Commentary on "The U.S. Payments Deficit and the Strong Dollar: Policy Options

Paul ***Craig Roberts***

I have the feeling that I was invited to this conference as a dissenting voice. I will not disappoint you, but I must begin by acknowledging that I am in agreement with the conclusion of Richard Cooper's paper that the strong dollar and the large trade deficit are a direct consequence of monetary policy. I also believe that Professor Cooper, although he has left the price effects out of his analysis, has done a good job of showing the problems with many of the commonly proposed "solutions" to the U.S. trade deficit. There are some issues where I disagree with Professor Cooper. I believe it will be helpful to this conference if I fold my disagreements into a broader policy context that, I believe, will strengthen Professor Cooper's paper.

Economists generally have misinterpreted Reagan administration policy as a mix of loose fiscal policy and tight monetary policy. I do not know what accounts for this misinterpretation of administration policy other than habitual Keynesian ways of thinking that precluded anyone looking at the administration's own statements of its policy and at the actual facts.

The administration quested and planned on the basis of a different monetary policy than the one that the Fed delivered. The administration was looking for a 50 percent reduction in the rate of M1 growth spread over a six year period. It did not expect 75 percent of this reduction to show up the first year, nor did it expect the volatility that has characterized monetary policy. To quote from the February 18, 1981, report that announced the administration's economic policy: "The economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half those levels by 1986."

The administration certainly had no intention of attempting to cure inflation overnight with a recessionary monetary policy. Indeed given the constraints of conventional thinking at the time, such a policy would have had no credibility. Forecasting models such as DRI had a "'core rate of inflation" of 10 percent, which established a 10 percent inflation floor even with restrictive monetary and fiscal policies. Moreover, administration policy-

makers wanted to break the roller coaster cycle of fighting inflation with unemployment and vice versa.

The same unexpected monetary policy that produced a sharp and unexpected disinflation produced the large unexpected budget deficits that have been misinterpreted as a loose fiscal policy in Keynesian terms. The administration did not expect these deficit—nor did any other forecaster because no one predicted the sharp and sudden disinflation.[1] The administration's goals were to reduce federal expenditures and revenues to 19.3 percent of GNP by 1984.

It is perhaps useful to recall how unexpected the disinflation was. In 1981 the Reagan administration projected a 1982 inflation rate of 8.2 percent and was widely ridiculed for its "rosy scenario." That year I had to deal in public forums with large numbers of academic and Wall Street economists who were confident that inflation could not fall as low as 8.2 percent in 1982. The actual figure came in at 3.9 percent.

It is instructive to recall the inflation hysteria to which economists contributed in 1981. I remember a meeting of the Federal Reserve Board with its academic consultants at which prominent economists maintained that monetary policy was a "weak sister." They were convinced that the combination of tax cuts with a double-digit core rate of inflation meant that monetary policy could, at best, conduct a weak rearguard action. Chairman Volcker was concerned that a rise in inflation would be blamed on the Fed. In the time honored Washington way, he acted to protect his institution and simply turned off the money, reasoning that an administration with monetarists in office could not blame the Fed for inflation if there was no growth in M1. There is every indication that Volcker did not anticipate the results of this policy and that he was surprised by the telephone call from the Mexicans in the summer of 1982. He responded to the Mexican crisis by telling the Treasury Secretary that he was going to let interest rates go into a "free fall." And they did, despite massive upward revisions in the deficit forecasts issued by the Congressional Budget Office and Henry Kaufman.

The recession was unexpected also. Literally everyone "knew" that the problem was inflation. When on the advice of my office Secretary Regan warned in the first week of August 1981 that the Fed's monetary policy was leading the economy into recession, he was greeted with incredulity. Two months passed before he was willing to make another public statement. By then the situation was desperate. Regan again called for the Fed to honor its own targets and to loosen the extraordinarily tight monetary reins. The only

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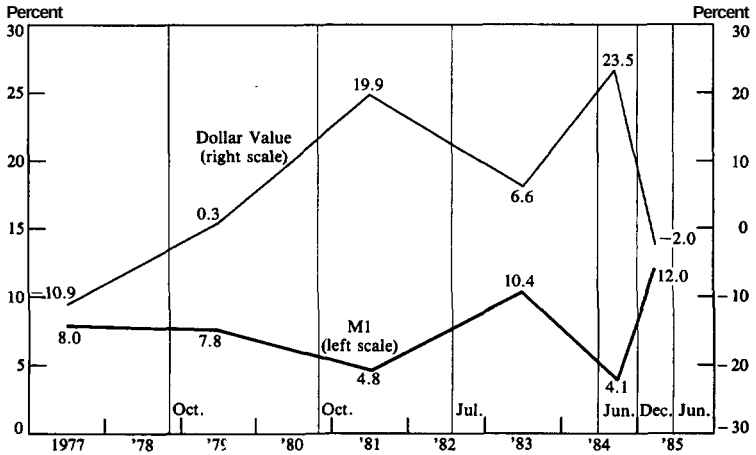
[1] In addition to the cyclical increase in the deficit, the recession contributed to the structural deficit. Because of the rapid fall in inflation relative to economic forecasts, the revenue loss fmm the lower nominal GNP is permanent as long as inflation remains down unless the previous peak nominal *GNP growth* rate can be achieved from real GNP growth.

result was another load of ridicule dumped on the Treasury Secretary.

