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The Strong Dollar and the U.S. Trade Deficit

Statement by Dean Baker,

Co-Director, Center for Economic and Policy Research

before the Senate Commerce Committee

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I appreciate the opportunity to address the Senate Commerce Committee about the problems created by the strong dollar and the current trade deficit. In the last 3 years U.S. manufacturing has lost 1 million jobs. During this time the trade deficit has soared from less than $90 billion in 1997, 1.1 percent of GDP, to more than $400 billion in the last quarter of 2000, or 4.0 percent of GDP. This loss of jobs has not only had a devastating impact on the workers directly affected[1], but it is also creating serious long-run problems for the economy as a whole. The trade deficit is causing the United States to borrow money from abroad at an annual rate of more than $450 billion a year. This is no more sustainable than a budget deficit of $450 billion. The immediate cause of this huge deficit is the high dollar, which effectively subsidizes the purchase of imports. It is important to understand how the high dollar hurts domestic production and why the current situation is unsustainable.

The exchange rate between the dollar and other currencies effectively determines the relative price of foreign and domestic goods. When the dollar rises in value relative to other currencies, all goods produced in the United States become more expensive relative to foreign goods, or to put it another, way foreign goods become cheaper for people living in the United States. For example, if the dollar rises by 20 percent against the British Pound, then goods produced in Britain suddenly become 20 percent cheaper for people in the United States, whereas goods produced in the United States become 20 percent more expensive for people in Britain.

This is essentially what has happened in the last four years. The East Asian financial crisis caused the currencies of the region to plummet in value against all major world currencies. Because of the relative strength and stability of the U.S. economy, many investors put their assets in the United States, causing the dollar to rise against other major currencies, as well. As a result, the dollar has risen by approximately 20 percent against the currencies of its trading partners since the middle of 1997.[2] This rise in the dollar has made U.S. goods approximately 20 percent more expensive relative to the goods produced by our trading partners.

Figures 1a and 1b show how this impacts U.S. goods. They show the cost to consumers in the United States of a ton of steel produced domestically compared to the cost of a ton of steel produced abroad in both a normal dollar scenario and a strong dollar scenario. As can be seen, the rise in the dollar lowers the price of the foreign produced steel relative to the price of steel produced in the United States. In this example, a ton of foreign steel which would have cost $220 before the drop in the dollar now costs U.S. consumers just $176 as a result of the rise in the dollar. This means that if U.S. producers could produce steel profitable at $200 per ton, the rise in the dollar created a situation in which they are no longer competitive. Instead of underselling the foreign competition by $20 per ton, the costs of U.S. producers are now $24 per ton higher than the price of the foreign steel.

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[1] According the Labor Department's 2000 Worker Displacement Survey 26.5 percent of the long-tenured workers who lost their jobs in the period 1997-1999 were either unemployed or out of the workforce altogether. Only 43 percent of these workers were able to find jobs that paid comparable or higher wages.

[2] This calculation is based on the real value of the dollar measured by the Federal Reserve Board's OITP currency index.

This describes the situation that has devastated much of U.S. manufacturing in the last four years. The high dollar has also contributed to the nation's farm problems through the exact same mechanism. As a result of the high dollar, foreign agricultural products appear far cheaper to U.S. consumers and U.S. agricultural products are far more expensive to consumers overseas. The high dollar has the same impact on our agricultural products as if the United States subsidized all imported items by 20 percent, and every other nation imposed a 20 percent tariff on imports from the United States.

There are some short-term benefits to a high dollar since it effectively allows us to buy foreign goods at below their true cost. This helps keep inflation down and allows the nation to consume more than it is producing. But this effect is only short-term. The only way that the United States can pay for these imports is through foreign borrowing, and this clearly has its limits. It is possible for a nation like the United States, with a $10 trillion economy, to borrow $450 billion for a year or two, but it cannot do so indefinitely.

Figure 2a shows the growth of the foreign debt of the United States assuming that it continues to run a trade deficit equal to 4.0 percent of GDP, as it did in the fourth quarter of 2000. By 2010, the foreign debt will be $10.6 trillion. By 2020, the debt will be $32.5 trillion. If the current trade deficits persist for 30 years, the foreign debt will be more than $90 trillion.[3] If the trade deficit remains at its current size relative to the economy for 50 years, then the foreign debt will exceed $400 trillion.

Figure 2b shows the same information, but expressed as a percentage of GDP, which is a more meaningful figure. The foreign debt is already approaching 20 percent of GDP, which places us near the top of the industrialized world. If current trends continue, the foreign debt will exceed 50 percent of GDP by 2007, a far higher level of indebtedness than any industrialized nation has ever experienced. By 2017, the foreign debt will exceed 100 percent of GDP, a situation only experienced by the most impoverished of developing nations. In 2032 the foreign debt would be more than twice GDP, and nearly four times GDP by 2050.

Of course, the United States will never see its foreign debt reach these levels. The dollar will undoubtedly fall and bring the trade deficit closer to balance long before the foreign debt comes close to the levels shown on these graphs. But the point here should be clear, the situation is unsustainable. The high dollar is causing the nation to live beyond its means. While the short-term effects can be positive -- as is the case for a family running up credit card debt -- in the long-term, today's trade deficits will leave us with a huge foreign debt to repay.

On a slightly different topic, there is one other point that I want to make on how we think about trade agreements. The proponents of recent pacts such as NAFTA or PNTR for China generally argued their case based on the increased trade that would ensue. Specifically, they held out the promise of increased U.S. exports to the countries affected and the jobs that such exports would create.

[3] These calculations assume that the trade deficit remains at 4 percent of GDP, real GDP grows at 3.0 percent annually, and that the real rate of interest on foreign debt is 4.0 percent.

After the approval of these agreements it was generally acknowledged that these agreements were about investment, not trade (e.g. see "For Many, China Trade Bill Isn't About Exports," by John Burgess, *Washington Post*, May 27, 2000, page E1). There are legitimate grounds for differing opinions on the merits of the various commercial agreements that have come before Congress in the past, and which will be presented to it in the near future. However, the public will benefit far more if the debate is conducted in an honest manner. The notion that that the United States will ever export on a large scale products like steel or automobiles to China or Mexico, as was argued by the proponents of PNTR, is ridiculous on its face. If the proponents of these agreements really believe that they advance the public good, then they should be prepared to tell the nation why an agreement that promotes U.S. investment in China, Mexico, or elsewhere in the developing world will help the nation as a whole. If they can't make this case, then they must not believe that these agreements really benefit the nation as a whole.