THE UNITED STATES IN A GLOBAL ECONOMY: RISKS AND CHALLENGES

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Consensus on America's economic status is growing. Continued dependence on foreign capital and foreign energy, argues Alan Stoga, will erode US influence. An aggressive government strategy, however, can avert economic disaster and ensure America's international position.

INTRODUCTION

Many political pundits preach today that the United States is in irreversible decline, politically and economically. In fact, US political and economic power *has* waned both in absolute and in relative terms. This decline partly reflected the inevitable and wholly desirable rise of other nations, not just Germany and Japan, but emerging countries such as Korea and Brazil. But it also reflected the failure over the past two decades to adjust the American economy to changing international circumstances, to remain competitive, to update the international commercial and financial institutional fabric created after World War II, and to remain committed to a global system. Whether the decline proves permanent is a function of whether or not these conditions are reversed, rather than of some immutable laws of economic history.

Two particular issues symbolize the failure to manage the economy prudently and represent tangible risks to the country's future. One is an *immediate* crisis: America's unsustainably large trade deficit and the consequent accumulation of foreign debt. The other is a *prospective* crisis: increasing US dependence on foreign oil. These issues are linked in several ways. Growing volumes of imported oil, even at low prices, contribute to the intractability of the trade deficit. The unwillingness of politicians to deal effectively with either issue is symptomatic of at least nearsighted national leadership. Both issues have profound consequences for America's international position and future security.

The data are daunting. The country's net foreign liabilities approach $500 billion; the foreign deficit in 1988, even after the fall in the dollar and sharp increases in exports, added around $130 billion to the total. No credible forecaster expects the deficit to fall below $100 billion during the next several years, unless the dollar declines dramatically or a major US recession develops. In the first eight months of 1988 the trade deficit totalled $92 billion, with oil imports equal to almost one-third of the total deficit. Imported oil ac-

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counted for 36 percent of the oil consumed in the United States during this period, up from 27 percent in 1985. The country seems headed toward at least 50 percent dependency on foreign oil. (During the 1970s, dependence on imported oil rose from 27 percent at the start of the decade to a peak of 46 percent in 1977.)

BACKGROUND

The country's trade, debt, and energy problems need to be understood in context, and the appropriate context is a global one. Since World War II, the United States has defined and dominated the world economy, sustaining the international economic system almost by itself. The dollar has been the global reserve currency, and the United States, the world's banker. American savings, American financial ingenuity, and access to cheap oil first financed the postwar recovery of Japan and Western Europe and then played the leading role in financing the development of the newly industrializing countries.

Among business and government leaders, broad consensus that the United States benefited from this leadership role and from the maintenance of a more or less free trade and payments system dominated the postwar era. This leadership role, after all, gained markets for American exporters and political allies for the country in the global competition with the Soviet Union. The trade and payments system fueled an economic boom that brought record prosperity to much of the world, especially the United States. Economic leadership enabled America to maintain a unique degree of policy flexibility since the United States alone could finance its deficits simply by issuing more dollars.

Other benefits accrued. American exporters gained because most of their trade was denominated in their own currency. The US economy benefited from the country's ability to set the world's economic ground rules. Since the international financial organizations heeded US advice, American industrial and financial companies were often better placed than others to benefit from their lending and development programs. American economic success provided the essential underpinning for American political leadership: it paid for global American defense commitments and provided both a model and a market for countries emerging from the devastation of war or the constraints of colonialism.

Today, however, strong and reliable American support for a leading US role in the world economy has faded. Protectionist feelings are strong, even within sectors of the business community that traditionally have favored free trade. Almost no one endorses the idea that the United States should play a leading role in financing renewed growth in the Third World. Little sympathy can be found for the notion that the country should sometimes accept higher unemployment in return for the advantages of the dollar's role as the reserve currency. The United States seems preoccupied with the short-term costs rather than the long-term benefits of interacting with the rest of the world.