Economists should understand that the nominal GNP forecast is the key to the deficit forecast. If nominal GNP is far below forecast, the deficit will be far above forecast. The nominal GNP levels have been far below everyone's projections in 1981. It does not serve the purpose of understanding or the interests of sound policy to equate the unexpected results of an unexpected monetary policy with the administration's fiscal policy. The same monetary policy that disinflated and restored the dollar's value (Figure 1) produced the budget and trade deficits.

FIGURE 1
Money Growth Rates and Growth Rates for the Value of the Dollar Over Selected Periods, 1977-Mid-1985



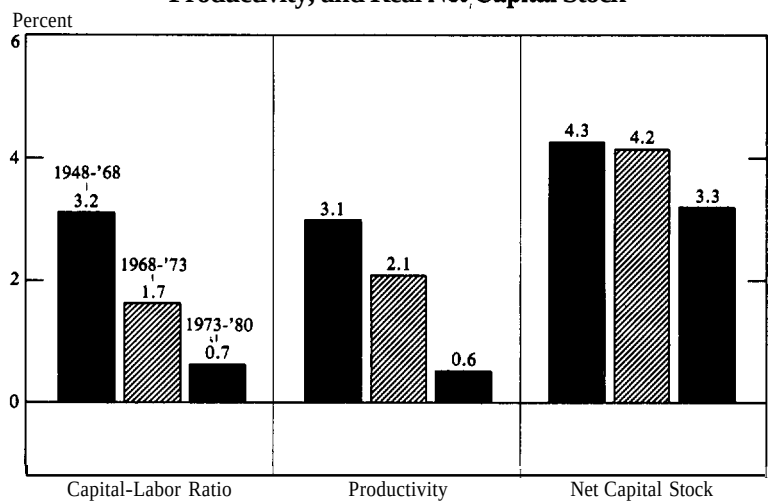
Source: Federal Reserve Board. Dollar value is based on Federal Reserve index of weighted-average exchange value of U.S. dollar against currencies of other G-10 countries plus Switzerland. March 1973 = 100.

It is impossible to believe that the inflation rate could unexpectedly drop from double-digit rates back to the rates of the 1960s and for the dollar not to change in value. Economists, if not journalists and politicians, should understand that the Fed cannot simultaneously make the dollar a more desirable currency in which to hold assets and fail to meet the increased world demand for dollars without the dollar rising in value. Part of the dollar's rise in value is due to lower tax rates including the lower rates resulting from the lower inflation. The trade deficit is a manifestation of an adjustment process that was set in motion by a change in the inflation and investment climate.

This relationship should be self-evident to economists. It makes it difficult to understand the overwhelming emphasis on budget deficits as the key to the dollar's rise in value-especially when the linkage between budget

deficits and interest rates is weak or non-existent over the period of the recent U.S. experience that they are supposed to explain. Equally curious are economists who believed quite strongly in the Phillips curve in 1981 but who write and speak today as if fighting inflation is a free lunch. All of the adjustments (seen as costs in many quarters) associated with lower than expected inflation—a stronger dollar, the trade deficit, budget deficits larger than projected, and the erosion of asset values underlying the world debt structure—have been attributed to tax rate reduction. Perhaps political and ideological opposition on distributional grounds to the supply-side policy have crowded out economic thinking. Or perhaps it is just the self-interest motive at work protecting human capital.

FIGURE 2
Rates of Growth in the Capital-Labor Ratio, Productivity, and Real Net Capital Stock



Note: Capital-labor ratio is real net capital stock (gross stock less replacement requirements and pollution abatement expenditures) in the private business sector divided by the civilian labor force (excluding government).

Productivity is output per hour of all persons in the private business sector.

Concerning the administration's fiscal policy, perhaps never has a policy been so willfully misunderstood. The purpose of the administration's tax and budget policy was to reduce the cost of labor and capital in order both to spur real economic growth and to address the nation's competitiveness problem. As Professor Cooper notes, unemployed U.S. resources indicate a competitiveness problem rather than excess demand from excessive fiscal stimulus. This competitiveness problem predates the dollar's recovery.

In the 1970s despite a weakening dollar, the external position of the U.S. deteriorated. The competitiveness problem has its origin in the collapse in the growth of the capital-labor ratio and labor productivity during the 1970s (Figure 2.) As a result, high priced U.S. labor was no longer shielded from foreign competition by strong productivity growth. The focus on exchange rates alone overlooks the impact of rising total factor costs.

