

FAST TRACK TO TRADE DEFICITS

Mushrooming foreign debt begs for strategic pause before approving new agreements

by Jeff Faux

The Bush Administration is proposing to put trade agreements on a “fast track,” a procedure that would bar Congress from making any amendments, and thereby make it easier to negotiate a Free Trade Agreement of the Americas (FTAA) and a new round of trade concessions with the World Trade Organization (WTO).

Much of the debate about FTAA and the WTO has centered on whether workers and the environment should be accorded the protections these agreements now give to investors. Largely ignored, however, is a fundamental economic concern—the connection between U.S. trade policies and the unsustainable trade deficits that have followed in their wake.

Even before September 11, these trade deficits posed a threat to U.S. economic stability. Post-September 11, the potential damage has been made more dangerous by the new global political uncertainties. No member of Congress, however strong his or her belief in the principles of free trade, can responsibly vote to accede to the administration’s demand for fast track authority unless it is accompanied by a clear and credible program for reversing the country’s rapidly growing foreign debt.

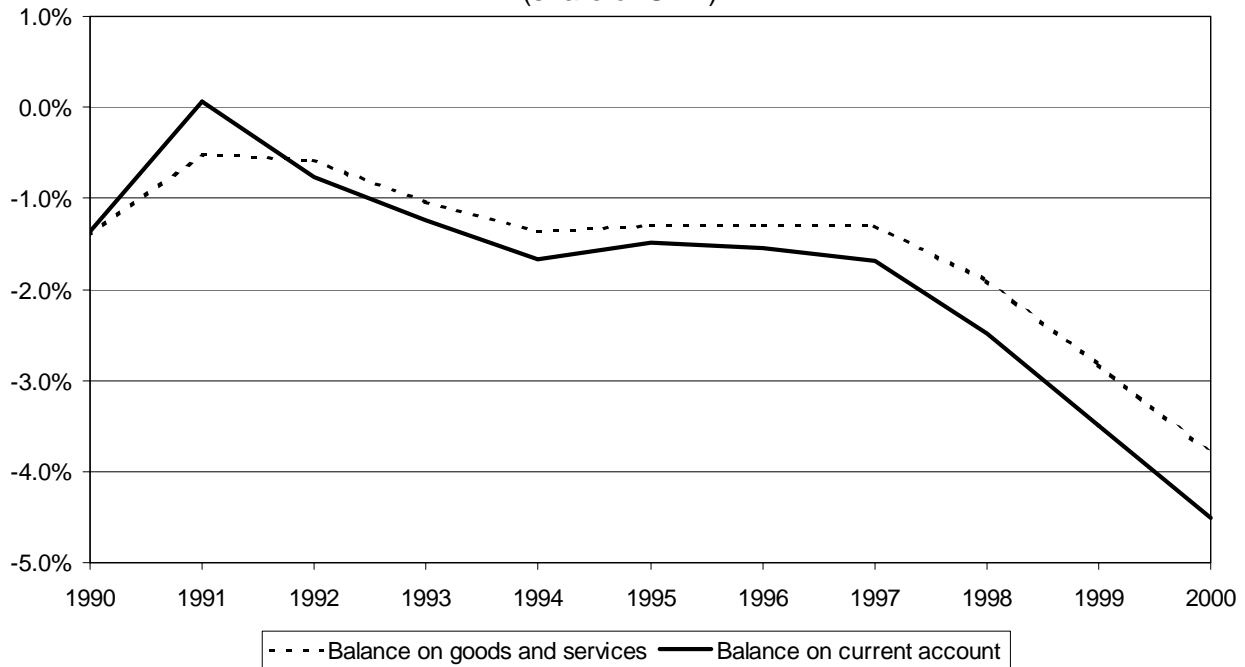
Piling on the deficits

Fast track promoters do not discuss the trade deficit (exports minus imports), asserting instead that the increase in total trade is the measure of an agreement’s success.¹ The logic here is similar to that of the Depression-era street vendor who, when asked how he expected to survive buying apples for a dime and selling them for a nickel, replied that he would make it up in volume.

Yet no one disputes that, for the past quarter century, Americans have been buying more from the rest of the world than they have been selling. Despite assurances that trade expansion under the North American Free Trade Agreement (NAFTA) and the WTO would reduce the trade deficit, the gap between imports and exports has

FIGURE A

U.S. trade and current account deficits, 1990-2000
(share of GDP)



Source: Bureau of Economic Analysis.

