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America's International Problems: As Seen by Her Largest Trading Partner

By Michael C. McCracken*

The U.S. is Canada's largest trading partner, and international trade is important to Canada's economy. U.S. methods to cure its trade deficit are critical for Canada, with protectionism a major concern. The Canada — U.S. Free Trade Agreement is a positive step, advantageous to both parties. High U.S. real interest rates have an adverse effect in the international economy. LDC debt will not be repaid and should be considered as a form of foreign aid. The U.S. must become more competitive internationally; currency depreciation can only buy time for readjustment.

OBSERVATIONS ON ECONOMIC problems by economists outside of the country are not always popular. Canadians rarely appreciate comments from Wall Street, Washington, or Houston about perceived Canadian problems. But the temptation is too great! On all maps Canada is above the U.S.; that alone should provide Canadians a better perspective. But three better reasons come to mind for venturing some views for your consideration:

1. The U.S. is Canada's largest trading partner (80 percent of Canadian trade), a major investor in the Canadian private sector, and a dominant in-

fluence on Canadian values through the media, two-way travel, textbooks, and other more subtle linkages. As such, observation of the U.S. economy is not only accepted as worthwhile, but quite necessary to the task of economic analysis in Canada.

2. International trade accounts directly for about 30 percent of Canada's Gross Domestic Product. Movements in the Canadian-U.S. exchange rate have direct and large impacts on domestic price formation and the Canadian Consumer Price Index. Thus we are an "open economy", and as such have learned a few hard lessons.
3. Finally, there is a matter of perspective. As a comparatively small country next to you, Canada's history is dominated by efforts to respond to significant influences beyond its control. It has had to learn that moderation and compromise are essential to its wellbeing and, perhaps, survival. This requirements always has provided a perspective different from that of the U.S.

THE U.S. CURRENT ACCOUNT DEFICIT

Welcome to the real world! The U.S. is joining the community of nations dependent upon trade for a significant part of their economic activity. The virtue is the opportunity to realize the gains from trade, but the responsibility is to work to improve the system and to coordinate economic policy. By its size, the U.S. has been a major player "involved" in international trade but not "committed" in the same way as you are now becoming.

Current account deficits are not the end of the world. For most of Canada's history, current account deficits have been the norm, allowing a higher in-

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vestment level and higher real income growth than would have been otherwise possible. (This strategy is of course not new to you; it too was your strategy prior to the 1920s.) The "costs" have been a substantial degree of foreign ownership in some industries and external debt that must be serviced. The key issue is the *social* return on the foreign liabilities compared to their financing and other costs.

Our concern is not the U.S. current account deficit, but rather the policies you might pursue to reduce it. Commentators have been disappointed that recent declines in the U.S. dollar have not led to immediate improvements in the trade balance. In fact, some seemed to be disappointed that the December 1987 declines did not help the November 1987 numbers! Patience is not a U.S. virtue.

Yes, there is a J-curve, and yes, trade elasticities are low in the short term. But relative prices do work; strong evidence of that already is appearing through the U.S. real trade balance. Don't forget that it took five years of appreciation of the U.S. dollar to create the current deficits.

Another important force improving the trade balance could be the income effect from growth in other countries. This force has been helped by lower oil prices and will be further helped if interest rates continue to decline in real terms, and if the U.S. continues to expand without increased protectionism. But even with both price and income effects working together, it will take about the same amount of time to get out of the deficit as it took to get into it.

In the meantime, the U.S. will experience a substantial increase in net liabilities to foreigners, including no doubt a substantial increase in direct investment from abroad. It is with some ghoulish delight that Canadians watch the debate about foreign investment in the United States. We have heard your complaints for years about Canadian attitudes towards foreign (U.S.) investment. We understand your reaction to direct foreign investment in your key industries. The use of "Stars and Stripes" advertising is already evident in the ads of the U.S.-owned automobile firms, presumably aimed at the "transplants" of the Japanese auto firms located in the U.S.

