

U.S. TRADE DEFICITS AND INTERNATIONAL COMPETITIVENESS

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"Physician, heal thyself." Luke 4:23

Thank you. It's a pleasure to be here. Today I'd like to talk about our trade deficit and what it implies about our ability to compete globally.

We've had this trade deficit for over a decade. Some people, and a number of policymakers, see this as a symptom that we've lost our edge in international competition. Here's their diagnosis of the problem: Foreign competitors are able to take markets away from U.S. producers because they have some important advantages. In particular, they have lower wages, superior technology, and "unfair" trade practices.

What's their prescription to fix the problem and return U.S. industries to competitive health? They'd like to see the government try to manage international competition by taking a more protectionist stance and targeting certain industries for special support.

My own view is that this analysis is off the mark. I do *not* think the trade deficit is due to lower wages, superior technology, and "unfair" trade practices abroad. On the contrary, I think we can find the sources of the trade deficit in certain macroeconomic fundamentals—namely, our own government budget deficit and our investment and saving patterns. Moreover, I don't think the trade deficit is necessarily the best way to judge our competitiveness. There are more important factors to

consider. In particular, I would point to price competitiveness and productivity.

Let me begin by looking at just how bad the trade deficit is. First, I think it's a mistake to focus too much on the most recent numbers, which haven't been too good. The reason it's a mistake is that the source of the problem is more cyclical than it is structural. The U.S. has been in recovery for a while now. But many of our industrial trading partners are still in recession. So the recent bulge in our trade deficit is largely due to the fact that, as we continue to grow and import more, the weakness abroad is hurting our exports.

Now let me look at the longer view. Although the trade deficit has persisted for over a decade, the situation is much better now than it was in the mid-1980s. The merchandise trade deficit fell from a peak of \$160 billion in 1987 to \$96 billion in 1992. Relative to GDP, it declined from 3.5 percent to 1.6 percent. The current account deficit, which includes trade in services, improved even more dramatically. It dropped from a deficit of \$167 billion in 1987 to \$62 billion in 1992—or from 3.5 percent of GDP to 1 percent of GDP.¹

Why the turnaround? Because over the past six years, U.S. exports have surged. From 1986 through 1992 the total value of U.S. merchandise exports almost doubled, growing more than 12 percent per year.² In volume terms, exports grew almost as fast, averaging more than 10 per cent per year.³ A major source of strength in this export growth has been manufactures.⁴ And it's notable

¹In 1991 the trade balance deficit fell to almost \$70 billion due to the cyclical decline of imports associated with the U.S. recession. The current account improved even more, to a \$4 billion deficit, as the result of cash contributions of coalition partners in Operation Desert Storm.

²Annual export growth from 1986 to 1989 was a robust 17 percent; annual growth from 1989 to 1992 slowed largely due to slower economic growth in major U.S. export markets, but was still a relatively strong 7 percent.

³Annual export volume growth also slowed over this period, averaging 13 percent from 1986 to 1989 and 5.4 percent from 1989 to 1992.

⁴Manufactures make up more than 60 percent of U.S. merchandise exports. Since 1986, the value of U.S. manufactured exports has more than doubled, rising at 14 percent per year, and the volume of manufactured exports has grown at an annual rate of 13 percent. The value of civilian aircraft exports, which account for

that this sector has continued to show strength even during the worldwide economic slowdown of the past few years.⁵ So the big picture on the trade deficit is that the situation is better than it was in the mid-1980s, because U.S. exports have surged since then.

Now let me look at the problem of "unfair trade practices." By this I mean such things as government support of selected industries through export subsidies and trade protection. The evidence is clear that virtually all countries, including the U.S., impose at least some restrictions on imports and provide government support for exports. Still, there's *no* evidence that the U.S. trade deficits of the 1980s were caused by greater foreign trade barriers or other unfair trade practices. First of all, between 1981 and 1987, when the deficit was at its peak, the deterioration in our trade position was *pervasive*. It spread uniformly and proportionately across capital goods, automotive products, and consumer goods. And the deterioration was roughly in proportion to each of our major trading partner's share of U.S. import and exports in 1981. If unfair foreign trade practices had caused the pervasive decline in the early 1980s, they would have had to change uniformly and suddenly around 1981, an unlikely conspiracy.

