

Money, Trade, and Investment

Cato Institute scholars frequently address issues of sound money, free trade, and international economics. Among the speakers at our 21st Annual Monetary Conference on November 20 were Alan Greenspan, chairman of the Federal Reserve Board, and Václav Klaus, president of the Czech Republic. Dan Griswold, associate director of Cato's Center for Trade Policy Studies, spoke at a Capitol Hill Briefing on October 17. Excerpts from their remarks follow.

Alan Greenspan: The current account deficit of the United States, essentially net exports of goods and services, has continued to widen over the past couple of years. The external deficit receded modestly during our mild recession of 2001 only to rebound to a record 5 percent of gross domestic product earlier this year. Our persistent current account deficit is a growing concern because it adds to the stock of outstanding external debt that could become increasingly more difficult to finance.

These developments raise the question of whether the record imbalance will benignly defuse, as it largely did after its previous peak of about 3.5 percent of GDP in 1986, or whether the resolution will be more troublesome.

In the 1960s and 1970s, because our trading partners were growing far faster than we were, a trade gap did not surface. When, in the 1980s, the difference in growth rates narrowed while the dollar rose, our trade and the associated current account deficits widened dramatically. By the late 1980s, we had become a net debtor nation, ending seven decades as a net creditor. While most recent data reaffirm our above-average propensity to import, there is evidence to suggest that its magnitude has diminished.

There is no simple measure by which to judge the sustainability of either a string of current account deficits or their consequence: a significant buildup in external claims that need to be serviced. Financing comes from receipts from exports, earnings on assets, and, if available, funds borrowed from foreigners. In the end, it will likely be the reluctance of foreign country residents to accumulate additional debt

and equity claims against U.S. residents that will serve as the restraint on the size of tolerable U.S. imbalances in the global arena.

With the seeming willingness of foreigners to hold progressively greater amounts of cross-border claims against U.S. residents, at what point do net claims (that is, gross claims less gross liabilities) against us become unsustainable and deficits decline? Presumably, a U.S. current account deficit of 5 percent or more of GDP would not have been readily fundable a half a century ago or perhaps even a couple of decades ago. The ability to move that much of world saving to the United States in response to relative rates of return would have been



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hindered by a far lower degree of international financial intermediation. Endeavoring to transfer the equivalent of 5 percent of U.S. GDP from foreign financial institutions and persons to the United States would presumably have induced changes in the prices of assets that would have proved inhibiting.

There is, for the moment, little evidence of stress in funding U.S. current account deficits. To be sure, the real exchange rate for the dollar has, on balance, declined more than 10 percent broadly and roughly 20 percent against the major foreign cur-

rencies since early 2002. Yet inflation, the typical symptom of a weak currency, appears quiescent. Indeed, inflation premiums embedded in long-term interest rates apparently have fluctuated in a relatively narrow range since early 2002. More generally, the vast savings transfer has occurred without measurable disruption to the balance of international finance. In fact, in recent months credit risk spreads have fallen and equity prices have risen throughout much of the global economy.

To date, the widening to record levels of the U.S. ratio of current account deficit to GDP has been seemingly uneventful. But I have little doubt that, should it continue, at some point in the future adjustments will be set in motion that will eventually slow and presumably reverse the rate of accumulation of net claims on U.S. residents.

The history of such adjustments has been mixed. According to the aforementioned Federal Reserve study of current account corrections in developed countries, although the large majority of episodes were characterized by some significant slowing of economic growth, most economies managed the adjustment without crisis. The institutional strengths of many of these developed economies—the rule of law, transparency, and investor and property protection—likely helped to minimize disruptions associated with current account adjustments. The United Kingdom, however, had significant adjustment difficulties in its early postwar years, as did, more recently, Mexico, Thailand, Korea, Russia, Brazil, and Argentina, to name just a few.

Can market forces incrementally defuse a worrisome buildup in a nation's current account deficit and net external debt before a crisis more abruptly does so? The answer seems to lie with the degree of flexibility in both domestic and international markets. In domestic economies that approach full flexibility, imbalances are likely to be adjusted well before they become potentially destabilizing. In a similarly flexible world economy, as debt projections rise, product and equity prices, interest rates, and exchange rates could change, presumably to reestablish global balance.