You will find that foreign investment is generally a positive factor, providing jobs in your communities, transferring technologies that may not have been otherwise available, and contributing to the economic structure of the country. Remember the positive messages about the role of foreign investment from your old lecture notes used on other countries for decades.

PROTECTIONISM REMAINS A MAJOR CONCERN

Continuing U.S. protectionism is perceived as a major threat by Canadians and most other trading

partners. With the decision on shakes and shingles, the forced imposition of a 15 percent Canadian export tax on softwood lumber, the preliminary dumping finding on potash (recently dropped in return for Canadian producers agreeing to charge you higher prices) and the Omnibus Trade Bill moving through Congress, we fear that the pace of protectionism is picking up, not slowing down. The current Presidential campaign has some candidates promoting increased protectionism as the "quick fix" needed. Presumably, they take this position because it sells well on the hustings.

In the case of softwood lumber and potash, the Canadian industries invested in productive and competitive mills, aggressively marketed the product and captured an increasing share of the U.S. market as a result. Isn't that the American Way?

To be penalized for this success and to see you purposefully set out to hurt your domestic consumer through higher prices seem quite odd. Do you know the effects of your actions? Are you aware that hurting the Canadian industry and its suppliers will reduce the remittances from your many subsidiaries? Yes, you too share in our "costs" of protectionism.

Also present is the danger of political pressure in Canada to respond in kind. An "eye for an eye", or more correctly an "ear for a knothole", might be used to describe the recent action by Canada to impose a duty on U.S. corn exports to Canada in response to alleged U.S. subsidies. This step is as reprehensible as the recent applications of U.S. trade remedy laws, but understandable in the political context.

In the Canadian Budget of February 1987, the Minister of Finance removed a number of tariffs that were originally imposed in retaliation for the 35 percent shakes and shingles tariff imposed by the U.S. in June 1986. You will rest easier tonight knowing that Christmas trees can now be exported to Canada without duty! As well, tariffs on books, computer parts, tea bags, and diesel motor rail cars have been eliminated, returning these commodities to their previous duty-free status.

Two reasons were behind this move: (1) to signal a desire for a cease-fire on protectionist moves; and (2) to appease the Canadian consumers and producers being hurt by these moves, and fearing that further U.S. retaliation would result.

My concern is not restricted to U.S. protectionism aimed at Canada. The recent threats aimed at European and Pacific Rim exports to the U.S., the escalating tension with Japan in computer chips and other areas, and the announced intent of the U.S. to apply sanctions against countries that allegedly compete unfairly with U.S. firms in third-country markets are not good signs. I hope that, before implementing such moves, the U.S. will examine the effects on its econ-

omy from weaker economic growth abroad, coupled with retaliatory steps against U.S. exports and investments. From the simulations that I have seen, it is clear that all parties are worse off. Does this make sense? Or is it simply macho-economics substituting for good macroeconomic policy?

The U.S. should remember that more than 100 Finance Ministers can have significant influence on you, and not all of them have learned the benefits of moderation and compromise.

THE CANADA-U.S. FREE TRADE AGREEMENT

All is not bleak! Forces are at work in liberalizing trade. Canada and the U.S. have negotiated a Free Trade Agreement, which was signed by President Reagan and Prime Minister Mulroney on January 2, 1988. Ratification of this Agreement is on the Congressional agenda and proceeding in Canada's Parliament with an implementation date of January 1, 1989.

The Free Trade Agreement (FTA) will:

1. eliminate all tariffs on trade between Canada and the U.S.,
2. eliminate some of the nontariff barriers affecting trade in goods and services,
3. facilitate fair competition within the free trade area by enhancing access to each other's markets,
4. liberalize the conditions for crossborder investment,
5. establish joint administration of the Agreement and procedures for dispute resolution.