Of all the U.S. trading partners, Japan continues to be singled out for having the most unfair trading practices. But it's doubtful that such policies have been a major cause of U.S. trade deficits. First of all, the Japanese market has become somewhat more *open*—not more closed—over the past decade. Second, Japan's share of changes in the total U.S. non-oil merchandise trade deficit have been proportional to its U.S. trade share.⁶ For example, in 1981, about 9 percent of our exports

about thirteen percent of total manufactured exports, has grown at an annual rate of 16 percent since 1986.

⁵In 1991 and 1992, the export value of U.S. manufactures grew at an annual rate of almost 9 percent. Civilian aircraft exports grew at an 8 percent annual rate.

⁶Oil comprises about 10 percent of total U.S. imports, and including it in the calculation comparing the change in Japan's share of the U.S. deficit would have distorted the result, because there is virtually no trade in oil between the U.S. and Japan.

went to Japan, and about 20 percent of our imports came from Japan. That left us with a bilateral deficit of \$16 billion. If the same shares prevailed in 1992, we would have had a bilateral deficit of \$57 billion—which is in fact a little larger than the actual deficit of \$51 billion. So I think there's not much evidence to say that restrictive trade practices have been the driving force behind changes in the U.S. trade deficit.

Of course, the doors to Japanese and other foreign markets aren't exactly wide open to U.S. exporters. But even if existing foreign restrictions on U.S. exports were completely removed, most estimates suggest we'd reduce our trade deficit by only modest amounts.⁷

Now let me look at our international competitiveness in terms of our production costs and productivity. Is there any evidence that U.S. price competitiveness declined during the 1980s? If we make the comparison in dollar terms, then the answer is: "Yes, price competitiveness *did* decline." Between 1980 and 1985 unit labor costs in dollars rose at an annual rate of 3.1 percent in the U.S., while unit labor costs fell in 10 of 11 other industrial countries.

But that information doesn't give us a complete picture. If we make the comparison in national currency terms, then unit labor costs actually *rose* in most of those other countries. Therefore, it was the appreciation of the dollar in the early 1980s, not underlying cost increases, that primarily caused U.S. manufacturers to lose price competitiveness to foreign producers during this period.

The fall of the dollar since the mid-1980s has made foreign unit labor costs measured in dollars now substantially higher than they were in 1980. Between the 1985 peak in the dollar and 1992, U.S. unit labor costs rose at only 1 percent per year, while costs in Japan, France, Germany,

⁷It should be noted that Japanese imports of manufactured goods are indeed the lowest among industrialized countries, amounting to 6 percent of the total Japanese market compared to over 15 percent for both the U.S. and Germany. This is due less to explicit government tariffs and quantitative restrictions than it is to barriers associated with technical standards, and the practices of the wholesale and retail distribution system.

Korea, and Taiwan, for example, all rose at roughly 10 percent annually over the period 1985-1992. Therefore, most of the apparent improvement in U.S. international competitiveness is due to changes in the value of the dollar. Furthermore, manufacturing in the U.S. now appears to have a significant cost advantage over manufacturing in other countries.

What about productivity? The U.S. had relatively *strong* productivity growth during the 1980s. Between 1980 and 1985, manufactures output per worker grew 3.3 percent annually in the U.S., compared to 4.0 percent in Japan, 2.3 percent in France, and 2.1 percent in Germany. Since the mid-1980s U.S. productivity has continued to keep pace and even exceed that in much of the rest of the world. From 1985 to 1992 U.S. manufacturing output per worker grew at 2.9 percent per year, compared to 2.3 percent in Japan, 0.8 percent in Germany, and 2.8 percent in France.⁸

Now that we can't blame the trade deficit on our competitors' lower labor costs, higher productivity, or unfair trade practices, where do we look for the source of it? The answer, I think, is in macroeconomic fundamentals. By definition, a country's trade balance is the mirror image of its pattern of saving and investment. So, for example, a country with more investment opportunities than its domestic saving can handle will borrow from abroad and run a trade deficit. This is true even if its costs are relatively low, its home markets are protected, and its exports are subsidized. The converse also holds true: A country with high saving relative to investment will run trade *surpluses*—even if its markets are open and its products are regarded as "noncompetitive."

