

Comments and Discussion

Gary Hufbauer: Neomercantilists are gaining new ground with each month's trade figures, each commercial dispute with Japan, and each newly revealed flaw in the economic spectacle known as Reaganomics. In the face of the neomercantilist attack, the papers delivered at this symposium make a reasoned and valiant effort to defend the ramparts of a liberal economic system.

Make no mistake. The ramparts are under attack. Watch the newspaper headlines and the magazine cover stories: "Free Trade Losing Its Supporters—Large U.S. Debts Strengthening Drive for Protectionist Legislation" (*Washington Post*, May 3, 1987); "Can America Compete?" (*Business Week*, April 20, 1987). And watch the names that grab the limelight on trade questions: Richard Gephardt, Lee Iacocca, Robert Reich, and Lester Thurow.

Neomercantilists have even breached the walls of the citadel. Contrast President Reagan's trade rhetoric with his trade actions. Ronald Reagan, the most resounding free trade rhetorician since Woodrow Wilson, has yielded to protectionist pressure in one industry after another—sugar, steel, autos, lumber, and more—in a series of "strategic withdrawals" designed to avert a full-scale rout.¹

In these comments, I offer my own assessment of the trade policy debate, starting with a brief review of the international trade worries that have so amply nourished neomercantilist thought, then presenting

1. Gary Clyde Hufbauer and Howard F. Rosen, *Trade Policy for Troubled Industries* (Washington, D.C.: Institute for International Economics, March 1986). It is worth noting that President Reagan's celebration of temporary "escape clause" protection in saving Harley Davidson overlooks the fact that most of his trade actions entailed semipermanent protection with no requirement that the domestic industry adjust to international competition on a prescribed timetable.

an overview of establishment defenses, and finally pointing to gaps in the establishment's barricades.

Two developments gave prominence to neomercantilist arguments. Both are well known. The first is the string of huge U.S. current account deficits: \$140 billion in 1986, about the same in 1987, and apparently exceeding \$100 billion for years to come. The inevitable corollary of back-to-back current account deficits is the rapid buildup of net external claims held by foreigners on U.S. assets: the trajectory of net external claims is now pointing toward \$1,000 billion in the early 1990s, about 20 percent of U.S. GNP.

The second spur to the neomercantilists is the growing fear that the United States is fast becoming a second-rate industrial power and the suspicion that superior Japanese economic statecraft is an important cause of America's relative decline.²

These developments inspire concern that much is wrong with American economic policy. The alleged ills include not only profligacy by the federal government and individual households, but also national neglect of worker skills and worker attitudes, inadequate civilian research and development, low business investment, and corporate strategy hobbled by a fear of takeover bids. Beyond these domestic shortcomings, the neomercantilists argue that an open trading system has enabled foreign firms to take a free ride on the vast U.S. market—to the disadvantage of American industry and workers.

Some observers see in these developments a watershed in American economic policy. Pat Choate, for example, divides American commercial history into three phases.³ From publication of Alexander Hamilton's *Report on Manufactures* in 1791 to Woodrow Wilson's inauguration in 1913, explicit U.S. policy was to promote industrial growth behind a wall of high tariffs. From the era of Woodrow Wilson to that of Ronald Reagan, policies of free trade dovetailed with ascendant American economic and political power. And after Ronald Reagan? Choate sees the distinct possibility of inward-looking policies, both diplomatic and

2. Among the insignia of relative decline are slower productivity growth in the United States than in Japan (even in the 1980s when the Japanese economy slowed down); superior Japanese commercialization of products invented in the United States, such as color television, video cassette recorders, and a range of semiconductors; far weaker secondary and vocational education systems in the United States than in Japan; far less job loyalty in the United States; and, of course, much lower U.S. saving and investment rates.