During the late 1960s and the 1970s policymakers trained in the Keynesian tradition focused on the income effects of fiscal policy and overlooked the relative price effects. Consequently, the tax component in the cost of production rose as inflation eroded the real value of depreciation allowances and pushed taxpayers into higher tax brackets. In the Keynesian model, marginal tax rates and the share of GNP collected in revenues are unimportant as long as the government spends the money. In the supply-side model, taxation is the main policy variable affecting the cost of capital and labor.

It would not be fair to Professor Cooper's paper for me to settle these issues here. However, it was necessary for me to raise them in order to properly evaluate Professor Cooper's policy recommendations. He calls for a tighter fiscal policy and a looser monetary policy. I favor the same policy, but I believe that our thinking is quite different. We both want to improve U.S. competitiveness. Professor Cooper is addressing this problem by seeking to lower the exchange value of the dollar. He believes that reducing future budget deficits will lower interest rates and capital inflows, thereby lowering the dollar exchange rate, while the Fed simultaneously achieves the same result by pumping more dollars into the currency market. In Professor Cooper's approach it makes no difference whether the deficit is reduced by cutting spending or by raising taxes, because his goal it to lower interest rates and reduce capital inflows.

In my approach, how the deficit is reduced makes all the difference in the world. Since our competitiveness problem is not one merely of the dollar's exchange value, the approach taken to deficit reduction is the key. Cutting federal spending would free real resources for the private sector and lower the cost of U.S. production, making the U.S. more competitive. On the other hand, higher taxes would reduce the trade deficit by raising the cost of capital (and labor), thereby causing capital outflows. The increased factor costs would raise the cost of production in the U.S. and worsen the basic cause of our competitiveness problem. Similarly, if during 1980-83 other countries achieved the "fiscal contractions" that Professor Cooper mentions through tax increases, we have an overlooked cause of greater capital inflow into the U.S.

In conclusion, I think that Professor Cooper is to be congratulated for recognizing the role played by monetary policy in the dollar's recovery and for demonstrating the simplistic nature of many proposed solutions to "the problem of the high dollar." However, U.S. competitiveness is not merely a

matter of the dollar's exchange value. **A** Keynesian perspective alone could result in the fiscal side of his recommendation being implemented in a way that would worsen the long-term problem of **U.S.** competitiveness. For example, recent work shows that investment in equipment is much more sensitive to changes in tax rates than to changes in interest rates.[2] We should note that the several tax increases since 1982 (Table 1) have failed to reduce the domestic and external deficits.

TABLE 1

What is Left of the Tax Cut? FY 1981 - FY *1989*

($ billions)

			Fiscal Years 1981 through 1989
Tax Cut:	Economic Recovery Tax Act of 1981 (ERTA)		-$1,488
Tax Increases:	Inflation-Induced Bracket Creep	+ $650	
	1977 Social Security Tax Rate Increases	+ $287	
	Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)	+ $311	
	Gasoline Tax Increase	+ $28	
	1983 Social Security Amendments	+ $90	
	"Downpayment"	+ $101	
	Other	+ $9	
Total Tax Increases			+ $1,476
Net Tax Cut			-$ 12
Nine Year Average Net Tax Cut			-$ 1.4

The linkage necessary to the deficit theory of the dollar's rise in value requires increasing capital outflows in response to higher **U.S.** interest rates. However, the net capital inflows do not seem to be primarily a response to interest rates. The data indicate that the main source of the net capital inflow is a collapse in **U.S.** capital outflows from $119 billion annually in 1982 to $21 billion in 1984. This sharp reduction in **U.S.** capital outflows seems to be due primarily to a portfolio adjustment resulting from **U.S.** banks reassessing their third world exposure. It is likely to have occurred regardless of

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[2] Aldona E. Robbins, Gary A. Robbins, and Paul Craig Roberts, "The Relative Impact of Taxation and Interest Rates on the Cost of Capital," in Dale Jorgenson and Ralph Landau, eds., ***Technology and Economic Policy,*** (Cambridge, Mass.: Ballinger, 1986.)

the level of **U.S.** interest rates. **If** indeed the capital inflows reflect a portfolio adjustment to lower **U.S.** inflation and tax rates and to over-exposed U.S. bank capital in foreign loans, the dollar should drop once the adjustment is completed, and with the usual lags the trade deficit will correct.

On closer examination economists might find that the current account deficit is explained by international portfolio adjustments. The view that capital inflows passively finance a current account deficit resulting from an overvalued currency is an example of out of date habitual ways of thinking. In a world in which money and capital markets have been internationalized, capital inflows can force countries to run current account deficits. If the initiative lies with capital inflows responding to disinflation, greater economic and political stability, higher after-tax rates of return on real investment, and cutbacks in capital outflows for'sound portfolio reasons, the picture that has been painted by some of the tax cuts launching the **U.S.** on an excess demand consumption binge that is financed by high interest rates sucking in foreign capital is silly in the extreme.