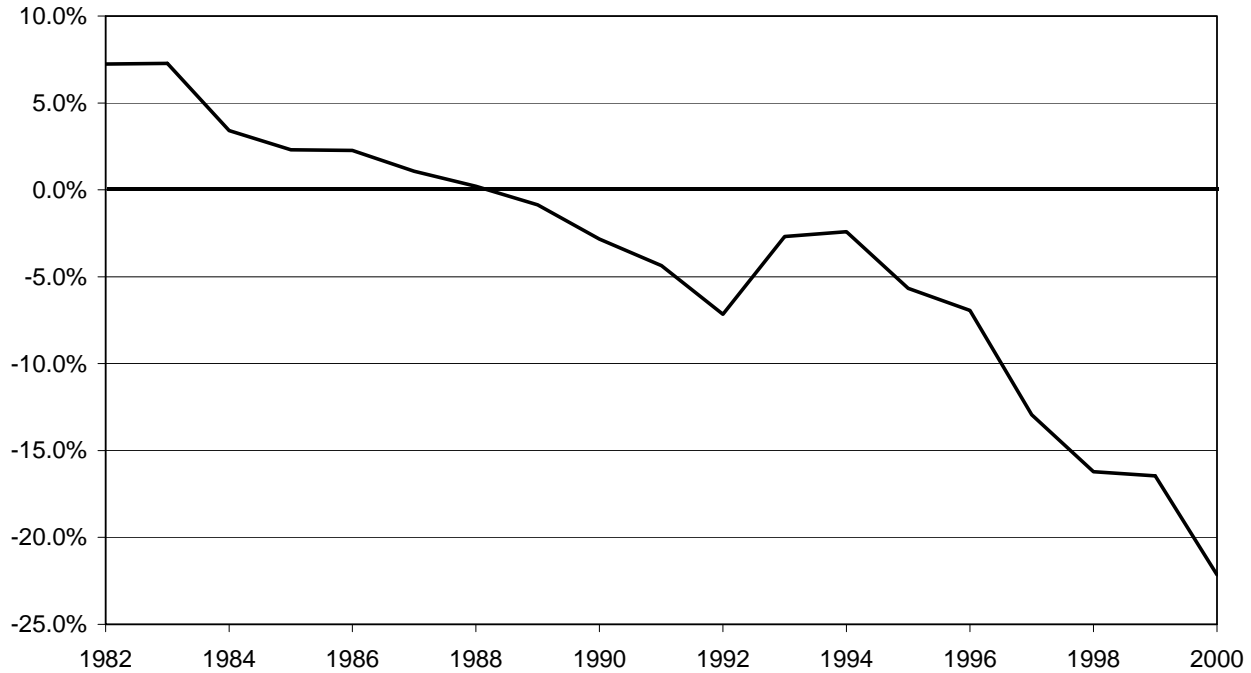
ballooned. Last year it drove the U.S. current account deficit (the total of all international financial transactions) to a record \$450 billion, or 4.5% of gross domestic product (**Figure A**). At issue is far more than nickels and dimes. The present slowdown in U.S. consumer incomes may slightly reduce the current account deficit this year, but it is still likely to be above \$400 billion. When the economy recovers, the deficit will continue its relentless expansion.

In order to finance this deficit, the United States has had to borrow from other countries and sell them more of our assets. Thus, each year the United States must devote more of its income to cover the interest on the debt and the transfer of profits to investors in other countries. After 1988, these payments began to exceed foreigners' remittances to the United States. Since then, the U.S. net international financial position has been running in the red. This net foreign "debt" is now 22% of GDP (**Figure B**). Assuming a recovery, the U.S. is on a trajectory to a debt burden of roughly 40% of GDP within five years. By way of comparison, Argentina, whose economy is collapsing under the weight of its external debt, owed 50% of its GDP to foreign investors last year.

But the United States is not Argentina. Not only is the dollar the world's most important reserve currency, but the U.S. also has better credit and more assets to sell. *Simple arithmetic, however, makes it clear that the United States cannot borrow forever in order to buy more from the world than it sells.* The interest burden will eventually be so heavy that foreign investors will be unwilling or unable to keep financing the rising U.S. debt. When that happens, the dollar will free-fall and interest rates will spike upward, with devastating economic consequences. The United States will then be forced to redress this imbalance in trade by either drastically devaluing the dollar or by pushing for a draconian deflation in real incomes, thus reducing demand for imports and

FIGURE B

Foreign debt (U.S. international investment position), percent of GDP, 1982-2000



Source: Bureau of Economic Analysis.

making U.S. goods cheap enough to run a surplus in world markets. The costs of balancing trade through deflation would be considerable; according to an earlier calculation, bringing a 2% current account deficit into balance would require a 10% drop in GDP and a jump of five full percentage points in the unemployment rate.² At today's deficit level, the required contraction would be even greater.