3. Lecture at Georgetown University, May 5, 1987.

commercial, with Congress playing a larger role in shaping the foreign policy agenda.⁴

Defenders of the liberal economic order can be grouped into three camps, two of which are represented in this symposium. The first camp argues that the neomercantilists are doing their best to whip up public anxiety and that the media have played into their hands by vastly exaggerating America's problems. In the face of hysteria, the right policy is simply to "keep calm." Purveyors of this advice include a range of economists from Arthur Laffer to Franco Modigliani to Herbert Stein, who more or less dismissed the problem in the *Wall Street Journal*. The market, Stein argued, knows better than the government what the optimum trade deficit is. Despite the deficit, U.S. total output and per capita output are higher now than they were in 1982, the last time the United States had a trade surplus. All that is happening is that international levels of per capita output are converging. "There must," he concluded, "be something more serious to worry about."⁵

The second establishment camp is occupied by mainstream macroeconomists, ably represented at this symposium by Rudiger Dornbusch, and including such advocates as C. Fred Bergsten, Alan Blinder, Martin Feldstein, and Stephen Marris. Mainstreamers insist that the huge current account deficit and buildup of net external claims is the direct and foreseeable result of Reaganomics, with its massive budget deficits, high real interest rates, and, until 1985, a vastly overvalued dollar.

To be sure, mainstreamers disagree among themselves as to proper policies for reducing the fiscal deficit, for depreciating the exchange rate, and for stimulating Japan and Europe. But they resoundingly agree with one another that the problem is a macroeconomic problem—by definition, a problem within their peculiar competence—and that the damage visited on the economy by Reaganomics can be largely undone by a dose of "anti-Reaganomics."

4. Peter F. Krogh, Dean of the School of Foreign Service at Georgetown University, contends that Congress is no longer providing the financial backing necessary to support American foreign policy on the scale pursued in the 1950s and 1960s. See Edmund A. Walsh School of Foreign Service, Georgetown University, *Report of the Dean, 1986*, pp. 9–10. For a more optimistic note on commercial policy trends, see Gary Hufbauer, "The Long View of Trade Policy," *Harvard International Review*, vol. 9 (February-March 1987), pp. 6–9.

5. Herbert Stein, "Leave the Trade Deficit Alone," *Wall Street Journal*, March 11, 1987.

The third establishment camp—well represented at this symposium by Robert Crandall, Robert Lawrence, Robert Litan, and Catherine Mann—goes on the offensive in the debate about whether America is still “No. 1.” These observers are not sanguine that the free flow of knowledge and capital will keep America from slipping to “No. 2.” But they argue that lagging performance must be addressed by renewed emphasis on the basics: more civilian research and development, better worker skills, more investment, and a balanced budget.

Conversely, they argue that congressional efforts to find new solutions in the realm of trade policy or industrial policy will at best prove ineffective and at worst damaging to the smooth workings of the economic system. Robert Crandall points to the ineffectiveness of steel protection and the outlandish cost of auto protection. Robert Lawrence and Robert Litan point to errors in the neomercantilist lament about low wages and the neomercantilist enthusiasm for matching foreign trade distortions with American trade distortions. Catherine Mann emphasizes the dangers of an “aggressive” trade policy posture: with a few miscalculations, everyone can be worse off.

A neomercantilist would lambast all three establishment camps as out of touch with the realities of economic life and given to excessive faith in market mechanisms. I do not agree with those arguments. But I do see gaps in the establishment barricades, and, in the spirit of friendly criticism, I will point them out.

Can we safely rely, as “keep calm” economists recommend, on markets to regulate the size of current account deficits and the accumulation of net external claims? Alan Blinder tells us why not. “As Herbert Stein is fond of pointing out, if something cannot continue forever, it will stop. So it is with the unseemly amount of foreign borrowing the U.S. has been doing lately to finance the trade deficit. We cannot feed our voracious borrowing habit at current rates indefinitely, so something will curb our appetite. But there are better and worse ways to stop.”⁶

Recent economic history justifies skepticism that financial market prices—namely, exchange rates, interest rates, and equity valuations—will send correct and timely signals to the real markets. If the signaling system functioned well, why did the world economy experience a

6. Alan S. Blinder, “It’s Time to Put an End to the Borrowing Binge,” *Business Week* (May 4, 1987), p. 22.

devastating recession between 1982 and 1984? Only with painful lurches does the financial system accomplish a shift of resources between broad areas of economic activity: from the government sector to the traded goods sector, from expenditure to savings, from stimulus in the United States to stimulus in Japan and Europe.

The market mechanism works well at moving resources from construction activity to retail services. But it does not necessarily deliver a national saving rate that is consistent with national aspirations. And to accomplish smooth transitions on an international scale, governments must pursue active and coordinated policies.

The “keep calm” defense tells America not to worry because the free flow of capital and knowledge will ensure a rough parity between the United States and other leading industrial nations. According to this argument, because there is a strong tendency toward “convergence,” the United States cannot regain its postwar position of leadership in the world economy, but it will not fall much behind Japan.