Americans no longer see themselves as the world's economic leader. According to survey data recently collected by a nationwide polling project ("Americans Talk Security"), only 22 percent of the population think the United States is the top economic power, while 34 percent think the United States has less economic power than Japan or Germany.[1] Fifty-six percent of Americans think economic competitors like Japan pose a greater national security threat than potential military opponents like the Soviet Union. These attitudes both contribute to and reflect the weakening of America's commitment to global economic leadership.

DEBTOR STATUS

Can the United States sustain or recapture the benefits of that leadership if the country depends excessively on foreign capital and foreign energy? Despite the willingness of foreigners to finance US deficits and sell the country energy in vast amounts — which some curiously construe as measures of American strength — the answer is "no." This conclusion is not based on the kind of protectionism which underlies concerns about the "buying up of America." The United States needs investment. Because the country does not save enough to pay for investment, it must come from foreigners. To an economist, foreign capital is every bit as efficient and productive as domestic capital.

As a debtor country, as a country dependent on foreign capital inflows for growth and investment, the United States is vulnerable to the needs and preferences of its foreign creditors. Eventually, the country must service its external liabilities to pay interest and profits and to repay principal. Such payments will drain resources away from future domestic consumption and investment.

The magnitude of the country's continuing trade deficits compounds this predicament. The problem is not only to keep foreigners investing in America, but to continue attracting new financing. This means that US interest rates must remain high. Moreover, it means that if interest rates rise abroad, they must rise in the United States. In sum, if a severe financial crisis develops abroad, the US economy will suffer.

Perhaps most importantly, the existing international system presumes American financial credibility and political leadership. The world still runs on a dollar system; the system can be no more stable than the dollar and the dollar no sounder than the underlying economy. The great postwar international economic institutions — the International Monetary Fund (IMF), World Bank (IBRD), General Agreement on Tariffs and Trade (GATT) — assume a world economy in which the United States is not the sole but the leading economic power.

Simply put, these assumptions are incompatible with a large debtor United States. Sooner or later the institutional structure erected around the leading

1 *The Wall Street Journal*, 17 October 1988.

role of the American economy could fracture. Trade likely could become more controlled and cartelized, despite the integrating pressure of technology. International financial markets could become more volatile. Sustained debtor status could result in movement away from a dollar-based system, ultimately leading to a deterioration in the country's international position.

Clearly, the American national interest rejects such prospects. The solution, at least in part, is to bring the US economy into better balance: increase American savings (the United States saves at a lower rate than any other major industrial country) and reduce the country's trade and budget deficits. This is the course upon which the country is now embarked, however grudgingly and gradually.

But more is needed. Domestic policy initiatives must be knit into a larger strategy which recognizes the vulnerabilities facing the United States and redefines not only the US role in the world economy, but the institutional structure of the global economy itself.

Fortunately, President Bush inherits important economic accomplishments which should make it politically easier to develop and implement a new economic strategy.

- Since 1980, the US economy has created 15 million new jobs at a time when unemployment in other industrial countries has stagnated.
- Parts of the US industry are again competitive in world markets, as evidenced by the growth of exports by 20 to 30 percent during the past two years. This marks an important revival of the US manufacturing sector.
- Inflation, while not wiped out, seems stable at around 4 to 5 percent.
- The macroeconomic coordination mechanism among the seven largest industrial countries has been refined and formalized considerably.

The president should work towards achieving a balance in the country's foreign trade accounts during his term. He must lay the basis for sustained equilibrium: small deficits, small surpluses. That means a swing of some $130 billion to $150 billion in the trade balance, through more exports *and* fewer imports. Increased exports will require further improvements in American competitiveness and productivity, as well as renewed efforts to open up foreign markets to US exports. Import reduction will require lower consumption and higher savings; in the short run this could mean a decline in the American standard of living which to a significant extent has been sustained by massive foreign borrowing. Such an adjustment might be achievable only through a recession. Recession, of course, also could be provoked by strained industrial capacity, higher interest rates, and foreign investor skepticism about the administration's commitment to sound economic policies. Or, a dramatic effort to cut the budget deficit (which while reassuring financial markets would reduce demand in the short run) could engender a recession. A coherent, effective

energy policy which *reduces* dependence on foreign oil imports would ease this adjustment considerably.

