

## Commentary

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*C. Fred Bergsten*

### **U.S. trade and the dollar**

David Richardson's paper addresses comprehensively the major issues now confronting U.S. trade policy, defined, properly, to encompass a wide range of international and domestic measures adopted by the government which affect trade flows. I agree with most of its major conclusions. However, the paper lacks focus and a clear sense of priorities — and it comes to no clear-cut conclusions. My own comments will thus emphasize what I regard as the most important problem now facing U.S. trade, and the policy changes needed to remedy that situation.

In my view, the United States today has a very severe trade problem — a problem which at least begins to run the risk of fostering deindustrialization of the U.S. economy. That problem is not related to pernicious practices by Japan Inc. or other foreign countries. Nor is it the lack of a level playing field; there is no conclusive evidence that trade distortions (however defined) are higher abroad than in the United States. The problem is not our own lack of an industrial policy, though there are several steps normally included under that rubric which the United States could and should sensibly undertake (see below).

Indeed, the United States until quite recently had no major trade problem. In his paper for this conference, Lawrence shows for the decade of the 1970s that trade in no way contributed to any “deindustrialization” of the United States. During the more recent past, U.S. trade performance was even better. From 1978 through 1980, U.S. exports grew twice as fast as world trade. The United States regained a share of world manufactured exports that it had last held in 1970. Our current account improved by more than \$15 billion despite a rise

of more than \$35 billion in the cost of oil imports — a gain of more than \$50 billion on everything else. The trade balance in manufactured products rose to its highest level ever, except for 1975 when the sharp domestic recession severely depressed imports of manufactured products. It would be extremely difficult to conclude that the United States faces any fundamental problem of international competitiveness.

Since early 1981, however, the United States has developed the major trade problem to which I refer — the massive overvaluation of the dollar in the exchange markets, compared with the underlying competitive relationship between the United States and its major rivals in international trade. Richardson cites the difficulties caused by volatile exchange rates for traders, but the greater problem by far is the misalignments which seem to have become so endemic in recent years. The current misalignment has produced a stunning loss of price competitiveness for all U.S. products which compete internationally, either in the U.S. market itself or abroad.

The traditional method for calculating the extent of such misalignments is based on the concept of purchasing power parity. A base period is selected when equilibrium is judged to have existed in the past, and the contemporary equilibrium rate is then derived by adjusting for differences in inflation rates between the two countries concerned in the intervening period. Using variants of this approach, a range of analysts have concluded that the dollar is presently overvalued by a trade-weighted average of 15-25 percent.

All purchasing power parity calculations suffer, however, from the arbitrariness inherently involved in regarding any previous period as representing "equilibrium." My colleague John Williamson has thus employed an alternative approach, in which he first calculates the exchange rate changes needed to actually achieve current account equilibrium — defined as the counterpart of underlying net capital flows and adjusted for differences in cyclical positions — for the five major industrial countries in 1976-77. He then brings these rates forward to the present, adjusting for structural changes which may have occurred in the meanwhile (such as the second oil shock, which hit Japan particularly hard) as well as inflation differentials. Williamson concludes that the dollar is overvalued by about 24 percent in trade-

weighted terms and, as shown in the accompanying table, by 20-30 percent against the yen and DM':

	Fundamental equilibrium rate (September 1983)	Market rate (September 12, 1983)
yen	205	243
DM	2.04	2.65
pound sterling	1.58	2.50
French franc	6.05	8.00

The impact on U.S. trade of such a currency misalignment is equivalent to placing a tax of 20-25 percent on all U.S. exports and paying a 20-25 percent subsidy on all imports coming into the United States. Traditionally, our trade balance deteriorates by about \$3 billion for every percentage point loss in U.S. price competitiveness. A deterioration of \$60-75 billion should thus be expected. Since our *merchandise* trade is in deficit by about \$25-30 billion when our *current account* is in equilibrium, as was in fact the case during 1979-81, it should be no surprise that this deterioration will take the U.S. merchandise deficit close to \$100 billion by 1984 — as recently forecast by administration officials — or even beyond. The corresponding current account deficit would be on the order of \$75 billion, five times the pre-1983 record.<sup>2</sup>

The effects on the U.S. economy of the deterioration in the trade balance have already become severe. Updating Richardson's Table 1, the trade balance in manufactured goods deteriorated by \$50 billion (annual rate) between 1980 and the first five months of 1983. From the first quarter of 1981 through the fourth quarter of 1982, the closest quarterly approximation to the recent recession, the deteriora-

1. John Williamson, *The Exchange Rate System*, Washington: Institute for International Economics, September 1983, esp. Table 11.