FTA is seen in Canada as being an important part of the restructuring of the Canadian economy towards larger-scale, world-class enterprises and also increased specialization encouraged by the access to the North American market. For Canada, this move furthers the basic economic strategy followed in the past thirty years, and recognizes that trading blocs in other parts of the world limit Canada's options. All regions of Canada are likely to benefit, inflation will be lowered, and real incomes will be improved. Such changes also should enhance the value of old and new investments in Canada, some of which you own.

The U.S. economy will gain in the same way, but with the smaller role of trade and the higher levels of productivity already in place, the effects will be less evident. The FTA will serve as a prototype for the GATT negotiations and will improve both countries' bargaining power at GATT. FTA provides an opportunity to signal the world that "free trade" is still the thrust of U.S. and Canadian policy.

The actual impact of the Free Trade Agreement will depend upon the actions undertaken by businesses, governments and other decisionmakers on both sides of the border. The challenge to the business

economist is to see the Agreement for what it is — an opportunity to realize the benefits of free trade in both countries.

ACID RAIN REMAINS A PROBLEM

In addition to the "normal" bilateral trade, at present Canada "exports" about 1.2 million tons of sulfur dioxide to the Eastern U.S., and, in turn, the U.S. "exports" about 3.2 million tons to Eastern Canada. The problem is that this "trade" is done in the form of acid rain, carried on winds across the international borders. In the process, much is also dumped on our own soils.

The Canadian objective is to reduce Canadian exports to 800,000 tons by 1994 (or before). If the U.S. can reduce its exports to 2 million tons, then together we may be able to contain the environmental damage to the eastern half of North America.

THE INTERNATIONAL IMPLICATIONS OF U.S. MONETARY POLICY

Although you are all no doubt aware of the adverse influence of high U.S. interest rates on the U.S. economy, it also has created major problems internationally. A country facing high U.S. interest rates either must match them to stabilize its exchange rate, or tolerate a depreciation of its currency. Different countries have reacted in different ways. But the point is that a policy response was required that may not have been in that country's domestic interests, either in timing, direction, or amount. As well, when the U.S. economy is in difficulty, it is bad news for all of its trading partners.

Persistent real interest rates in excess of the real growth of an economy creates major distortions in income distribution and leads to rising and unstable growth in debt-Gross Domestic Product ratios.

These same high real interest rates create the same problem for external debt-export ratios. If you are forced to finance your growing international debt obligations at real rates that exceed the real growth in your exports, then the debt services component of the current account balance will grow much more rapidly. Progress on reducing the current account deficit will be difficult, and increased foreign borrowing will be required. The situation can be stabilized only by either a reduction in real interest rates, an increase in real export growth, or even more drastic action to achieve a positive trade balance.

Given the nature of international capital markets and the current U.S. position as a large borrower, it is highly irresponsible for the Federal Reserve to pursue a tight monetary policy to cool down the U.S. economy. Or, turning it around, if the Fed does pursue such a policy, then it must assume responsibility

for the international as well as domestic effects of such a policy.

The current international debt situation is a good example of what can happen. The Less-Developed Countries (LDCs) incurred the debts in the 1970s with confidence that real rates would remain low and world economic growth would continue. It made economic sense to borrow to finance their expansion. The dialogue between developed and developing countries seemed to be leading to a recognition of the common problems and the positive role for international capital flows. Obviously, this view was shared at the time by the lenders in the developed countries.

Who could have imagined that the U.S. would set out to raise interest rates to unheard-of levels and deliberately to trigger the worst recession since the Great Depression? Well, it happened! As a consequence, the international debts piled up and the inability of the LDCs to service them became chronic. Most LDCs (and perhaps some lenders) in the current situation hold the U.S. government responsible for the debt problem and expect the developed countries to live with the consequences of their actions.