But the United States cannot go it alone. Unless a new economic strategy is designed in concert with our foreign partners, the risk of economic warfare — which *would* produce recession — is great. We have skirmished over trade issues with the Japanese and Europeans in recent years, at a time when massive US trade deficits makes their economic lives considerably easier. As the United States gets serious about reducing the deficit, foreign economies will come under pressures, intensifying these skirmishes. Foreigners will fight tenaciously to hold on to their share of the market as well as to resist being overwhelmed by US exporters in their own and third markets. Foreigners are far more effective protectionists than Americans, if only because they are less instinctively free traders.

To avoid, or at least manage, these tensions will be a considerable challenge given the background of growing regionalism in Europe and in Asia. The European preoccupation with creating a single market, the expansion of the European Community to include more countries, and Western Europe's fascination with commercial opportunities in Eastern Europe and the Soviet Union will make Europe more inward-looking. At the same time, Japan seems intent on creating an Asian economic zone centered on its own economy. These initiatives could complicate the American drive for more exports and fewer imports and obstruct efforts to construct a more cohesive economic strategy.

Again, to the extent that energy imports fall rather than rise, the trade adjustments needed in other areas will be eased.

OIL DEPENDENCY

It is important to put the US oil situation in context.[2] Oil accounts for 40 percent of the energy consumed in the United States; 16 percent is imported. Coupled with modest amounts of other energy imports, the United States is more than 80 percent energy self-sufficient.

Today's sufficiency almost certainly represents the highwater mark. Compared to 1973, the United States uses more than one-quarter less energy per unit of economic activity; conservation reduced energy consumption dramatically. The drop in the real price of oil to the level of the early 1970s, however, renders conservation less urgent.

The collapse of oil prices since 1986 already has affected US oil consumption and production significantly. Oil consumption is almost 17 million barrels per day, *up* more than 1 million barrels since the end of 1985. United States production — the second largest in the world — is now around 8 million barrels per day, *down* almost 1 million barrels. At current prices, every 1 million barrel increase in imports adds $6 to $7 billion per year to the trade deficit.

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2 Daniel Yergin, "Energy Security in the 1990s," *Foreign Affairs*, Fall 1988.

Falling Oil Prices Are a Mixed Blessing

In the long run, conservation efforts wind down and domestic production falls, increasing the country's dependence on foreign oil, an issue both of price and of security of supply. If a sustained period of low prices is followed by a sustained period of high prices, the United States will find itself once again with an uncompetitive industrial infrastructure premised on cheap energy.

Even in the short run, excessively low oil prices seem to hurt the economy, although the balance is finely drawn and unevenly distributed. The United States is both the world's largest consumer and second largest producer. The benefits of falling prices — lower inflation and more purchasing power — are diffused, while the costs are concentrated.

Whether low oil prices help or hurt the United States depends on the extent to which the conservation and production effects are permanent and on whether or not oil prices rise. Despite the inaccuracy of oil forecasts over the past fifteen years (between 1970 and the mid-1980s the consensus on oil prices changed four times) it seems likely that for economic as well as political reasons, oil prices will rise again in real terms, although perhaps not until the mid-1990s.

For the next several years, however, excess productive capacity and a political struggle among key producers for hegemony in the Arab Gulf are likely to keep oil prices volatile, but essentially low. Sustained availability of cheap oil ultimately would be harmful for the United States if it persists in its current course of increasing dependence on foreign energy. If, however, Washington uses the window of a few more years of low oil prices to restart the engine of conservation, to develop non-oil energy sources, and to reinvigorate the domestic energy industry, the country not only will be prepared for rising energy prices during the next decade, but will benefit from lower energy bills, which would contribute significantly to reducing the trade deficit during the next years.

Proposed Agenda

Until the United States addresses existing fundamental financial and economic imbalances, the international economic system will be prone to crisis; other industrial countries will hesitate to accept US leadership; international financial institutions will become less effective; trade tensions will rise; global and US growth will be lower (or, at least, below what it could be); and the American standard of living will be vulnerable.

The United States and the world economy clearly would benefit if the president adopted an economic strategy which puts the country on a smooth trajectory toward sustainable economic growth and financial stability. The key elements of such a strategy are not difficult to identify:

• Put the budget deficit on a credit path toward balance.

