Introduction and Summary

Even after a considerable improvement during 1988, U.S. international trade and payments deficits remain remarkably large by historical standards. Some further reduction of our external deficits may occur over the next year or so, but without significant policy initiatives or major economic shocks, these deficits will continue to be much too high for the long-term economic health of the U.S. and the world economy. The five articles in this issue are designed to assess the economic implications and problems of continuing large external deficits and the adjustments that will be required to restore equilibrium to the external accounts.

In recent years, much has been written about the issues raised by the U.S. external deficits. Research reported here is intended to add further to our general understanding of these issues. Its special focus, however, is on the medium-term economic and financial implications of alternative paths for the external deficits and on the macroeconomic performance trade-offs involved in the adjustment process. These analyses, of course, cannot provide a numerically precise blueprint of the consequences of the alternatives they examine. Nevertheless, the articles make clear the tangible and serious risks posed by continued large U.S. external deficits, and collectively they underscore the need for timely policy measures to reduce the external deficits substantially over the next several years.

The first three articles address two broad issues that have been at the core of the debate over the U.S. external deficit: the medium- and long-term consequences of continued large deficits and the problems they may create, and the macroeconomic adjustments in the U.S. economy that are likely to be required to restore long-term equilibrium to the external accounts. The remaining two studies focus on more specific implications of the external adjustment problem. One examines the extent to which trade deficit reduction can be achieved in the near term without placing undue strains on U.S. manufacturing capacity that would fuel inflationary pressures; the other considers the effects of recent changes in competitiveness and macroeconomic forces on U.S. trade in capital goods, a large U.S. industry and a major factor in the overall trade picture.

Both history and common sense suggest that persistent large external deficits eventually lead to serious economic difficulties. Yet with the U.S. economy in the seventh year of the present economic expansion, skeptics increasingly question whether this country's current account deficit is necessarily harmful or in need of policy remedies. The first study, by Charles Pigott, provides a perspective on this controversy by giving an overview of the economic consequences and problems resulting from continued large U.S. current account deficits. Pigott argues that the present external imbalance is not manageable in a fundamental and practical sense. In the first place, the financing of ongoing deficits of anywhere near their present size, even if technically possible, may well lead to upward pressures on domestic real interest rates, downward pressure on the dollar, and perhaps other serious financial strains as foreigners become increasingly reluctant to bear the risk of holding additional dollar assets. These pressures are likely to increase the longer substantial external deficits persist and ultimately could have significant adverse consequences for the U.S. economy.

Moreover, as U.S. debt service payments rise with accumulating foreign debt, the international deficit excluding net payments on indebtedness will have to move back toward balance and the corresponding gap between national spending and output will have to close. In these circumstances, a significant decline in investment, with adverse consequences for future growth and living standards, is almost inevitable unless private consumption and government spending can be restrained. Restoring trade balance will also require other macroeconomic adjustments, including a substantial slowing of aggregate spending and changes in its composition, and a significant reallocation of resources among major sectors of the economy. These adjustments, Pigott argues, are likely to be protracted and difficult under the best of circumstances, and may very well increase in severity the longer deficit reduction is delayed.

The question, therefore, is not whether a current account adjustment is needed but how and when it will occur and at what cost. In the second article, Janet Ceglowski and Bruce Kasman attempt to quantify the macroeconomic trade-offs involved in restoring the current account to long-term equilibrium. Using an empirical framework incorporating key macroeconomic relations between the external sector and the U.S. economy, the authors explore ways in which the current account deficit could be reduced to 1 percent of GNP over the next five years—that is, by the end of 1993. Feasible paths to this equilibrium are shown to be limited by several key features of the present economic situation, particularly the relatively high level of resource utilization and the need to maintain, or even increase, current rates of capital formation in order to ensure adequate growth in future productive capacity. The results imply that achieving the deficit reduction under these circumstances will require a slowing of domestic demand growth over the next five years to no more than half its average pace over 1983-88—and a still greater slowdown in private consumption and government spending. Collectively, the simulations strongly suggest that the options for reducing the current account deficit in a manner consistent with other economic goals are fairly limited. Monetary policy actions alone, and/or further declines in the dollar without changes in the macroeconomic forces underlying the external imbalance, cannot provide a lasting improvement but could delay the more fundamental adjustments needed for long-term equilibrium. The authors conclude that an appropriate combination of fiscal and monetary policies—which includes, among other things, a large reduction in the government budget deficit to raise national saving—appears to be the best option for achieving a substantial reduction in the external deficit while maintaining full employment, avoiding upward pressures on inflation, and preserving long-term growth prospects.

