Time for *a* Plaza II

U.S. trade deficits were caused not by American extravagance but by misaligned exchange rates.

By Richard C. Koo

Many economists, much like the Japanese government thirty years ago and the Chinese government more recently, have preached that U.S. trade deficits are the result of Americans consuming more than they produce, and therefore have little to do with so-called unfair trade practices in the surplus countries. According to this theory, no meaningful improvement in U.S. trade deficits is possible unless Americans begin saving more and consuming less. This argument has been repeated countless times, but its fallacy becomes obvious when the issue is dis-aggregated to the level of individual industries, products and consumers.

U.S. trade deficits soared starting in the 1970s when imports of Japanese cars, televisions, and other products increased rapidly. By 1991, Japan alone accounted for 65 percent of the U.S. trade deficit. According to economists, imports from Japan increased because the United States did not have enough capacity to meet domestic demand or because domestic demand was so strong that exports had to be redirected to satisfy it. But the reality was the exact opposite.

There were hundreds of factories in the United States capable of producing those products, but they were forced to cut output and shed jobs because the Japanese competition offered better value to U.S. consumers. Instead of enjoying booming growth from strong domestic demand—as suggested by the argument above—many U.S. manufacturers

Richard C. Koo is the Chief Economist of the Nomura Research Institute and author of The Other Half of Macroeconomics and the Fate of Globalization *(2018).*

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

went bankrupt, resulting in the loss of millions of jobs. Even though the United States was willing and able to produce more goods with enough labor and capital, its trade deficit grew because Japanese products were cheaper.

The natural tendency of consumers to save money by purchasing cheaper imports caused the loss of domestic production and jobs in industries that were competing with imports. At the aggregate level, that made Americans look as though they were consuming more than they were producing, but at the level of individual households and consumers, no one was living beyond their means. On the contrary, they were being just as frugal, if not more so, by shifting their purchases to less expensive imports.

In 1985, finance ministers **Gerhard Stoltenberg** *of West Germany,* **Pierre Bérégovoy** *of France,* **James A. Baker III** *of the United States,* **Nigel Lawson** *of Britain, and* **Noboru Takeshita** *of Japan reached an agreement to lower the yen-dollar rate from ¥240 to the dollar in September 1985 to ¥120 at the end of 1987, thereby defusing protectionist pressures, during a meeting at New York City's Plaza Hotel.*

This outcome, wherein individual consumers are diligently trying to save but collectively end up dis-saving, is the fallacy-of-composition problem economist John Maynard Keynes called the "paradox of thrift." It is a paradox because individual consumers are trying to save money by buying cheaper imported goods, but because their actions lead to the substitution of domestic products with imports, they collectively end up increasing the trade deficit by reducing the output, income, and savings of fellow citizens who happen to work in industries competing with imports. Forcing Americans to save more and consume less in such a situation, as the economists recommend, will make the paradox of thrift problem even worse by reducing jobs and incomes, which benefits no one.

Today, with the dollar at its strongest point in thirty years, a similar initiative may be needed to preserve the U.S.-led free trade system, which has brought unprecedented prosperity and peace for humanity since it was introduced after World War II.

This fallacy-of-composition problem naturally works in reverse for trade surplus countries. The Asian countries that chose an export-led growth model all experienced rapid increases in production, income, and savings because the paradox was working in reverse for them.

The correct way to address such a trade imbalance is to lower the dollar's exchange rate and thereby restore the competitiveness of U.S. manufacturers. Until 1980, this adjustment happened more or less automatically via the flexible exchange rate system, under which exchange rates tended to appreciate in surplus countries and depreciate in deficit countries.

If the United States was running a trade deficit with Japan, the dollars that companies such as Toyota and Nissan earned in the United States and that had to be sold for yen to pay workers and suppliers in Japan exceeded the yen that firms such as Chrysler and General Motors earned in Japan and that had to be exchanged for dollars to pay workers in the United States. Because exporters and importers were the main participants in the foreign exchange market, this

Continued on page 64

Continued from page 49

imbalance in demand for dollars and yen caused the dollar to fall from ¥360 in 1971 to less than ¥180 in 1978. That, in turn, kept the trade imbalance between the two countries under control. In this regard, unfair trade practices in the surplus countries would have accelerated the dollar depreciation by reducing the demand for dollars by American exporters.

That all changed in 1980 when cross-border capital flows were deregulated in many countries, starting with the United States. The U.S. Treasury Department also forced Japan to open its financial markets to cross-border capital flows via the Japan-U.S. Yen-Dollar Committee. Soon the foreign exchange market was dominated by portfolio investors that viewed the market as just another place to make money, essentially no different from the stock and bond markets. These investors currently account for fully 95 percent of all foreign exchange trading, while importers and exporters are responsible for just 5 percent.

The dollar's role as a reserve currency, together with relatively high U.S. interest rates, attracted huge capital inflows from abroad. Since foreign investors must first acquire dollars to purchase U.S. assets, their demand for dollars kept the U.S. currency strong in spite of the nation's large trade deficits. More precisely, it was the strong dollar—supported by portfolio capital inflows into the United States—that weakened the country's manufacturing competitiveness and kept its trade deficit from shrinking. The foreign exchange market had completely lost its original function as a balancer of trade.

This post-1980 development means that governments in both surplus and deficit countries must now actively participate in the foreign exchange market, either by restricting certain types of capital flows or by intervening directly to prevent exchange rates from moving in a direction that would exacerbate trade imbalances. This is nothing new, of course. The G5 countries (later the G7) used the Plaza Accord to lower the yen-dollar rate from ¥240 to the dollar in September 1985 to ¥120 at the end of 1987, thereby defusing protectionist pressures. Today, with the dollar at its strongest point in thirty years, a similar initiative may be needed to preserve the U.S.-led free trade system, which has brought unprecedented prosperity and peace for humanity since it was introduced after World War II.

This outcome, wherein individual consumers are diligently trying to save but collectively end up dis-saving, is the fallacy-of-composition problem economist John Maynard Keynes called the "paradox of thrift."

Forcing Americans to save more and consume less in such a situation, as the economists recommend, will make the paradox of thrift problem even worse by reducing jobs and incomes, which benefits no one.

The economic onslaught from Japan in the 1970s, followed by Taiwan, Korea, Mexico, and finally China, caused much of the United States to become de-industrialized. In many cases today, any increase in domestic demand can only be met by importing more because local producers have disappeared. Demand shocks also have a major influence on imports, at least in the short run. One example was the 2008 Great Financial Crisis triggered by the Lehman collapse, which sent the U.S. unemployment rate to 10 percent and reduced imports. Such situations led many economists to argue that any attempt to reduce the U.S. trade deficit must include efforts to reduce domestic demand in the United States. But the United States ended up where it is today not because of American extravagance, as many have suggested but never took place, but rather because of an excessively strong dollar triggering a paradox of thrift problem. No meaningful resolution of the trade imbalance is possible unless we address the misalignment of exchange rates. ◆