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mine at what point foreign accumulation of net claims on the United States will slow or even reverse, but it is evident that the greater the degree of international flexibility, the less the risk of a crisis. The experience of the United States over the past three years is illustrative. The apparent ability of our economy to withstand a number of severe shocks since mid-2000, with only a small decline in real GDP, attests to the marked increase in our economy's flexibility over the past quarter century.

Should globalization be allowed to proceed and thereby create an ever more flexible international financial system, history suggests that current imbalances will be defused with little disruption. And if other currencies, such as the euro, emerge to share the dollar's role as a global reserve currency, that process, too, is likely to be benign.

I say this with one major caveat. Some clouds of emerging protectionism have become increasingly visible on today's horizon. Over the years, protected interests have often endeavored to stop in its tracks the process of unsettling economic change. Pitted against the powerful forces of market competition, virtually all such efforts have failed. The costs of any new such protectionist initiatives, in the context of wide current account imbalances, could significantly erode the flexibility of the global economy. Consequently, it is imperative that creeping protectionism be thwarted and reversed.

Václav Klaus: I am convinced that the driving force behind European monetary unification has been strictly political, not economic. This argument is supported by my own personal experience, based on numerous explicit conversations about it with key European political leaders in recent years. The economic arguments have always been marginalized or taken only very superficially. The political ambition has been quite dominant. The euro has always been considered a useful instrument for the creation of the European political union.

I also believe that the largest part of the positive economic impact of European integration, as well as of EU enlargement, has come through the liberalization of trade

and investment and has already been obtained in Europe. The marginal contribution of further economic or non-economic unification will be close to zero, if not negative.

Because of that, neither the birth of the euro nor the next EU enlargement in the year 2004 represents any breakthroughs. Trade patterns are determined by comparative advantage, not by monetary factors. The role of exchange rate risk as a factor determining foreign investment and the cost of capital is relatively small.

Looking at the economic performance of the euro zone in the first years of the euro's existence, even the pro-European activists must admit that the overall expectations of an economic boost and the claims



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that the introduction of the euro would speed up economic growth have not been fulfilled. This is not a surprise to me and, to be fair, not everyone had such expectations. Many of us knew that the formation of a regional common currency is neither a necessary nor a sufficient condition for healthy economic growth.

Eight Central and East European countries will become EU members in May 2004. And in their accession treaties with the EU, signed in April 2003 in Athens—I was one of those who signed it—they promise to enter the euro zone. Many peo-

ple in these countries look forward to it. They expect to gain from euro stability, from decreasing exchange rate risk, from a credible monetary policy. I am struck that they don't see the other side of such an arrangement, because it's more than evident that the transition countries need a maximum of flexibility and should not introduce any artificial rigidities. They should not take actions against their own economic interests for political reasons.

The main costs for them will be the loss of independent monetary policy. Such a loss will have very different effects on them than on the developed and more stable EU member countries of Western Europe. It makes no economic sense for them to have the same interest rates as Germany or France.

These countries will also be hurt by the loss of the possibility of exchange rate movements. Transition countries are in a permanent process of real appreciation. And there is no way, in my opinion, to make it possible with fixed exchange rates, with the inflation and interest rate targets of the Maastricht Treaty, and with stability-backed conditions concerning budget deficits. It simply can't go together.

There is also a very high risk of fixing the exchange rates away from long-term equilibrium, because the convergence process will not be, in the moment of their entry into the euro zone, completed. The result will be the insufficient final exchange rates realignment, a problem we see with some current euro zone members as well.

I am also afraid that the rigidities of a monetary union and a growing macroeconomic disequilibrium will block real convergence and create transfer economics, as in East Germany after reunification. The difference will be that there will not be adequate fiscal transfers, because such fiscal transfers in the contemporary European Union are not available.

So my conclusion is that there is no need for these countries to rush into the euro zone. The euro is here to stay, but I would say that to keep the European single currency will be costly in terms of economic growth and in terms of inevitable fiscal transfers compensating the weaker partners. It may gen-

Continued on page 10

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POLICY FORUM *Continued from page 9*

erate unnecessary tensions among nations. I think we should be aware of that.

