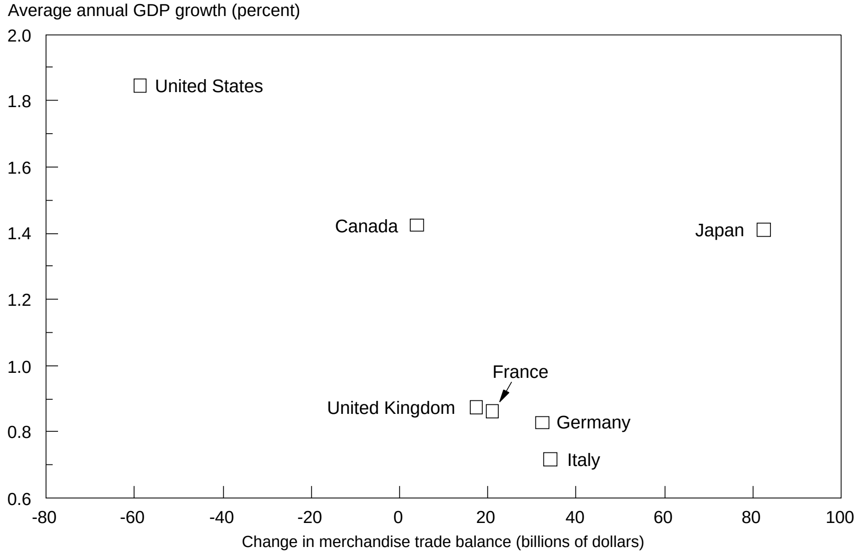
Chart 8-3 **Employment Growth and the Trade Deficit**
The trade deficit tends to rise when employment growth is strong because of increased demand for imported goods and services.



Note: Data for 1995 are estimates.
Sources: Departments of Commerce and Labor, and Council of Economic Advisers.

The same conclusion holds if we look across the other major industrial countries. In the 1990s trade balances have improved in those of the seven leading industrial market economies (the Group of Seven, or G–7) where economic growth and employment creation was weak (Chart 8–4).

Chart 8-4 **Economic Growth and Changes in Trade Balances in the G-7 Countries, 1990-94**
Across the major industrial countries, recent improvements in the trade balance have been associated with weak economic performance.

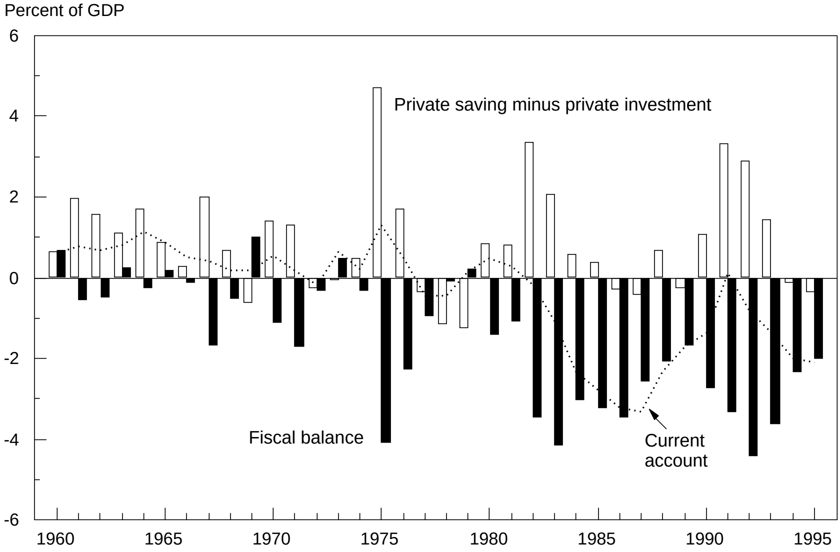


Note: Germany refers to unified Germany, 1991-94.
Sources: Department of Commerce, Organization for Economic Cooperation and Development, and Council of Economic Advisers.

