Question & Answer: The Trade Deficit

By Chad P. Bown and Rachel McCulloch

Wednesday, January 31, 2007

Beyond myth and emotion, here's the truth about our trade deficit. It's big, but it's not necessarily bad. In fact, it may be helping us live better, now and in the future. Economists Chad P. Bown and Rachel McCulloch explain.

1. What exactly is the trade deficit?

The U.S. trade deficit we read about most often is only one of several different trade balances reported in official statistics. It's the merchandise trade deficit, which is actually the narrowest overall measure of America's transactions with other countries. Thus, it can't tell the whole story of our trade position with the rest of the world.

The merchandise trade balance, also called the balance on goods trade, is the difference between the total dollar value of U.S. exports of tangible goods (like wheat and turbines) and the total dollar value of U.S. imports of tangible goods (like t-shirts and auto parts) over a specific month, quarter, or year. When imports of tangibles are greater than exports of tangibles, then the trade balance is negative, and there's a deficit.

2. Aren't tangible goods significant?

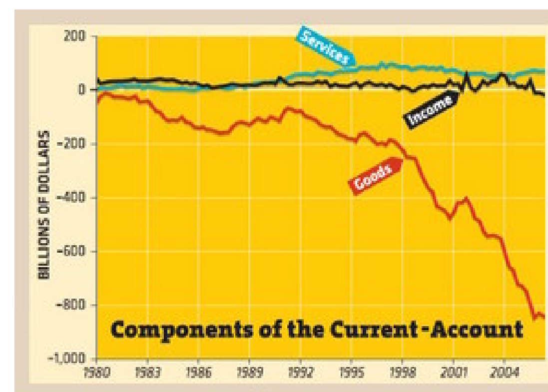
Sure, but tangibles have become much less important over time, while services have become more important. Today, only about one-fourth of the U.S. workforce is employed in the production of tangible goods; the rest work in diverse service sectors such as banking, healthcare, education, consulting, insurance, and information technology.[1]

The link between the U.S. merchandise trade balance and the nation's overall economic condition is, therefore, a weak one, and

getting weaker. Increasingly, analysts use a broader measure that includes services as well as tangible goods. Unfortunately, measuring the value of traded services is less straightforward than measuring the value of tangible goods (which simply get counted as they move out of, or into, the country), so some transactions on both sides are likely to be undervalued or even omitted entirely.

3. Just how large is the U.S. trade deficit?

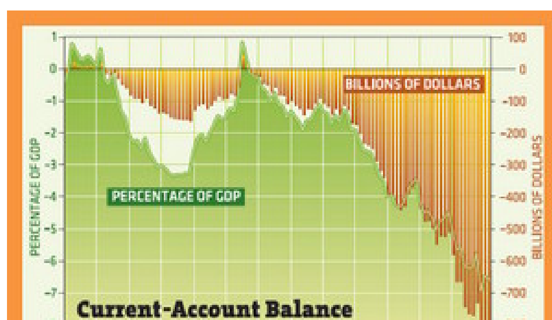
The United States has not had a surplus on merchandise trade since 1975, and the merchandise trade deficit has on average grown much faster than gross domestic product (GDP), the nation's total output of goods and services.[2] For 2005, the U.S. deficit on merchandise trade was $791.5 billion, or 6.4 percent of GDP. Both figures were records.



As Figure 1 shows, the United States is a net exporter of services. The U.S. deficit on goods and services trade, though large and growing, is therefore not as large as the deficit on merchandise trade alone. Still, this broader measure of the trade deficit has also been growing faster than the economy as a whole. It was 5.8 percent of GDP in 2005.

4. O.K. But what about the current-account deficit?

That's the broadest measure of America's international transactions. To the net value of U.S. exports and imports of goods and services, this measure adds another net figure—the difference between foreign payments to the United States and U.S. payments to foreigners.



Those payments have two sources. The first is net foreign income—mainly interest, dividends, and profits from foreign assets owned by Americans and from American assets owned by foreigners. The second is unilateral transfers, which include remittances (mainly sent by immigrants living in the U.S. to their families abroad), private charitable contributions to foreign countries, and U.S. official development assistance (foreign aid).

The current-account deficit summarizes the grand total of U.S. spending and receipts (on everything but assets, which we'll get to) and so indicates the final "bill" the nation must settle with the rest of the world. Figure 2 shows that the U.S. current-account deficit has also been growing much faster than GDP.

5. How do these various deficits link up to the billions of dollars of foreign capital that have been flowing into the U.S. economy?

When a household spends more in a given year than it receives in income, it must fill the gap either by borrowing or by drawing down, or selling, assets the family acquired in the past.

To pay the bill, the household may borrow by running up a credit card balance or arranging a home equity loan, or draw down assets by taking money out of a bank account, cashing a savings bond, or selling a piano. A business, likewise, can fill a gap between spending and receipts by borrowing through bank loans or bond issues, or selling off assets, including parts of the company, or by issuing stock—that is, by selling claims to part of its future stream of profits.