Dan Griswold: A lot of Americans have questions about the economy and about trade with low-wage countries—in particular India and China. There is no denying that the last three years have been brutal for the U.S. manufacturing sector. Only now is manufacturing output beginning to recover from a steep decline in 2001. In the past three years, 2.7 million net manufacturing jobs have been lost. This is a very challenging environment for American companies and many American workers.

The real debate is about why this is happening and what, if anything, Congress can or should do about it. Critics of trade are too quick to blame imports. Even the *Wall Street Journal* the other day had a story that talked about the “onslaught” of imports and “surging” imports, when in fact, imports have been pretty sluggish, or declining, over the last three years. Only now are the monthly import figures getting back up to their highs of the year 2000.

Conventional wisdom assumes that more imports mean less domestic production—a widget we import into the country is one less widget we produce, and we lay off the widget workers. But take a look at the chart. Actually, the truth is the opposite. The chart shows the growth of manufacturing imports and domestic output each year since 1988. And as you can see, in those years when the “surging onslaught” of imports was the greatest, that’s when the growth of domestic manufacturing output was also the greatest. In 2001, when manufacturing output fell, so did manufacturing imports. The reason is simple: Imports and output both rise and fall with domestic growth and demand.

Why the loss of jobs in manufacturing? There are two things working there, one good, one bad. The bad thing is the cyclical collapse in demand, especially among businesses. The other thing happening that has made jobs disappear in manufacturing is dramatic increases in productivity. We can produce more stuff with fewer workers. We produce three times as much as we did in

the 1960s with fewer workers because they’re three times more productive. This is not a bad thing. Rising worker productivity is the foundation of future prosperity.

Now, let me talk about China, because you can’t talk about trade and manufacturing without getting around to China. Imports from China do compete with domestic production—there’s no question about it. U.S. factories have closed. Workers have been laid off because of competition with China. But the numbers are relatively small, and in comparison, trade with China delivers huge benefits to the U.S. economy—most importantly, to American families.



Dan Griswold: “The other thing that has made jobs disappear in manufacturing is dramatic increases in productivity. We can produce more stuff with fewer workers.”

Roughly half of what we import from China is consumer products. China is a leading exporter of shoes, apparel, consumer electronics, sporting goods, furniture, and all the things that families would buy at a discount store. And these are products that are bought disproportionately by medium- and low-income families. In fact, according to my calculations, China’s 10th largest trading partner last year was Wal-Mart.

American producers benefit from lower-cost inputs such as machine parts, office products, and plastic moldings. These inputs allow U.S.-based manufacturing compa-

nies to remain more competitive in global markets. And then of course there is the fact that a lot of that production in China is in American-owned factories, which is good for their stockholders and the U.S. stock market.

Imports from China have grown rapidly, but they are nothing like a flood. In 2002, we imported \$125 billion in products from China. To put it in perspective, that’s about 10 percent of our total imports and about 1 percent of the \$10.4 trillion GDP of the United States. There is nothing alarming about the fact that Americans spend about a penny of every dollar of our income on products made by the one-fifth of mankind that lives in China.

There has been no giant sucking sound of U.S. factories and production moving wholesale to China. I have pored over the investment numbers the Department of Commerce puts out, and I am struck, frankly, by how modest the U.S. investment is in China. If the critics were right, U.S. multinationals would be falling over themselves to invest in China to take advantage of the low wages. In reality, U.S. investment in China has been modest and stable. If you look at the period from 1999 to 2002—the most recent four years for which we have figures—the average outflow of U.S. direct manufacturing investment is \$1.2 billion a year. And it has not been going up; it has been quite stable.

That compares to an annual average of \$16 billion in U.S. direct manufacturing investment in the European Union during that same period. Overall, U.S. manufacturers invest much more in rich, high-wage, high-standard foreign countries than they do in China. And the investment that goes to China is less than 1 percent of the approximately \$200 billion a year that is invested here in the United States in manufacturing capacity each year. It is overwhelmed by the net \$20 billion that comes in from other parts of the world.