Growth of the Current Account Deficit

From 1946 until 1982 the U.S. current account balance fluctuated around zero but was generally in surplus. Government deficits during recessions were balanced by weak domestic investment and an excess of private saving (Chart 8–5). The adoption, early in the 1980s, of tight monetary policy to combat inflation led to a sharp increase in U.S. interest rates, an inflow of foreign capital, and an appreciation of the dollar. At the same time, fiscal (tax and expenditure) policy led to large budget deficits that did not disappear when the economy was growing strongly and private investment was high. The so-called structural budget deficit, which is the actual deficit corrected for short-term fluctuations in GDP, increased by a full 2 percentage points of GDP between 1982 and 1984. Econometric simulations indicate that the shift in fiscal policies, coupled with a move toward more restrictive budget policies abroad, explains about two-thirds of the deterioration in the current account in the first half of the 1980s.

Chart 8-5 **Private Saving and Investment, the Fiscal Balance, and the Current Account**
The emergence of large fiscal deficits in the 1980s and a rebound in investment in the 1990s led to increasing current account deficits.



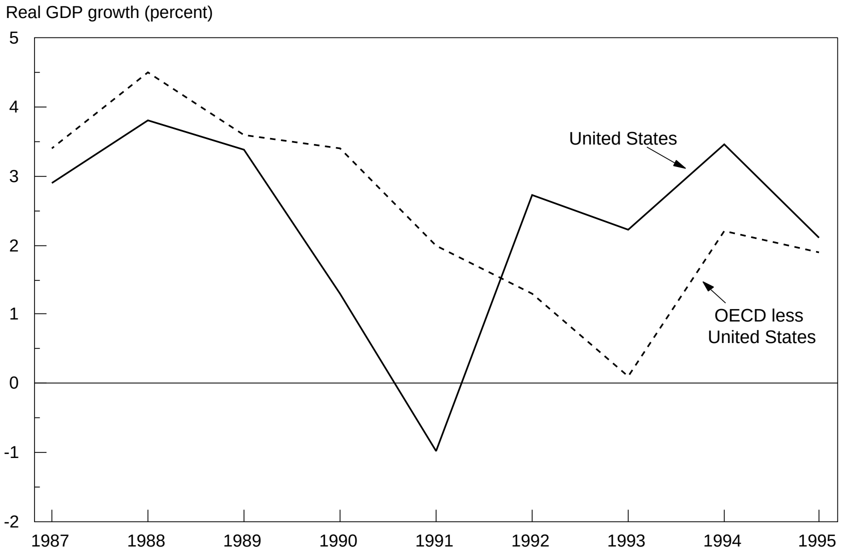
Note: The private saving and investment measures are gross private saving and gross private investment. The fiscal balance is gross government saving less gross government investment. The current account equals net foreign investment plus capital grants received. Data for 1995 are estimates.
Sources: Department of Commerce and Council of Economic Advisers.

Fiscal policy changes in the middle of the 1980s partly reversed the widening of the Federal budget deficit. But the slight reduction in the budget deficit was more than offset by a fall in private saving: the U.S. gross private saving rate (the sum of the saving rates of businesses and households), which averaged 18.3 percent of GDP in the first half of the decade, fell to 16.0 percent in the second half. In broad terms, then, the increase in the budget deficit and the fall in the domestic saving rate were responsible for the chronically large U.S. current account deficit. Although the budget deficit (both actual and structural) has fallen significantly during this Administration, a sharp increase in domestic investment during the cyclical recovery has driven the current account further into deficit over the past 3 years.

Current Account Developments in 1995

The current account deficit continued to increase in 1995, driven largely by high U.S. economic growth relative to our major trading partners. Although U.S. growth has been below the OECD average for much of the postwar period, in the period since 1992, the U.S. economy has grown faster than the economies of most other OECD countries, including major trading partners such as Germany and Japan (Chart 8–6). Although U.S. economic growth moderated in 1995, consistent with a desired "soft landing" of the economic expansion, it remained above the OECD average.

Chart 8-6 **Growth of Real GDP in the United States and Abroad**
Faster growth relative to other industrial countries since 1992 has contributed to the rise in the current account deficit.