The convergence story is contradicted by economic history. In 1899, U.K. per capita gross domestic product, then the highest in the world, was twice the French level and thirteen times the Japanese level.⁷ In 1985, the U.K. per capita gross national product was only 85 percent of the French level and just 71 percent of the Japanese level.⁸ Most Americans would not regard a U.S. per capita income that was only 71 percent of the Japanese level as “convergence.”

The convergence story is also contradicted by common sense. To be sure, a great deal of capital moves between nations; but national saving rates remain the foremost determinant of national investment rates. Moreover, even in this era of international technology licensing and multinational corporations, much production know-how remains highly specific to particular firms and particular workplaces.

The first thing to be said about the mainstream macroeconomic defense is that it misses half the debate. Even if the mainstreamers are right, and their prescriptions are followed, and the U.S. current account deficit

7. Alfred Maizels, *Industrial Growth and World Trade: An Empirical Study of Trends in Production, Consumption and Trade in Manufactures from 1899 to 1959 with a Discussion of Probable Future Trends* (Cambridge University Press, 1963), table E2, p. 533.

8. Central Intelligence Agency, *Handbook of Economic Statistics, 1986*, table 2, p. 24.

smoothly heads toward zero, does that answer American concerns about becoming “No. 2”? Probably not. External equilibrium provides no assurance that the quality of technological innovation or the rate of productivity growth will keep America at parity with Japan.

The second criticism of mainstreamers is that they have rigidly narrowed the array of solutions. Basically, their menu contains only three dishes: a smaller fiscal deficit in the United States, further depreciation of the dollar, and rapid growth in Europe and Japan.

By all accounts, this menu is unappealing to those who decide such matters. Between 1982 and 1986, the American body politic reached a consensus that federal expenditures should remain at about 24.5 percent of GNP and federal taxes should claim about 19.6 percent of GNP.⁹ Higher taxes and lower spending represent a serious assault on that consensus. With much huffing and puffing, the Senate now proposes to raise excise taxes some \$18 billion and to cut \$9 billion from defense and \$9 billion from social spending.¹⁰ All this, if enacted, would trim the fiscal gap less than 1 percentage point. Obviously, a more vigorous assault on the underlying taxation-expenditure consensus will be required to shrink the deficit in a significant way.

What about more dollar depreciation and greater stimulus abroad? The Federal Reserve, the Treasury, and key U.S. trading partners want no further depreciation of the dollar. And the German Minister of Economics, Martin Bangemann—acting as a spokesman for many leaders in Europe and Japan—wants no more economic stimulation.

There are, however, alternatives other than those on the mainstream menu. Let me illustrate by pointing to alternative ways of raising U.S. domestic savings.¹¹ As Alan Blinder points out, net domestic financial savings can be divided into three components: net household savings (household savings minus residential investment), net business savings (business savings minus nonresidential investment), and government

9. *Economic Report of the President, 1987*, table B-1, and table B-76.

10. See “Senate Clears Fiscal ‘88 Budget of \$1 Trillion,” *Wall Street Journal*, May 7, 1987.

11. In a similar vein, one could explore economic stimulation *outside* the OECD, financed by a major expansion of IMF and World Bank resources. One could also explore systems to achieve a dual exchange rate (for example, a balance of payments tariff). It is noteworthy that the prominent investor Warren E. Buffet recently rediscovered dual rates: “How to Solve Our Trade Mess without Ruining Our Economy,” *Washington Post*, May 3, 1987.

Table 1. Components of National Saving, 1978–86

Billions of current dollars

<i>Year</i>	<i>Household^a</i>	<i>Business^b</i>	<i>Government^c</i>	<i>Total</i>
1978	–19	11	0	–8
1979	–21	12	12	3
1980	14	27	–35	6
1981	37	–2	–30	5
1982	49	61	–111	–1
1983	–22	112	–129	–39
1984	–13	26	–102	–89
1985	–49	75	–136	–110
1986	–103	97	–142	–148

Source: Alan Blinder, "It's Time to Put an End to the Borrowing Binge," *Business Week* (May 4, 1987), p. 22.

a. Excess (deficiency) of personal savings over residential investment.

b. Excess (deficiency) of business savings (including depreciation allowances) over business investment.

c. Excess (deficiency) of taxation (federal, state, and local) over government spending.

savings (federal, state, and local taxes minus government expenditures at all levels). Allowing for statistical errors, total net domestic financial savings (or deficit) must equal the current account surplus (or deficit).