Many American companies can tell you that investment in places like China and India remains a challenge. The infrastructure there doesn’t work as well. The workers aren’t as well educated. They don’t have the rule of law or, in the case of India, they have

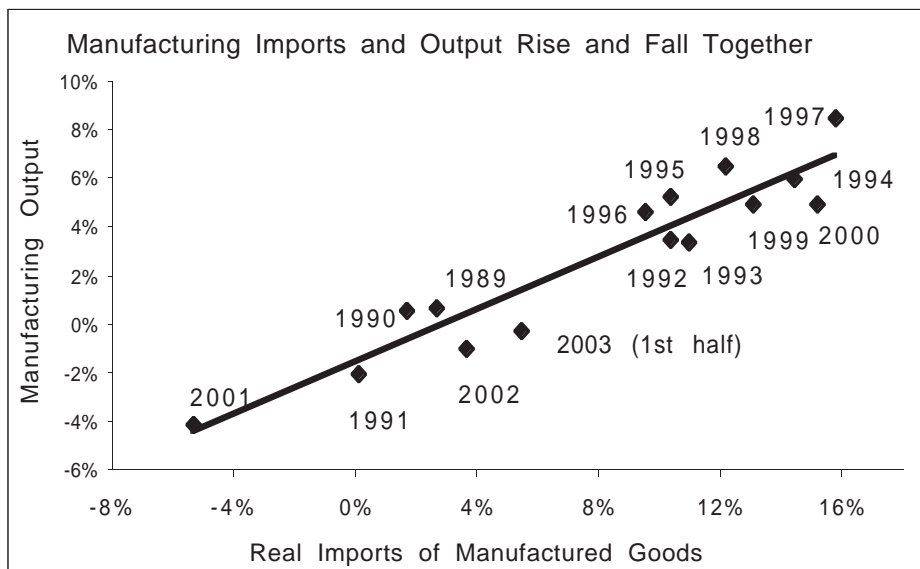
Continued on page 11

POLICY FORUM *Continued from page 10*

too many rules, making it difficult to do business there. That's why those countries are so poor. That's why the wages are so low, because things don't work as efficiently as they do in the developed countries.

While China is the world's fourth leading exporter, it is also the world's sixth leading importer. China is becoming the engine of demand in East Asia. It is rapidly becoming one of the world's top markets for automobile sales. And China has now displaced the United States as the world's number one importer of steel. China is the best friend the U.S. steel industry has right now, but you wouldn't know it from what the industry has been saying. Last year, while America's total exports to the rest of the world were declining, our exports to China were going up by 14 percent.

And what do the people of China do with all those dollars that they earn by selling in our market—the infamous bilateral trade deficit? Well, those dollars come back to the United States. If they don't come back here to buy our exports, they come back here to buy our Treasury bonds.



Sources: Bureau of Economic Analysis, Commerce Department; and Federal Reserve Board.

The Chinese Central Bank is one of the main purchasers of U.S. Treasury notes. That investment helps finance the federal budget deficit. It helps keep interest rates low. And it frees up private savings in the United States for investment in the private economy.

So our trade with China is a blessing three times over. It's a blessing to consumers, who enjoy lower prices at the store, which raises real wages. It's a blessing to producers through rising exports. And it's a blessing through capital inflows that keep domestic interest rates low. ■

News Notes

Gokhale Joins Social Security Project

Jagadeesh Gokhale, one of the nation's leading economists and an expert on entitlement reform, has joined the Cato Institute as a senior fellow. Gokhale, former senior economic adviser to the Federal Reserve Bank of Cleveland, has been on leave from the Fed for the past year, serving as a visiting scholar with the American Enterprise Institute. Gokhale will work with Cato's Project on Social Security Choice, examining the problems of the current Social Security system and helping to design market-based alternatives.



Jagadeesh Gokhale

Gokhale is widely recognized as one of the nation's leading experts on U.S. fiscal policy and its intergenerational impact. His latest book, *Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities*, coauthored with Kent Smet-

ters, drew widespread attention when it was published by AEI after the Bush administration declined to include it in the federal budget document for which it had been commissioned. Gokhale is also the author of "The Impact of Social Security Reform on Low-Income Workers" and coauthor of "Social Security Privatization: One Proposal" (with David Altig), both Cato Institute Social Security Choice Papers.



Jenifer Zeigler

Jenifer Zeigler has been named a policy analyst at the Cato Institute. She will specialize in welfare and entitlement issues. Previously a Cato research assistant, she holds a law degree and a Master of Public Administration from the University of Missouri. She also worked as a legislative assistant in the Missouri legislature.