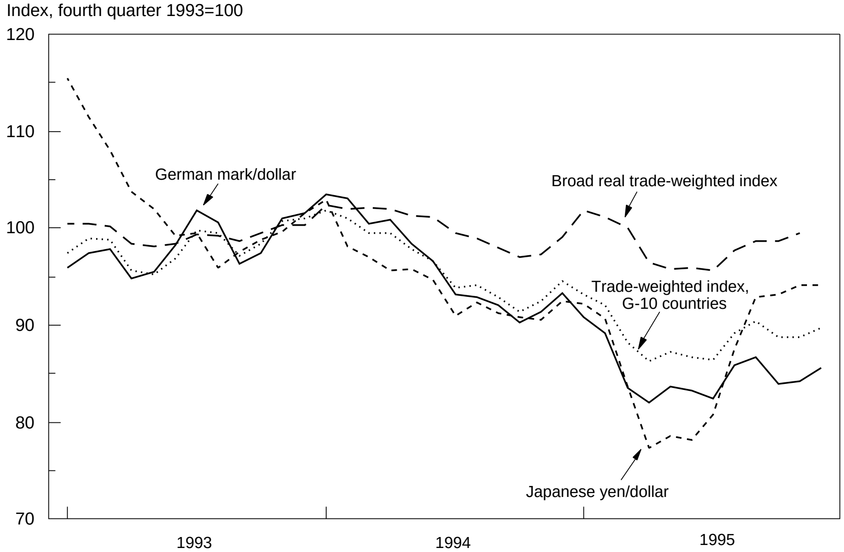


Note: Data for 1995 are estimates.
Sources: Department of Commerce, Organization for Economic Cooperation and Development, and Council of Economic Advisers.

Along with relative economic growth rates, changes in relative prices (most often due to exchange-rate changes) have important short-run influences on both bilateral trade balances and the overall current account balance. Beginning in February 1995 the U.S. dollar depreciated against the currencies of our major trading partners, and most sharply against the Japanese yen (Chart 8–7). The depreciation of the dollar went beyond what many viewed as justified by economic fundamentals, and a statement by the G–7 finance ministers and central bank governors at the end of April called for an orderly reversal of the preceding exchange-rate movements. Interest rate reductions in Japan and Germany and concerted currency market intervention in July and August were followed by a recovery of the dollar. Between the end of April and the end of August, the dollar appreciated by 16 percent against the yen and by 6 percent against the deutsche mark. Although these bilateral moves are noteworthy and will have a significant effect on bilateral trade, the movement of the dollar against a weighted average of the currencies of U.S. trading partners was more modest, particularly when an index covering a broad range of trading partners is examined.

Relative price and income movements influence bilateral trade balances in the short run, and there were important developments along these lines with several U.S. trading partners in 1995. The

Chart 8-7 **U.S. Dollar Exchange Rates**
The dollar has fluctuated sharply against the currencies of Japan and other major trading partners, but less sharply against broader indexes of foreign currencies



Note: The broad real trade-weighted index is relative to 101 trading partners, adjusted for domestic inflation. A rise in an index indicates an appreciation of the dollar.
Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of Dallas, and Council of Economic Advisers.

most dramatic change was in the balance with Mexico, following a severe financial and exchange-rate crisis in that country beginning in December 1994 (Box 8–5). The dramatic nominal depreciation of the peso outstripped the sharp increase in Mexico's price level, and so the real (inflation-adjusted) value of the peso fell, encouraging exports and discouraging imports. In addition, the downturn in economic activity within Mexico greatly affected that country's demand for imports. Consequently, the U.S. bilateral balance with Mexico fell from a $1.4 billion surplus in the first 11 months of 1994 to a deficit of $14.4 billion for the first 11 months of 1995.

Even so, as was emphasized above, U.S. exports to Mexico have held up far better than those of Mexico's other trading partners, and the provisions of NAFTA spared U.S. exporters from the emergency measures that Mexico imposed on its trade with other countries. Despite the severity of the crisis, Mexico appears to be adjusting successfully, and its longer term prospects are encouraging. As Mexican economic growth resumes, imports from the United States should rebound strongly.