As table 1 shows, American net household savings since 1980 have taken just as big a dive as government savings. This observation suggests that the current account deficit might be "cured" by a dramatic fall in residential investment or a dramatic rise in personal savings. It is not intuitively obvious that the harm from compressing household expenditures would exceed the harm from sharply raising taxes or substantially cutting government outlays.¹² How could economic policy encourage larger net household savings? Restrictions on consumer credit or high mortgage interest rates might work.

Increasing household savings is not the only way to reduce the federal deficit. Another possibility is to increase net business savings. It is often assumed that an increase in net business savings must entail a decline in nonresidential investment—bad for long-term growth. That need not be the case. With output per man-hour projected to rise about 2.0 percent annually, a policy that restricted annual real wage growth to 1.0 percent

12. Of course, any increase in domestic savings—household or government—is liable to cause a recession. In either case, government policy must manage the shift of resources to accomplish an increase in net exports.

for three years would do wonders for business savings.¹³ Indeed, such a policy might well add \$100 billion to business savings. Can real wage growth be limited in such a fashion? Conceivably a combination of restrictive monetary policy to restrain wage increases and exchange rate depreciation to raise prices of traded goods will do the trick.¹⁴

Those who warn that trade policy cannot be the only answer, perhaps not even the central answer, to those who would keep America ‘‘No. 1’’ are surely right. Common sense says that the quality and motivation of the labor force, the amount of investment, and the inventiveness of research laboratories are more important than trade policy. But common sense does not say that trade policy plays an insignificant role.

In the first place, there is a connection between the openness of markets and the extent of national savings. Michael Kalecki’s ‘‘degree of monopoly’’ theory deserves a modern revival. A closed-market trade policy that avoids marginal cost pricing can powerfully protect business earnings. And such earnings are a mainspring of the Japanese *keiretsu* system.

If U.S. commercial policy could gain access for American goods to Japanese markets, that would not just enlarge U.S. exports. It would also shrink Japanese business savings. And if U.S. investment policy could bring the apparatus of credit cards and discount retailing to Japanese consumers, the Japanese household saving rate might fall sharply.

In the second place, there are special problems with high-technology industries. In those industries, marginal costs of production are vastly lower than average costs of production, which include, among other outlays, R&D on failed projects and capital expenditures on quickly outmoded equipment. When one firm gets a march on another, it need only price at a significant discount to that other firm’s average costs, yet well above its *own* marginal cost, to achieve a ‘‘strategic’’ victory. This is the sort of businessman’s game that goes on all the time within a nation. By successfully playing such games, one firm can gain a decisive lead over its rivals.

13. See *Economic Report of the President, 1987*, table 1-5.

14. In fact, one can discern elements of this policy in the recent rhetoric and actions of the Federal Reserve Board.

The public policy problem arises when one nation's firms are generally better at the strategic game than another nation's firms—especially if the first nation's superiority is predicated on closed home markets. When that happens, how will the second nation's firms finance the R&D and capital equipment necessary to commercialize the next generation of products? One answer is to close markets at home. The better answer is to open markets abroad and to whittle away at the home-court advantage of foreign rivals.

Of course, opening markets is what GATT is all about. The imbalance of savings on a world scale and the high-technology dimension simply give new urgency to old concerns.

In the early GATT rounds, much protection was removed by a mutual exchange of concessions among industrial nations. The first six GATT rounds can, in fact, be seen as the exchange of carrots for carrots. By the Tokyo Round, however, the atmosphere had changed. Negotiations involved a combination of sticks and carrots. And, since the Tokyo Round, much trade policy has been dominated by the mutual threat of sticks. This is the regrettable but probably inevitable outcome of a world economy cowed by central bank austerity and of the unwillingness of the new economic leaders—Germany and Japan—to make unilateral trade concessions for the sake of the international system.

In this atmosphere, it is not surprising that Congressman Richard Gephardt (D.-Mo.) has gathered considerable support for his version of results-oriented trade reciprocity. Few Americans trust that enlightened Japanese self-interest will liberalize Japanese markets, and few Americans believe that the free flow of capital and know-how will ensure a congruence of economic well-being between the United States and Japan. All in all, the United States will be lucky if this episode of neomercantilism ends with no worse than the Gephardt amendment.