Balancing trade will be even more difficult because of the United States' eroded manufacturing base, which accounts for some 60% of exports. U.S. manufacturing capacity may well have shrunk below the level needed to eliminate the trade deficit through expanding exports. Given the relentless import competition, investors are reluctant to make long-term capital available to medium-sized and small manufacturing firms—and perhaps even some large ones as well. The grim outlook for manufacturing also reduces the incentive for young people to invest in becoming skilled workers.³

So far, the United States has avoided a crisis, in part because the red-hot economy of the 1990s induced foreign investors to buy U.S. bonds and other assets, thereby keeping up the growing flow of capital to cover the U.S. trade deficit. Until recently, the U.S. economy has been like a corporation whose booming domestic division has obscured the losses from the firm's foreign operations. From 1992 to 2000, 23 million jobs were created in the U.S. domestic sector, while close to 4 million jobs were lost in international trade.⁴ The domestic boom—powered in the last half of the 1990s by a stock market and debt bubble—was unsustainable. The currently rising unemployment rate makes the trade deficit's drag on growth more evident.

Policy makers' indifference to the trade deficit is extraordinary, especially when compared to the bipartisan

distress over the federal government's fiscal deficit when it reached the vicinity of 4% of GDP, or the consternation that resulted from projections that the Social Security Trust Fund might run a deficit in the year 2038. By comparison, the stage is set for the trade deficit to touch off a serious economic crisis long before the Social Security Trust Fund needs even a modest tax increase to cover its obligations.

Avoiding the issue

The connection between the trade deficit and trade policy has been obscured by a superficial argument that trade deficits are caused by "macroeconomic" imbalances that have nothing to do with the trade agreements the administration wants to put on a fast track.

The notion that a trade agreement that leaves one side or another at a disadvantage will have no effect on the overall trade deficit is highly debatable. Indeed, such an argument can only be defended by reference to abstract economic "models" that assume a world in which no one is ever unemployed, consumers and investors have perfect knowledge, and all adjustments happen instantaneously (e.g., someone laid off today from a steel mill in Indiana will immediately land a job as a real estate broker in Arizona).⁵

But despite these dubious assumptions, the trade deficit is, indeed, partly the product of macroeconomic imbalances, although just how much is in dispute. *But whatever one believes about the root cause of the trade deficit, expanding trade and investment without dealing with those root causes has made matters much worse.*

Ten years ago many thought the federal government's fiscal deficit was the cause of the trade deficit; the two were even referred to as the "twin" deficits. It was alleged that the federal deficit stimulated American consumers and business to buy more than the country was producing and to soak up the savings needed to finance the difference. The fiscal deficit was also made a symbol in the ideological dispute over the role and size of the federal government. That the federal government was not balancing its books made it easier to paint "big government" as irresponsible.

The federal government's fiscal deficit, of course, was steadily reduced in the 1990s and, by decade's end, had become a surplus. Yet, not only did its "twin" not disappear, it continued to grow.

The low savings rate still contributes to the trade deficit, but it is now a function of the deficiency in *private* rather than *public* savings. This is a much harder problem to solve. In fact, we do not know how to raise the private savings rate. Moreover, in the current recession, raising the savings rate, i.e., reducing consumer demand, is counterproductive.