Trends in the U.S. trade balance with Japan over the past year are the result of income and relative price forces pulling in opposite directions. The Japanese economy has seen almost no growth in output since 1991, and the recovery that was expected to occur in 1995 failed to materialize; current estimates of Japanese economic growth for 1995 are about half a percent. Despite this stagnation in demand, imports by Japan have surged because of the appreciation of the yen over the past 3 years, coupled with some market-opening measures, and Japan's current account surplus has narrowed. U.S. exports to Japan have grown rapidly in the last 3 years, particularly in those sectors covered by Framework and other trade agreements. The U.S. bilateral deficit with Japan has declined since mid-1995 and for the first 11 months of the year it was down 7 percent relative to 1994. Should the long-awaited recovery in Japan begin this year, the deficit with Japan should decline further.

As the events of the past year illustrate, individual exchange-rate movements and shifts in economic growth rates have large influences on bilateral balances. Movements in the overall current account balance are generally less extreme, because of the averaging that takes place across various country markets. But the rate of U.S. growth relative to that of its trading partners, together with overall movements in the dollar's exchange rate, has a considerable influence on the U.S. external balance, particularly on a year-to-year basis. Over longer periods cyclical movements tend to average out, and real exchange rates are influenced more by the requirements of long-run current account positions and current account servicing requirements. Over this longer time frame it makes sense to think in terms of propensities rather than levels (in other words, the shares of national income devoted to private saving, to domestic investment, and to financing the government budget deficit). The emergence of the U.S. current account deficit over the past 15 years has been the result of a decline in national saving as a share of GDP (resulting from lower private saving and an increase in the Federal budget deficit, both as shares of GDP), which has more than offset a decline in the investment-GDP ratio since the early 1980s.

CONSEQUENCES OF THE CURRENT ACCOUNT DEFICIT

The current account deficits that arose in the 1980s are an indicator neither of the ability of the United States to compete in the world market, nor of the efficacy of U.S. trade policy. U.S. export growth, and more broadly the growth of the U.S. economy, are much more informative measures of our relative economic standing. The current account deficit has not prevented a rapid increase in employment, and the recent increase in the external deficit is primarily the result of rapid economic growth. Furthermore, given the fiscal policy adopted in the early 1980s and the subsequent decline in the U.S. saving rate, the ability to borrow overseas and run a current account deficit has been critical in maintaining domestic investment and growth over the last 15 years. Had the United States been forced to run a balanced current account, interest rates would have been higher, and investment and economic growth lower, than what we experienced.

If this is so, why should one care about the trade and current account deficits? As explained above, the current account deficit is the difference between our expenditure and our income, and represents our net borrowing from the rest of the world. By running a large and persistent current account deficit we have been borrowing against future income, building up liabilities to the rest of the world that will have to be serviced in the future. Estimates show the United States moving from a net creditor position of over $250 billion in the early 1980s to a net debtor position of over half a trillion dollars by 1994. The positive net international asset position that the United States had built up over 100 years was eliminated in the space of about 6 years during the 1980s.

The debt-servicing requirements of this buildup of external debt are already making their presence felt. Net income on U.S. external assets was over $30 billion per year in the early 1980s. This inflow declined over the 1980s and eventually turned negative: in 1995 our net overseas *payments* are likely to be over $11 billion. Although these numbers are still quite manageable in an economy that produces $7,000 billion in income each year, the current trend is for an increasing share of U.S. income to be paid out to foreigners, and thus to be unavailable to support U.S. consumption and investment. In a period in which the size of the retirement-aged population will increase sharply, servicing our net foreign debt will be a further drain on the future working population.

The extent to which we rely on foreign borrowing also influences the terms on which we can borrow. Modern portfolio theory emphasizes the importance of relative rates of return in determining asset holdings. To induce foreigners to hold a larger share of their assets as claims on the United States, we may have to offer a higher interest rate. Very rough estimates place the share of U.S. assets in foreign portfolios at about 9 percent, about 2 percentage points higher than in 1982. This does not appear to be unduly large given the low transactions costs, high liquidity, and strong investor protection that characterize U.S. financial markets. In addition, the ratio of U.S. external debt to GDP is still moderate, and well below the ratios of some other industrial countries. But as the stock of foreign claims on the United States increases, U.S. financial markets will inevitably be more sensitive to foreign perceptions and external considerations.