2. The actual merchandise trade result could be even worse due to cyclical factors, if the United States continues to lead the world recovery, and because the continuing debt problems of countries which represent major U.S. markets (especially in Latin America) will inhibit their purchases from the United States. On the other hand, the recorder numbers may overstate the current account deficit by counting some U.S. services exports as "errors and omissions"; the magnitude of this statistical difficulty has been estimated as high as \$15-20 billion in Morgan Guaranty, *World Financial Markets*, May 1983. Even allowing for such a data problem, however, the current account deficit is clearly soaring to very high and record levels.

tion in net exports equalled more than three-quarters of the total decline in real U.S. GNP — despite the sharp decline in oil imports and the fact that in all previous postwar recessions, except 1958, the U.S. trade balance has improved sharply in the face of domestic recession.<sup>3</sup>

Moreover, this situation is becoming much worse. The further deterioration expected in 1983 and 1984 would take about one percentage point off the GNP recovery in each year. By the time the merchandise deficit hits \$100 billion, it will have cost the economy about 2 million jobs — mainly in the manufacturing sector.

The impact is also pervasive across U.S. industries. Numerous high-technology firms such as Hewlett-Packard, TRW, and Wang have testified to the adverse effects on them of the overvalued dollar. Since much of our future growth is likely to rely on such firms, the long-term outlook for the economy is jeopardized, as indicated by Bosworth during the discussion of his paper.

The possible long-term impact of dollar overvaluation is now becoming of particular concern, as it persists into a third year and as official administration spokesmen suggest that it may be a quasi-permanent phenomenon. Martin Feldstein argues that "dollar strength" will continue as long as huge deficits remain in the federal budget, with resulting high U.S. interest rates, and budget director David Stockman has admitted that those deficits are likely to persist "as far ahead as the eye can see".<sup>4</sup> Under such circumstances, as in the 1960s, we could anticipate growing offshore sourcing and foreign rather than domestic investment by American firms.

Beyond these direct effects on the economy, such severe dollar overvaluation is a potent source of pressure for protectionist trade policies. Indeed, the postwar history of U.S. trade policy suggests that dollar overvaluation (as in the late 1960s to early 1970s, in the mid-1970s, and now) may be the most accurate leading indicator of

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3. There were of course several pluses and minuses among the GNP components, so it would be incorrect to say that the decline in real net exports "caused" 78% of the recession. However, the trade decline was about twice as great as the housing decline and was by far the biggest single factor in the downturn.

4. Feldstein has in fact argued that dollar overvaluation and huge trade deficits are desirable in a second-best world of huge budget deficits, because only the corresponding inflow of capital from abroad can avoid crowding out. However, it is hard to see how such avoidance would offset the adverse effects on the investment plans of American industry of a quasi-permanent undermining of its international competitive position.

an outbreak of new import controls (and export subsidies).'

This impact of dollar overvaluation has already begun to appear extensively. Despite its free-trade rhetoric, the Reagan administration has moved to restrict imports sharply in at least a half-dozen industries: autos, textiles and apparel, sugar, steel, specialty steel, and motorcycles. Indeed, the administration is victimized by a fundamental policy contradiction: its complete neglect of the currency problem fatally undermines any prospect for **effective** implementation of its laissez-faire preferences regarding trade policy.

### Policy proposals

The central issue for U.S. trade policy is thus the continuing (and, as of this writing, growing) overvaluation of the dollar in the exchange markets, and what can be done about it. The most decisive policy step available is immediate action to reduce substantially the prospective ("outyear") deficits in the government budget, which would take pressure off interest rates directly and permit more expansionary monetary policy by the Federal Reserve without rekindling inflationary expectations. Such a reduction in U.S. interest rates (unless fully matched by reductions in foreign interest rates, which is unlikely) would limit, and probably reverse, the inflow of capital which has been a major element in pushing the dollar to such excessive levels.

I am quite pessimistic about the prospect for meaningful action on the budget, however. If the recovery continues, there will be no incentive to alter policy. If the recovery falters, few voices would support a reduction in fiscal stimulus. Only a further sharp rise in interest rates themselves, which would almost certainly take the dollar to new highs and thus intensify the trade problem substantially, would be likely to galvanize the political compromises needed to construct a responsible U.S. budget policy.

It may well be necessary, therefore, to deal with the currency/trade problem more directly. Richardson is correct in noting that sterilized intervention could be quite useful as part of **such a strategy**. At a min-

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5. See C. Fred Bergsten and John Williamson, "Exchange Rates and Trade Policy," in William R. Cline, ed., *Trade Policy in the 1980s*, Washington: Institute for International Economics, 1983. Such a relationship is easy to understand, since dollar overvaluation does in fact cause major competitive dislocation for a wide array of American industries and thus fosters political coalitions in support of deviations from the traditional liberal U.S. approach to trade policy.

imum, such intervention — if carried out with conviction, on a sustained and internationally coordinated basis and with substantial commitment of resources — can keep the situation from getting worse by braking further dollar appreciation. Moreover, when market forces push rates in the proper direction, as they inevitably do periodically, skillful intervention can accelerate the pace and extent of corrective movement; for example, a golden opportunity to achieve yen-dollar equilibrium occurred in early 1983 when joint intervention could have built on the 20 percent strengthening of the yen which occurred between November 1982 and mid-January of this year.