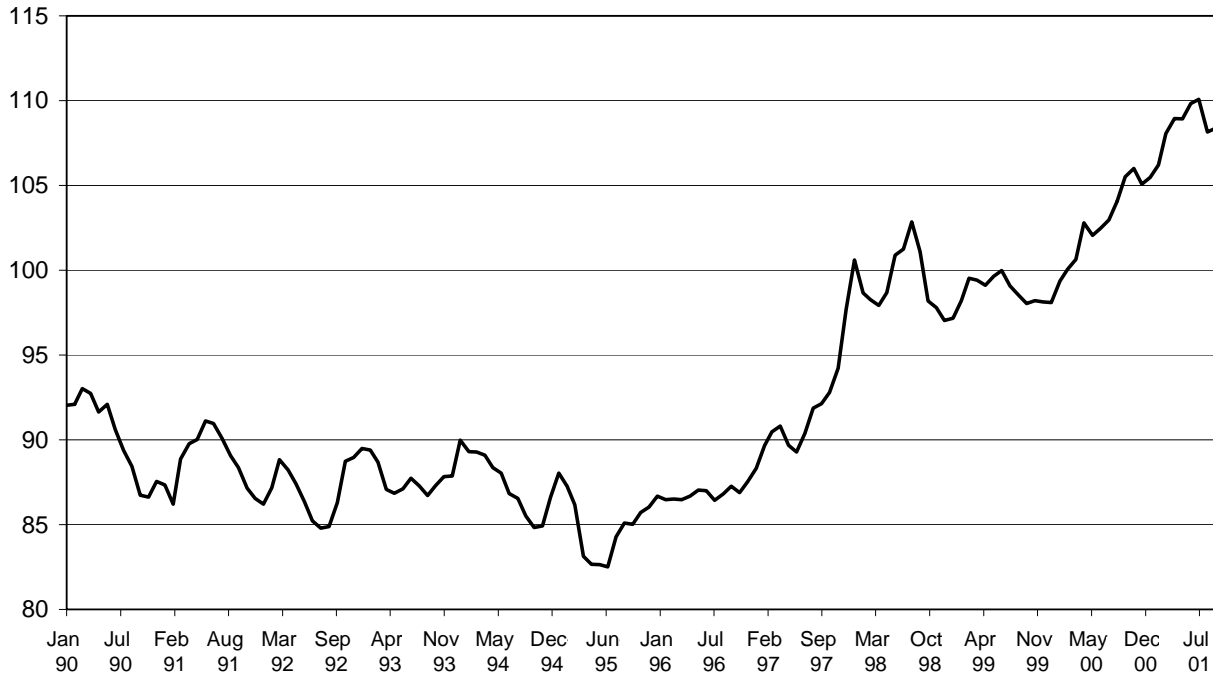
Another imbalance driving the trade deficit is the overvalued dollar, whose price against other major currencies is at least 25% too high. By making U.S. exports more expensive and imports cheaper, the expensive dollar has been a major cause of the erosion of U.S. manufacturing capacity (**Figure C**).

There are a number of reasons why the dollar is overvalued, including the attractiveness of a booming U.S. economy as a place for foreigners to invest in the 1990s. This was particularly true after the economic crises in East Asia and Russia. Slow growth, and therefore diminished investment opportunities, in Europe and Japan also helped make the U.S. a more attractive place to invest, which keeps the demand for dollars too high.

Whether one believes that the trade deficit is caused by low savings, a high dollar, slower growth in Japan and Europe, or some combination of all of these factors, the fact is that the U.S. government is not attempting to solve any of these problems. Indeed, the Bush Administration is deliberately moving in the opposite direction on

FIGURE C

Value of U.S. dollar, 1990-2000



Note: Price-adjusted broad dollar index.
Source: U.S. Federal Reserve Board of Governors.

all fronts. Its 10-year, \$1.3 trillion tax cut will further reduce the national savings rate, and the administration has repeatedly declared opposition to any effort to significantly reduce the value of the dollar. It has also been unwilling to use its political clout to pressure Europe and Japan into faster growth, and the need for allies in the war against terrorism makes it unlikely that it will do so in the near future.

Moreover, the trade agreements themselves have clearly made a major contribution to the growth of the deficit. U.S. negotiators have persistently traded off the interests of those who produce in the United States in favor of the interests of the finance industry and those who want to outsource U.S. production to take advantage of cheap labor. Despite the label “free trade,” the agreements have been mostly concerned with internationalizing the rights of U.S. investors to override national and local regulations, particularly those that protect labor rights, human rights, and the environment. This free trade strategy resulted in deals like NAFTA, which its promoters promised would increase the U.S. trade surplus with Mexico. Instead, NAFTA resulted in the creation of a trade deficit with Mexico, in large part because of the outsourcing of U.S. production to Mexico, where workers were not free to bargain and environmental costs were not assessed against producing firms.⁶

The debt machine

The result of all these factors is that U.S. consumers and businesses now have an inordinate propensity to import. According to last year’s report of the U.S. Trade Deficit Commission, “For an equal increase in national income in the United States and foreign countries, the United States increases its purchase of imports proportionally more

than foreigners increase their exports.”⁷ With the trade gap structured to grow faster than U.S. income, it is no surprise that trade agreements have had the perverse effect of widening the trade deficit and thus increasing U.S. borrowing from overseas. In a recent *New York Times* article (“America Is Borrowing Trouble,” April 9, 2001), Nobel prize-winning economists Franco Modigliani and Robert Solow recently characterized the large and growing deficit in the U.S. international trade balance as “the greatest potential danger facing the economy in the years to come.” *The U.S. economy has become a machine for the production of foreign debt.*

