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The United States Deficit and the "New Economy": Mortgaging the Future or Investing for Success?

ST. LOUIS, Mo. — In the growing economy of the United States during the 1990s, a rising trade deficit has been a source of concern to some. But whether the growing deficit is a positive or negative development depends on what we're doing with the money we're borrowing to finance the deficit.

Offering that viewpoint is Michael Pakko, a senior economist with the Federal Reserve Bank of St. Louis. Pakko examined the trade deficit amid the claim that the United States is experiencing what has been dubbed the "New Economy" — an unprecedented period of high productivity, low inflation, low unemployment and seemingly limitless economic growth. His comments appear in the latest issue of ***Review***, the St. Louis Fed's bimonthly journal of business and economic issues.

Whether the nation's deficit borrowing is wise, Pakko said, depends on how we're spending the money. "For example," he said, "a household that is continually running up debt to finance current consumption or a firm that is accumulating debt to cover operating losses might well be following an unwise and unsustainable course. On the other hand, when borrowing is undertaken to finance investments that will yield a flow of profits over time, it can be a perfectly sound policy."

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The nation seems to be following the latter course, Pakko noted, since the United States leads the world in investing in cutting-edge technologies. In 1997, for example, spending on information technology in the United States accounted for a full 4.5 percent of GDP, compared to only 2.6 percent in Japan and 2.3 percent in western Europe. Although statistics so far have yielded little indication that the adoption of new technologies has resulted in any significant, measured gains in productivity, Pakko said that is consistent with economic models of technological advancement.

"During the early stages of technological breakthroughs like those we are witnessing in information processing and telecommunications, a period of slow growth is predicted as new technologies are integrated and adapted to production processes," he explained.

Eventually, Pakko observed, the decline in U.S. net exports as a fraction of the national income will be reversed, either as the investment boom runs its course or as foreigners become increasingly unwilling to finance mounting deficits and the debt.

"Whether that's an orderly process or a 'crash and burn' scenario is crucial for evaluating the prospects for continued economic strength suggested by the advocates of the so-called new economy," he said. "The conditions under which the present trade deficit ultimately will be reversed might be an important indicator of whether the new economy has entered a new, more mature phase, or whether its promises were illusory."

Pakko also emphasized that the recent decline in the country's net exports, although large, is not unprecedented. For example, although the current deficit was a record $221 billion in 1998, that figure is only 2.6 percent of GNP. The peak deficit of the 1980s, however, reached 3.5 percent of GNP in 1987.

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