Forum

THE TRADE BIND

Now It's Harder to Fix a Recession

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OVER the past two months, the dollar has reversed course, gaining about 5 percent against the Japanese yen and 9 percent against the German mark. It is not hard to identify the cause: the greater-than-anticipated improvement in the trade balance. But it is more difficult to see why the trade figures took currency traders by surprise. Economists and their models have confidently been predicting just such an improvement since the dollar began to decline in 1985.

What happened was that month after month of dismal statistics seemed to belie the forecasts. Economists had understated the lag time required for the 1985 through 1987 dollar depreciation to exercise its favorable effect. Those who predicted that the decline in the deficit would be rapid tended to receive the most attention. Neither politicians nor the media seem to be interested in statements about what will happen in three to five years. At most, they want to know what will happen between now and the next election.

When the promised improvement in the trade figures failed to materialize by 1987, many who had put their faith in optimistic forecasts began to feel foolish. Swinging to the opposite extreme, they abandoned the view that the dollar could affect the trade deficit. Thus when the long-awaited improvement materialized this year, it caught the foreign exchange markets by surprise.

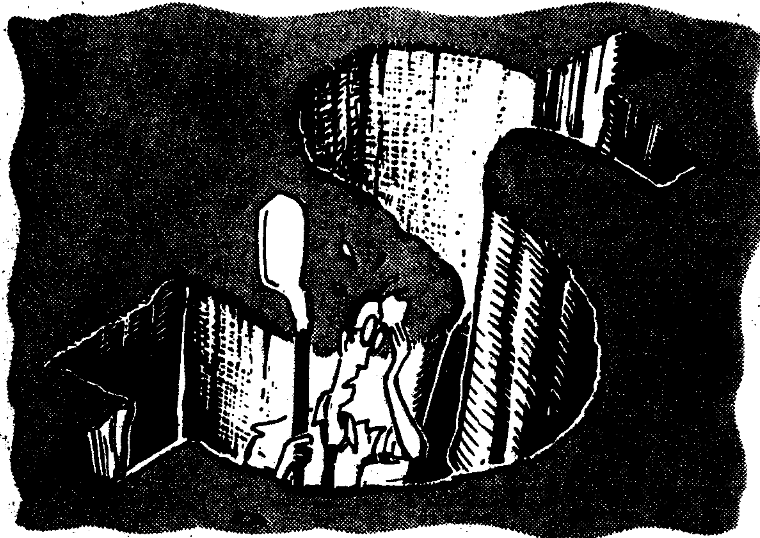
How can we avoid both excessive optimism and undue pessimism about the trade situation? We can look at more than just the experience of the last 15 years. Over the last century of American history, 95 percent of one year's trade imbalance typically has persisted into the next. After four years, more than three quarters of the deficit or surplus has remained. History underscores the recklessness of predicting a quick fix.

True, exchange rate changes can accelerate the process. But we should not expect even big changes to have immediate effects. When Britain devalued in 1931, 1949 and 1967, politicians were disappointed each time by the lack of an immediate improvement in the trade figures. But in a few years, improvements came.

There is one guaranteed method of engineering a rapid improvement in the trade balance. If the economy veers into recession, the deficit will decline very rapidly. There is no faster way of reducing imports than a recession, which decreases demand.

This implication of the business cycle for the trade deficit is familiar to economists and historians alike. History provides numerous examples of large trade deficits that have been eliminated rapidly. But, leaving aside wartime, the only instances in the last century of American, Canadian, British and Japanese history when large trade deficits were eliminated in a few years were with the intervention of a large recession.

Less familiar are the implications of the trade deficit for the business cycle. That the United States is now in the sixth year of expansion neither greatly increases nor greatly decreases the likelihood that the 10th postwar recession will occur in 1988. But sooner or later that recession will come. When it does, it will differ from its predecessors, because the enormous current account deficits that the United States has been running since 1982 have exhausted 75 years of accumulated net overseas investments. The United States has been transformed from international creditor to international debtor to the tune of about $500 billion. Consequently, in the future, Washington will no longer be free to use monetary or fiscal policies against the threat of recession.



Drawings by Peter Kuper

The United States is not used to having its policy options limited.

First, policy makers will no longer be free to respond by using monetary policy — raising the rate of monetary growth or reducing interest rates. A recession would almost certainly coincide with increased worries on the part of our Japanese and other overseas creditors about the value of their investments in this country. They might respond sharply, by selling their American assets and precipitating a bond market fall like that of April 1987, or a stock market crash like that of October 1987. The Federal Reserve would feel compelled to reassure these creditors by keeping interest rates high enough to continue attracting their capital. It seems unlikely that the Fed would deliberately choose to create inflation to decrease the real value of the debt.

NOR will policy makers be free to respond to the threat of recession by using fiscal policy — raising government spending or cutting taxes. We already have a $150 billion Federal budget deficit at the peak of the business cycle. If income starts to decline, tax receipts will follow, and the annual budget deficit will climb to $200 billion in no time. Congress and the White House will at last see the ill effects of eight years of budget deficits. Washington will acquire, at precisely the wrong moment, the political will to resist spending increases and to raise taxes. And if domestic politics do not deliver this result, our foreign creditors will, by refusing to buy our bonds unless we tighten our belt. We will have moved from a passive fiscal policy to one that reinforces rather than offsets changes in private spending.

The loss of freedom to use policy is a new position for Americans. But it is familiar to other debtors. The indebted nations of Latin America have for the last six years been paying just such a price for earlier borrowing. While their economies have switched from trade deficits to surpluses, they have had no fun doing it. A contraction of income even more severe than that of the 1930's has been the tool for reducing imports. There has been little scope for expansionary policies to counter a recession given the need to keep creditors happy. The Latin American debtors' trade surpluses look "good" until one realizes that the dollars they earn are not being used to raise living standards but to pay interest on their debts.

The same fate lies in store for the United States. The trade balance will almost certainly continue to improve over the next few years. But this will provide no grounds for rejoicing. The dollars we earn will simply go to paying interest on our debts. Our living standards will have to rise more slowly than in the past. As in a classic tragedy, this outcome was predictable — the inevitable result of eight years of excess. ■

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