Welcome to the PTL Club! This is the acronym for "Pass The Losses". Let me explain. The debts owed by the less-developed countries, and some not so less-developed, will not be repaid. The only issue is how the citizens of the lending countries will make their international aid donation. It is likely to be a combination of losses incurred by shareholders of lenders, higher taxes to cover the purchase of debt from financial institutions, higher taxes to make up for the taxes lost if the debt is written off, and higher margins paid to the financial institutions by the consumers. It is convenient for all parties to ignore the realities and to buy the time to push the risk off to others. Even the LDCs see no advantage in triggering a panic; after all it's not their problem!

Several positive points exist in this situation. I do not expect any *crisis* to emerge as a result of the international debt being absorbed. This process has been underway for a number of years, the writeoffs are being made, and the consumers are paying the shot.

The LDCs will look back on this period as one in which they received a substantial injection of foreign aid. Perhaps the aid could have been more effectively used if all parties had recognized it as such in the beginning, but nevertheless it has served a useful purpose. New lending will take place, but perhaps with indexed instruments and known real rates.

Perhaps the U.S. also will have learned some lessons. I would be surprised to see a repeat of the restrictive monetary policies of the early 1980s, at least until the current policymakers retire.

THE C WORD

The new American word is "competitiveness". Unfortunately, it is often linked with the need to "hit" some country because they are "too competitive". But international competitiveness is really a complex concept that includes exchange rates, relative unit labor costs, relative marketing efforts, and relative design and quality elements of the products.

With a given constellation of exchange rates, improving competitiveness is essentially an *internal challenge*. The task is to reallocate resources towards more productive sectors. It is not possible to be more competitive in all products. Remember the notion of comparative advantage? The challenge is to focus your efforts on those areas with the potential for high levels of productivity and productivity growth. In this case a complementarity exists between domestic and international objectives. Improvements in domestic real incomes and international competitiveness both flow from improved productivity.

It is the responsibility of the business economist to emphasize the real meaning of competitiveness. Do not distort it to mean increased protectionism! It is in everyone's interest that U.S. real incomes rise; as well, you will benefit from rising real incomes in other countries as a result of their increased competitiveness through productivity gains.

EXCHANGE RATE DEPRECIATION

Depreciation of the U.S. dollar is the "easy way out", but you should recognize that it means that you are prepared to have *lower* real incomes for your consumers, and transfer that loss to others as a gain in their real incomes. Do you really want to do that? It would seem much more sensible to be "earning" an exchange rate appreciation, or at least stability, through enhanced productivity performance.

Depreciation can buy some time for adjustment, can help soak up idle capacity through improving exports and can improve the profitability of import-competing firms. But the real adjustment through increased competitiveness is still necessary.

You also will find that many firms will like the low dollar and will vigorously lobby to maintain it even if they are at full capacity. Little recognition will be given to the benefits to the firms from an earned appreciation, because the lower input costs and rising real incomes of consumers are more difficult to capture than the direct advantages to the bottom-line of a lower dollar.

Don't count on the U.S. dollar staying down forever. A good chance exists that you have already overshoot the longer term "equilibrium" exchange rate (that is never observed). Those firms that become

more competitive will have little difficulty in coping with the inevitable appreciation of the U.S. dollar.

CONCLUSION

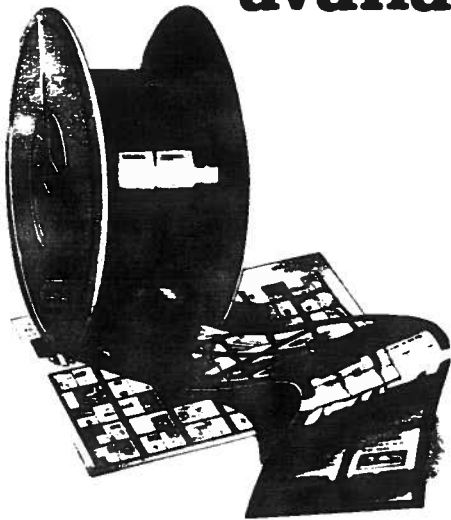
In brief my major points are as follows:

1. The suggestion to slow U.S. growth as a "cure" for the external deficit is likely to be counter-productive. Increased domestic investment, additional efforts on international marketing and support of the international trading system will help. The adoption of an "outward-looking" stance will be a new challenge, both for many U.S. businesses and for U.S. policy-makers.
2. Protectionism remains a concern. It is not in U.S. interests that the Omnibus Trade Bill proceeds, nor will it help your trading partners.
3. The Canada-U.S. Free Trade Arrangement offers a positive demonstration of a better approach; its implementation will be of mutual

benefit.