In addition, the United States will have to seek help from its major trading partners to correct the currency problem. Japan, for example, could quickly strengthen the yen by borrowing heavily abroad (and converting the proceeds to yen) and limiting, probably through administrative guidance, the huge capital outflows by Japanese firms and investors which have dominated Japan's current account and been the immediate source of yen **weakness**.<sup>6</sup> Several major allies — notably Germany, Japan, and the United Kingdom — could help by adopting much more expansionary fiscal policies, as part of a coordinated effort to sustain the global recovery as well as to adjust the huge trade and currency imbalances.'

For the longer **run**, we will need to move to an international monetary system **which is** less tolerant of overshooting and misalignments, of which the current dollar overvaluation is the most dramatic and costly example. My preferred alternative is a system of "crawling target zones" under which the major countries would continually assess the ranges (of perhaps 15-20 percent) within which their currencies should appropriately lie, adjust those ranges to account for inflation differentials and other changes in underlying competitive conditions (**hence, the "crawl"**), and commit themselves to take the actions **necessary to** keep rates from moving outside those zones. One purpose of such a system would be to bring external pressures to

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6. Details can be found in C. Fred Bergsten, "What to Do About the U.S.-Japan Economic Problem," *Foreign Affairs*, Summer 1982, updated in testimony of April 7, 1983, before the Senate Foreign Relations Committee.

7. Details can be found in *Promoting World Recovery: A Statement on Global Economic Strategy by Twenty-Six Economists from Fourteen Countries*, Washington: Institute for International Economics, December 1982, as updated and quantified in C. Fred Bergsten and Lawrence R. Klein, "Assuring World Recovery: The Need for a Global Strategy," *The Economist*, April 23, 1983.

bear to help prevent the emergence of policies as destructive to both national and international prosperity as the current U.S. fiscal-monetary mix.<sup>8</sup>

### Other "trade policy" steps

Finally, I would add a few words on other steps which would seem necessary to recreate a viable U.S. trade policy for the 1980s.<sup>9</sup>

First, Richardson is clearly correct in calling for a new, worker-oriented, adjustment-centered program of government response to trade dislocation. The Trade Adjustment Assistance program, for all its shortcomings, represented a critical political component of U.S. trade policy for almost two decades. A renovation of that program, correcting its flaws but restoring its contribution to overall trade policy, is essential.<sup>10</sup>

Second, it is also essential to renew the process of international trade-liberalizing and rule-making negotiations. History shows that trade policy is like a bicycle: it either moves forward toward greater openness, in the general interest, or it topples toward controls under the pressure of narrow, **sectoral** forces. Moreover, there is a wide range of both old issues (such as agriculture, subsidies, and textiles) and new issues (such as investment and **services**) which require new international conventions and agreements. I believe that Richardson is too quick to give up on the prospects for forging new multilateral connections, though I have no objection to arrangements between smaller groups of countries if they advance the ultimate objectives cited here.

Third, the United States should use its current trade policy tools — particularly countervailing and anti-dumping duties — aggressively against predatory practices of foreign governments and firms. Fortunately, we have remedies on the books to deal with most of the objectionable practices — although further evolution may well be needed both in defining "subsidies" and in fashioning effective responses to

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8. Details are in Williamson, *The Exchange Rate System*.

9. Elaboration can be found in C. Fred Bergsten and William R. Cline, *Trade Policy in the 1980s*, Washington: Institute for International Economics, November 1982.

10. One set of proposals can be found in Gary Clyde Hufbauer and Howard Rosen, *Managing Comparative Disadvantage*, Washington: Institute for International Economics, forthcoming.

them." Active use thereof is an essential component of any effective U.S. trade policy.

Finally, there are certain steps we could and should take which are sometimes included under the rubric of "industrial policy."<sup>12</sup> We clearly need to develop visions of where our major industries are going over the next 10 to 20 years, to see whether we like the prospects and to serve as a baseline against which policy proposals for those industries (including trade measures) can be judged. We need current analysis of the policies adopted by foreign governments to promote their industries, rather than coming in a decade or more later to try to address a problem that — if it ever existed — is much too far gone to remedy effectively. We need to coordinate the various policies frequently taken toward a particular industry by different parts of our government. And we need to insist on an effective adjustment program by any industry which gets government help, such as import relief, and monitor that program zealously to assure its implementation. A new governmental entity could be created to carry out these functions, which in addition to its merits per se could provide a stepping stone for more extensive "industrial policy" actions later if the modest initial efforts succeeded and if it became clear that a further effort were needed.

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11. See ~~Gary~~ Clyde Hufbauer, *Subsidies in International Trade*, Washington: Institute for International Economics, 1983.

12. See my "What Kind of Industrial Policy for the United States?" Testimony before the Subcommittee on Economic Stabilization of the House Banking, Finance and Urban Affairs Committee, June 9, 1983.