POLICY OPTIONS TO REDUCE THE CURRENT ACCOUNT DEFICIT

Given that a sustained current account deficit is costly to the Nation, what policy options are available to reduce it? As we have seen, trade policy has little impact on the overall current account balance. To shrink or eliminate the current account deficit, either the government budget deficit must be narrowed, or private saving must rise relative to investment, or both. Maintaining and if possible increasing the rate of investment in the United States is critical for the growth of American incomes and is a firmly held goal of the Administration. So the only desirable options are to raise the rate of saving and to reduce the government budget deficit. Unfortunately, the policy tools to raise private saving are inherently limited: anything that might strengthen incentives to save by raising the return to saving would also reduce the amount of saving required to meet a future wealth or consumption target. And if private saving incentives take the form of tax expenditures ("tax breaks"), the induced increase in private saving must be greater than the loss of tax revenue in order for national (public plus private) saving to increase. The budget deficit is under far more direct policy control. The Administration's budget, which would eliminate the Federal deficit by 2002, provides the most promising way of reducing the U.S. current account and trade deficits.

Reducing the U.S. current account deficit is primarily, but not entirely, in our own hands. Since global saving equals global investment, the sum of all countries' current account balances (when accurately measured) must equal zero. Thus a reduction in the U.S. current account deficit must go hand in hand with a decline in the current account surplus of the rest of the world. Complementary policy in foreign countries, particularly those with large current account surpluses, would assist in the transition. That is why an important component of the Framework negotiations with Japan focused on the promotion of macroeconomic policies in that country that would encourage strong domestic demand-led growth. But one should not exaggerate the foreign responsibility for reducing the U.S. deficit. A reduction in one country's surplus will not ensure a corresponding fall in the U.S. deficit. And even without any policy actions by foreign countries, changes in exchange rates and in world interest rates would accommodate the elimination of the U.S. current account deficit. Fundamentally, the U.S. current account balance will be determined by our own saving, investment, and budget policy, and continued reduction of the Federal budget deficit is the most effective tool for reducing our external deficit.

CONCLUSION

A system of liberal international trade and investment boosts overall living standards by allowing all participants to concentrate on what they do best, to learn from others, and to ensure competition. Consumers in open economies enjoy access to a wider variety of goods at lower prices than those living in economies that insulate domestic producers from foreign competition. Trade shifts jobs into sectors in which an economy is relatively efficient, and therefore boosts productivity and wages. In the United States, jobs supported by goods exports pay 13 percent more than the national average. Open trade and investment also have positive dynamic effects: exposure to the competitive pressures of the international marketplace spurs domestic firms to improve productivity and boost innovation. At the same time, exposure to international markets and foreign direct investment facilitates the flow of technology across borders, allowing producers to employ domestic resources more efficiently.

Abundant evidence testifies to the advantages of open markets over protectionism. Countries with outward-looking, liberal trade and investment policies grow faster, the data show, than countries with inward-looking, closed policies. The general consensus among economists is that open markets raise growth and productivity.

Achieving the benefits of trade requires continual change and adaptation. And even though most studies suggest that the effect has been small in the United States, trade can worsen wage inequality. The Administration therefore recognizes that, while outward-looking trade and foreign direct investment policies are critical to the future strength of the economy, we must help those injured by the lowering of trade barriers to make the requisite adjustments. In today's global economy, there is simply no alternative to competing.

This Administration has been remarkably successful in promoting competition around the world. A concerted set of multilateral, regional, and bilateral trade negotiations has produced the Uruguay Round agreement, NAFTA, and the Framework agreement with Japan. Ambitious plans have been laid for free trade across the Pacific and throughout the Americas. Partly reflecting this active trade policy, U.S. exports of goods and services have grown by 20 percent since this Administration took office.

The continuing external deficit remains a cause for concern, but it must be kept in mind that the deficit is caused by macroeconomic factors, not trade policy. It should not be used as a test of whether trade is beneficial or whether our trade policy is effective. The most effective policy option for reducing the trade deficit is the reduction or elimination of the Federal budget deficit.