4. Serious efforts to increase competitiveness will be necessary in order to restore stability to the U.S. current account balance. These moves will be of benefit to all countries.
5. Canadian environmental concerns are real; they require serious actions in both countries.
6. High real interest rates in the U.S. are no longer a meaningful option for reducing U.S. domestic growth, not only because of their domestic consequences but also because of their effects on the international economy.
7. The LDC debt problem is now a problem for the creditor groups; it should be seen as a legacy of past U.S. monetary policy.
8. International trade is a win-win proposition. Most countries are more exposed and open to international pressures than the U.S. They have coped with the same problems and found solutions; take advantage of the experience!

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TABLE 1. Foreign direct investment in Canada, 1975-1986

Year	Position at beginning of year	Capital flows	Retained earnings	Other factors	Net increase in book value	Position at year-end
Année	Bilan au début de l'année	Flux de capitaux	Bénéfices non répartis	Autres causes	Augmentation nette de la valeur comptable	Bilan en fin d'année
millions of dollars						
millions de dollars						
1975	36,385	+ 725	+ 2,553	- 2,274	1,004	37,389
1976	37,389	- 300	+ 2,744	+ 478	2,922	40,311
1977	40,311	+ 475	+ 2,971	- 74	3,372	43,683
1978	43,683	+ 135	+ 3,720	+ 719	4,574	48,257
1979	48,257	+ 750	+ 4,783	+ 481	6,014	54,271
1980	54,271	- 800	+ 5,442	+ 1,131	7,373	61,644
1981	61,644	- 4,400	+ 3,671	+ 5,580	4,851	66,495
1982	66,495	- 1,025	+ 1,299	+ 2,067	2,341	68,836
1983	68,836	+ 300	+ 3,200	+ 240	3,740	72,576
1984	72,576	+ 1,700	+ 5,051	+ 246	6,997	79,573
1985	79,573	- 2,950	+ 5,150	+ 2,168	4,368	83,941
1986	83,941	+ 1,550	+ 4,607	+ 2,872	9,029	92,970

TABLEAU 1. L'investissement direct étranger au Canada, 1975-1986

TABLE 2. Canadian direct investment abroad, 1975-1986

Year	Position at beginning of year	Capital flows	Retained earnings and other factors	Net increase in book value	Position at year-end
Année	Bilan au début de l'année	Flux de capitaux	Bénéfices non répartis et autres causes	Augmentation nette de la valeur comptable	Bilan en fin d'année
millions of dollars					
millions de dollars					
1975	9,210	+ 915	+ 401	1,316	10,526
1976	10,526	+ 590	+ 375	965	11,491
1977	11,491	+ 740	+ 1,278	2,018	13,509
1978	13,509	+ 2,325	+ 588	2,913	16,422
1979	16,422	+ 2,550	+ 1,014	3,564	19,986
1980	19,986	+ 3,150	+ 2,717	5,867	25,853
1981	25,853	+ 6,900	- 175	6,725	32,578
1982	32,578	+ 875	+ 2,336	3,211	35,789
1983	35,789	+ 3,400	- 1,068	2,332	38,121
1984	38,121	+ 2,950	+ 1,717	4,667	42,788
1985	42,788	+ 5,100	+ 2,529	7,629	50,417
1986	50,417	+ 4,521	+ 1,165	5,686	56,103

TABLEAU 2. L'investissement direct canadien à l'étranger, 1975-1986