Free trade advocates also argue, more credibly, that consumers benefit from the lower prices that imports provide. There is clearly some truth to this, although the numbers used by the U.S. trade representative vastly overstate these gains and ignore the distributional consequences.⁸ But the U.S. consumer also benefited in the short term from a federal fiscal deficit that provided more government services and lower taxes. Yet that deficit was widely denounced as “immoral” because it called for making future generations pay for the present generation’s consumption, even though some of those government services, such as education and infrastructure spending, were investments in the future. By that standard, a trade deficit that puts a much larger burden on tomorrow’s citizens in order that today’s should enjoy cheaper consumer goods is even more immoral.

The fast track trade-off

Economic policy, like economics, is commonly a question of trade-offs. For members of Congress concerned with what is best for America, fast track poses just such a choice. Fast track may bring with it one modest benefit of somewhat unknown quantity: cheaper imports. The costs are much higher. Fast track is guaranteed to accelerate expansion of a trade deficit that erodes jobs and incomes, add to the growing burden of foreign debt, and make the U.S. economy more vulnerable to a financial crisis.

Moreover, under the conditions of a long, drawn-out war against terrorism, the United States should not be indifferent to the vulnerability that a less stable dollar creates. Nor to the possibility that a financial crisis might require the U.S. government to use precious political capital in order to enlist the support of other nations to stop a flight from the dollar.

Unfortunately, the lack of debate over fast track’s effect on economic stability has made it difficult for Congress to properly weigh these issues. Now is not the time for Congress to abandon its responsibility to scrutinize and modify trade agreements that might have extremely dangerous consequences. Rather it is the time to delay the process, and take a strategic pause in order to evaluate the effects of a relentlessly mushrooming trade deficit.

At this perilous point in U.S. history, even devout believers in free trade owe it to the nation to examine the actual trajectory of this piling on of foreign debt. Before we continue down the path of further deregulation of international trade and investment, the administration should be asked to come forward with a convincing strategy to deal with savings imbalances, to deflate the overvalued dollar, to strengthen manufacturing, to coordinate growth policies, and, perhaps, to instruct its trade negotiators on the difference between nickels, dimes, and dollars.

Endnotes

1. Richard Mills of the U.S. trade representative's office recently heralded jobs gained from rising exports as unequivocal evidence that NAFTA has "worked" for America's workers (*Washington Post*, Letters, July 28, 2001). See also Zoellick, Robert, 2001, Countering Terror With Trade, *Washington Post*, September 20, p. A35.
2. Godley, Wynne. 1995. *A Critical Imbalance in U.S. Trade, The U.S. Balance of Payments, International Indebtedness, and Economic Policy*. Public Policy Brief No. 23, Annandale-on-Hudson, N.Y.: Jerome Levy Economics Institute.
3. Scott, Robert E. 2001. *Fast Track to Lost Jobs*. Washington, D.C.: Economic Policy Institute.
4. Faux, Jeff. 2001. "Why U.S. Manufacturing Needs a 'Strategic Pause' in Trade Policy." Testimony before Committee on Commerce, Science, and Transportation hearing, titled *The Current State of American Manufacturing Industries*. U.S. Senate, June.
5. Dorman, Peter. 2001. *The Free Trade Magic Act*. Washington, D.C.: Economic Policy Institute.
6. Scott, Robert E. 2001. *NAFTA at Seven*. Washington, D.C.: Economic Policy Institute.
7. Trade Deficit Review Commission. 2000. *The U.S. Trade Deficit: Causes, Consequences, and Recommendations for Action*. Washington, D.C.: U.S. Trade Deficit Review Commission.
8. The U.S. trade representative's claim of gains from recent trade agreements amounting to between \$1,300 and \$2,000 for the average American family of four (Zoellick 2001) is based on abstract economic models—not empirical evidence—that employ unrealistic and often inaccurate assumptions about the real economy (see Dorman 2001). More realistic analyses have demonstrated accelerated inequalities due to trade. In their recent briefing paper, *Will New Trade Gains Make Us Rich? An Assessment of the Prospective Gains* (2001), Dean Baker and Mark Weisbrot of the Center for Economic and Policy Research found that, "for the three quarters of the [U.S.] labor force who lack college degrees the negative distributional effect of trade over the last two decades almost certainly outweighed the positive growth effects, causing them a net loss of real income."