How? Reaffirm the Gramm-Rudman-Hollings deficit reduction targets. Implement spending cuts and selective tax increases in 1989. As in November

1987, convene a budget summit during the early months of the new administration not only to reduce the current fiscal deficit, but to set the constraints for 1990.

• Develop new savings incentives.
Some analysts have pointed out that it should not be surprising that the Japanese save and invest more, consume less, and produce more per worker. Their tax system is strongly pro-savings and investment; the American system favors home ownership and consumption. This should be corrected. For example, the taxes on long-term capital gains should be sharply cut, and short-term capital gains taxed at a penalty rate.

• Reduce oil consumption.
The United States has the lowest gasoline taxes among the major industrial countries. Increased gas taxes would promote conservation and help to balance the budget. Every penny of gasoline tax raises $1 billion in tax revenue; a 25 cent tax increase applied to deficit reduction would go a long way to convincing financial markets and US allies that the administration and the Congress are serious about deficit reduction.

• Increase domestic energy productivity.
Creating incentives for domestic oil exploration and for accelerated development of a natural gas network is necessary. Overcoming the opprobrium carried by nuclear power — despite significant improvements in technology during recent years — and utilizing abundant coal resources in environmentally sensible ways will increase domestic productivity of other energy sources.

• Balance the trade deficit.
Increased domestic savings and reduced consumption will help. President Bush should commit himself to removing as many impediments as possible to increased American exports. The government should eliminate regulatory restrictions on exports (except in well-defined cases of national security), forcing the country's major trading partners to open their markets further, and resolve the Third World debt crisis which has reduced demand for US goods. In addition, the president should reassess and then realign US trade policy to achieve the necessary shift in the country's external position. This would be an historic shift in US trade policy. During the postwar period, the US aimed to sustain the global free trade system, rather than to achieve a more narrowly defined national objective.

• Modernize the structure of international institutions.
Insist that rising economic powers — including Japan and Germany (or, perhaps, the European Community) as well as countries like Korea and Brazil — share the responsibilities and not just the rewards of helping to manage the international economic system. They must open their markets, reduce their surpluses, help finance Third World debt and development solutions, and reduce trade tensions. These countries need to be better integrated into the governance of the international institutions. The International Monetary

Fund, the World Bank, and the General Agreement on Tariffs and Trade all need to be retooled to serve the global economy of the 1990s rather than that of the 1950s. For example, IMF and World Bank management might rotate among candidates put forward by the United States, Europe, and Japan instead of remaining lodged with the United States (in the case of the World Bank) and Europe (IMF).

To implement such a strategy will require aggressive American leadership at home and abroad as well as the cooperation of other major trading nations. Many European and Japanese leaders seem prepared to cooperate if presented with a coherent US strategy. Indeed, they appear increasingly worried that continuing lack of US strategy could produce a global recession, more protectionism and financial turmoil. They enjoy their surpluses, but they know US deficits must be eliminated.

But even if these countries reluctantly support a US initiative — the international system is too interdependent for the Japanese and Germans to resist totally — the United States holds the commercial and financial clout to achieve its purposes. The US capital market is the world's most sophisticated. The economy is the richest and largest. US industry, recovering from the slump of the 1970s and early 1980s, is increasingly competitive in world markets. Despite the profound changes occurring in the relationship between the United States and the Soviet Union, the West still is dependent on US military strength for its defense.

Ultimately, these assets will enable the country to define an economic strategy which combines unilateral, bilateral, and multilateral elements. For example, if some of the major trading nations are unwilling to abide by America's preferred discipline of free trade in goods and services, then the United States could carve out a preferential trade and finance zone among a select group of countries such as Canada, Mexico, Brazil, and Korea, while maintaining less intense commercial relations with others.

Demonstrated willingness to use the country's assets to manage a global economic adjustment coupled with a coherent domestic energy strategy which aims to restore US productivity and competitiveness would lay the basis for a revitalized and stable global economy. The data suggest that economic ascent is within reach of a determined American leadership.