In the case of the U.S., the emergence and persistence of large trade deficits since the early 1980s can be attributed largely to changes in the nation's saving-investment balance. Over the 1960s and 1970s, the U.S. (gross) national saving rate roughly equaled the investment rate and remained constant at about 20 percent of GNP. As a result the current account remained approximately in

⁸In 1992 manufacturing output per worker grew 5.4 percent in the U.S., fell 9.1 percent in Japan; and grew 3.2 percent in France, and 0.4 percent in Germany.

balance. But in the early 1980s, the national saving rate fell, largely because of bigger government budget deficits.⁹ The resulting net saving deficit led to higher real interest rates, the appreciation of the dollar, and the associated current account deficits that emerged in the early 1980s. In the second half of the 1980s the budget deficit turned around somewhat, interest rates and the dollar fell, and the current account deficit began to narrow. So it's primarily *macroeconomic developments* that explain the worsening of the U.S. trade balance in the early 1980s followed by its improvement later in the decade. To keep the trend of improvement going in the long run, we'll need further macroeconomic policy adjustments. Ideally, we'd accomplish this through either a fiscal contraction or an increase in private saving. Less ideally, we could accomplish it through a reduction in domestic investment. The current plans for reduced federal budget deficits are in the right direction.

In conclusion, I think the U.S. is in reasonably good competitive shape. U.S. exports have boomed and the trade deficit is lower than it was in the mid-1980s. More important, measures of labor costs and productivity, particularly in manufacturing, indicate resurgent U.S. price competitiveness. U.S. productivity growth in the 1980s has been comparable with and, in some cases better than, other industrial countries abroad. The continued existence of U.S. trade deficits reflects an imbalance of national saving below investment, not any fundamental decline in U.S. international competitiveness.

Of course, when you talk about competition, you're always talking about winners and losers. And there's no question that some industries are going to continue to face difficult times from foreign competitors. But the real winners will be consumers for whom foreign competition means better quality U.S. products. The experience of the U.S. automobile industry is a case in point. Moreover, in a dynamic competitive world economy, with new products, technologies, and production processes

⁹The government budget deficits rose by roughly two percentage points; the private saving and investment rates fell by about one percentage point each.

continually becoming available, there will always be some firms on the decline as others are on the rise. The appropriate policy response to an industry that's losing ground to foreign competition is not to erect barriers to imports, but rather to facilitate the redirection of workers who lose jobs to more productive employment opportunities elsewhere. If the protectionist route is followed, newer, more efficient industries will have less scope to expand, and overall output and economic welfare will suffer.

And this brings me back to the main question of this conference: U.S. prosperity in a competitive world. The real issue of our long-term prosperity, of maintaining and improving American living standards, doesn't depend on how stiff the competition is abroad. It depends primarily on our *own* productivity growth and our ability to maintain a stable economic environment. The Federal Reserve has a role in this, of course. And that is to conduct a low-inflation monetary policy. But that's not enough. This country also must grapple with the hard issues of devising the means to boost productivity—

- with policies that foster greater private capital formation,
- with policies that increase investment in infrastructure,
- with policies that expand research and development expenditures,
- with policies that improve the quality of education,
- and with policies that stimulate entrepreneurial activity.

To sum this all up: Our prosperity doesn't depend on distorting markets with industrial policies and protectionist barriers; instead it depends on improving our productivity and letting markets work to bring out the best in our natural and human resources.

Thank you.