General Discussion

William Poole suggested that policy should focus on the U.S. saving rate rather than the trade deficit. He reasoned that reductions in the trade deficit not accompanied by an increase in national saving would not make the United States better off, since without additional saving,

investment would have to fall. In Poole's judgment, policy should be directed toward reducing the budget deficit and changing incentives for private saving. With the emphasis instead on the trade deficit, U.S. monetary policy has focused on depreciating the dollar, while, abroad, monetary expansion has accelerated to limit the dollar's decline. Poole argued that this combination of policies would accelerate inflation. Christopher Sims saw the resistance of the monetary authorities to competitive depreciation to be based on just such inflation fears. But he noted that alternative means of improving the trade balance might not be any better for inflation.

Richard Cooper argued that a further devaluation of the dollar would risk seriously depressing world economic activity over the next twelve to eighteen months. Investment demands, he noted, are already fragile in many major industrial nations. As those nations lose export markets, downward accelerators may depress their economies further. Such weakness, in turn, could reduce the exports of the debt-ridden LDCs. Although stimulating domestic demand in Europe and Japan could offset their loss of exports and minimize these risks, the needed expansionary policies are not yet in place. Some have argued that a willingness on the part of the United States to depreciate the dollar further might move other nations to adopt the needed expansionary policies. But Cooper contended that the Germans, and perhaps the Japanese as well, would not respond prospectively but only to an actual crisis, which is what the United States should be trying to avoid. He concluded that the risks in trying to force cooperative behavior through the threat of further competitive depreciation are too great at this time.

James Tobin wondered if Dornbusch had a strong case for depreciation rather than a uniform tariff as a way to bring down the U.S. trade deficit. Tobin viewed both the fact that a revenue tariff would not affect capital account transactions and the fact that it would reduce the budget deficit as points in its favor. Sims commented that one can make a case for policy intervention to affect exchange rates without believing that asset market participants have poor foresight or that government officials can forecast better than the market. For example, there may be a political decision to be made concerning distribution between young and old or current and future generations.

Paul Krugman suggested that the economic costs of increased U.S.

protectionism would be relatively small. If other countries did not retaliate when the United States imposed tariffs, optimal tariff theory suggests that the imposition of the tariffs could actually make the United States better off. Even if other countries did retaliate, so that the United States ended up with 10 percent tariffs at all borders, the welfare losses involved would be only on the order of 0.2 percent of GNP, about \$8 billion, for the United States. In Krugman's view, economists' vehement opposition to trade protection exaggerates its costs and must be justified on other grounds. One might argue that free trade is an important component of the Western alliance; if the alliance cannot cooperate on trade, trust in its ability to cooperate on other matters may be eroded. In addition, there is legitimate concern that protectionism will take the form of cartelization, which could impose much larger costs than tariffs.

Cooper argued that increased protection by the United States endangers the world's liberal trading system even though today's climate differs from that of the early 1930s. As Mann points out, at the time of the Smoot-Hawley tariffs, the United States had been warned in advance that the imposition of tariffs would be met with retaliation. Today, the countries of Europe and elsewhere are themselves on the edge of protecting various industries for domestic political reasons. If the United States were to raise its barriers, the political consensus abroad would push those countries over the edge.

Cooper also observed that the game-theoretic benefits of "getting tougher" were difficult for the United States to realize. A threat must be credible to be useful. But in the U.S. political system, a threat is credible only after a strong public constituency has been mobilized in its favor. However, once that happens, it becomes not just a threat that can be withdrawn in response to appropriate behavior abroad, but rather a policy with public support that is hard to reverse.

William Cline questioned Crandall's conclusion that protection in the auto industry had very different effects from protection in steel. He pointed to Crandall's data showing that the steel import share declined 3 percentage points between 1984 and 1986 after rising 10 percentage points from 1980 to 1984. He also questioned whether the scope for geographical diversification in steel eliminated the protective effect of the arrangement, noting that the United States promptly forced export restraints on such countries as Argentina and Brazil after the EC

agreement. Cooper noted that Crandall's estimates may overstate the effects of voluntary restraint agreements on the prices of Japanese autos sold in the United States, insofar as he assumes that in their absence prices would have moved with the yen-dollar exchange rate. In fact, work by Mann has shown that prices of goods not subject to voluntary restraint agreements do not track exchange rates well either. To identify convincingly the effects of those agreements, one must take account of normal markup practices in response to the exchange rate, Cooper concluded.