The potential financial market consequences of the failure to reduce the external deficit in coming years are analyzed in the third study by Juann Hung, Charles Pigott, and Anthony Rodrigues. The large current account deficits have led to substantial growth in U.S. indebtedness to foreigners, raising concerns about the possible financial strains that may arise if the deficits continue. To examine this issue, the article first identifies key aspects of the financing of the current account deficit over the last several years and then combines that information with other evidence to assess the likely future path of U.S. external debt and its impact on interest rates and exchange rates. The authors note that the financing of the external deficit has come primarily from private foreign sources, except during 1987, and generally has been accomplished more smoothly than many observers thought possible. Foreign demand for U.S. assets has been boosted by a number of favorable developments, including increased international financial integration and the strong preference by investors in Japan for high-yielding, longer term dollar instruments. Financial developments in coming years may not be as favorable, however, particularly because foreign investors are likely to face increasing incentives to diversify into other currencies as their dollar holdings grow.

In assessing possible future financial strains, the authors acknowledge that the numerous forces affecting the deficit financing cannot be predicted at all adequately. They attempt instead to provide a qualitative indication of the strains that may arise under two scenarios: in the first, the deficit remains at its current level in relation to GNP, while in the second, the deficit falls steadily over the next five years. The analysis suggests that a deficit that declined substantially in coming years could be financed with only modest, and possibly even negligible, upward pressures on domestic real interest rates or downward pressures on the dollar. In contrast, these financial pressures could turn out to be economically significant and quite problematic if large external deficits continued, since U.S. external dollar debt would almost certainly rise markedly in relation to foreign wealth.

The fourth article by Spence Hilton concerns a near-term issue that has been much discussed recently, whether the U.S. manufacturing sector will have enough capacity to accommodate a significant reduction in the trade deficit over the next two years or so. Hilton points out that manufacturing capacity utilization rates are already close to past cyclical peak levels in many, although not all, industries. Distinguishing

between primary and advanced processing sectors, and using relations estimated from past historical experience and survey data on planned corporate investments, he estimates that manufacturing potential output is likely to rise slightly faster during 1988-90 than its average over 1984-87. Hilton then assesses the total demands on this capacity that are likely to arise under plausible paths for trade deficit reduction and domestic demand growth. His calculations suggest that if the growth of domestic demand can be slowed to about 2 percent annually from its 1988 pace of 3¼ percent, the trade deficit could fall by as much as $40 billion over the next two years without undue strains on manufacturing capacity. In the absence of a major slowdown in the pace of domestic demand, however, reducing the trade deficit significantly over the near term will create inflationary bottlenecks in the manufacturing sector. One obvious implication of these results is that the capacity of the U.S. economy to achieve continued trade deficit reduction depends critically upon our ability to restrain the growth of domestic demand.

In the last study, James Orr discusses the U.S. trade performance in capital goods. The capital goods industry was the strongest U.S. export sector and enjoyed mounting trade surpluses during much of the 1970s, but its performance has deteriorated sharply since 1981. Orr shows that the trade surplus in capital goods trade would have fallen considerably during the 1980s even if the growth rates of imports and exports had remained at their 1975-81 average. Still, actual recent performance has been markedly worse than the projected trend. Using historical estimates of income and price elasticities with respect to international trade in capital goods, Orr attributes a considerable part of this difference to possible delay in the adjustment to the depreciation of the dollar in recent years. Even after full adjustment of capital goods trade to the lagged exchange rate effects, however, U.S. trade performance in capital goods is likely to remain weaker than in the early 1980s because of structural changes in the capital goods industry, especially the emergence of Taiwan, South Korea, and other newly industrialized Asian economies as important producers of capital goods.

Overall, our research on the external adjustment problem indicates the need for significant policy actions to reduce U.S. external deficits, although it does not provide precise details of the policies or their consequences. Collectively, the five studies in this issue suggest at least three important policy implications. First, continued large U.S. external deficits pose substantial risks that are likely to increase over time and may jeopardize important long-term economic goals. Second, the present excess of national spending over output that underlies the external deficit cannot be sustained indefinitely, and restoring external equilibrium will require protracted and substantial macroeconomic changes that may well become more severe the longer the adjustment is postponed. Third, without fundamental policy actions to restrain domestic noninvestment spending and to raise national saving, the necessary external adjustment can be achieved only by sacrificing other key economic goals—price stability, high employment, and adequate long-term growth in the economy's productive capacity. These broad conclusions underscore the need for timely economic policy initiatives to continue and reinforce the process of bringing the external accounts back toward balance over the next several years.