In a similar way, the nation's growing current-account deficit must be matched by an equal surplus on its financial account. This surplus is the difference for a given year between the total dollar value of all U.S. sales of assets to foreigners and borrowing from them (also called U.S. capital inflows or foreign investment in the United States) and the total dollar value of all U.S. purchases of assets from foreigners and loans to them (also called U.S. capital outflows or U.S. investment abroad).

6. Are these financial-account surpluses causing the United States to get deeper into debt to the rest of the world?

We often hear that the U.S. has gone from being the world's number-one creditor to being the world's number-one debtor. The truth is more complicated.

Remember that the financial-account surplus that balances out the current-account deficit is composed of both borrowing and selling assets. Although U.S. borrowing has been important—foreigners are major customers for U.S. Treasury securities and other bonds, and so are indeed lending to Americans—a major part of the capital inflow is through private foreign purchases of U.S. equities (stocks), and another large part is through increased foreign ownership of companies based in the United States.

This last form of capital inflow is called foreign direct investment (FDI). It includes transactions in which a foreign firm acquires a

substantial stake in an existing U.S. company (mergers and acquisitions) as well as ones in which a foreign firm builds something new in the United States (greenfield investment).

There is a key difference between debt and equity investments. U.S. debt held by foreigners requires us to make scheduled payments of interest and principal, but foreign equity investments do not. Also, unlike the debt of most developing countries, U.S. debt is denominated in this country's own currency, which we issue ourselves. Thus, the U.S. financial position, although perhaps worrisome for other reasons, does not hold the threat of triggering the kind of financial crisis we have seen recently in East Asia or Latin America.

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In addition, as Figure 1 shows, there has been little change in U.S. net asset income despite the huge growth in the rest of the world's net holdings of U.S. assets, which have quadrupled since 1994. One reason is that much of the foreign-held debt is in the form of U.S. Treasury securities, very safe assets with low interest rates.

In contrast, much of U.S. holdings of foreign assets represent foreign direct investments, such as factories and mines. These assets, because they are riskier, typically yield a much higher return per dollar. Moreover, many of these U.S. investments were made long ago, so their true market value is much higher than what appears in the official statistics.

7. But the current-account deficit does mean that the United States is spending more than it is earning. Shouldn't that be a concern?

It is certainly true that the current-account deficit means the country as a whole—that is, the private sector plus the government—is spending more than it is earning (for the government, what is relevant is the excess of spending over tax receipts—the budget deficit). However, that discrepancy by itself is not necessarily worrisome.

A household often makes up the gap in a particular year between spending and income by borrowing or by selling assets. That can be either a smart strategy or the first step toward financial disaster. The same is true with nations. Most people would agree that borrowing or selling assets is smart as a way to finance education or the purchase of a new home (investments that have long-term payoffs, in a higher-paying job or a comfortable shelter)—but perhaps less smart as a way to finance an expensive vacation.

Still, even borrowing for a vacation might be fine if the household's income is expected to grow fast enough that it can easily pay off the credit-card balance down the road.

Now, look at the United States. The heavy foreign capital inflow we are now experiencing means that our capital stock is growing faster than it otherwise would. That may sound all right, but this faster growth could also be achieved by Americans' saving more, and that approach would mean lower future payments of interest, dividends, and profits to the rest of the world.

8. So, do today's large deficits mean a lower living standard for future generations?

The answer is not so simple. It depends on how fast the economy will grow over time—a measure we can't determine. We do know that the influx of foreign capital helps to keep U.S. interest rates down and thus stimulates U.S. investment. Imports of foreign–produced capital goods and intermediate goods and services can also stimulate U.S. investment and R&D, making us more productive. Thus, the openness of the U.S. economy may be one factor helping to maintain the nation's rate of productivity growth.

If we can keep boosting our productivity, then our children may be able to meet the obligations to foreigners and, at the same time, enjoy a higher standard of living than we have today. So today's foreign capital inflows, far from hurting our kids and grandkids, may be helping them. Foreign capital in the 19th century, for example, helped build America's railroads, which continue to benefit us today.

9. But what if foreigners begin to save less, or shift their savings into non–U.S. assets?

A change in the behavior of foreign savers (whether individuals or central banks) could force a reduction in the gap between U.S. spending and income. This might mean less credit from abroad and higher interest rates in the United States. Some observers worry about a "hard landing" involving a rapid decline in the international value of the dollar as well as higher domestic interest rates.

Plain common sense tells us that the trade deficit and the current-account deficit can't keep rising forever and that a reversal is inevitable. But neither economics nor history tells us when the reversal will begin, and whether it will occur gradually with little disruption of the U.S. economy or instead be rapid and painful.

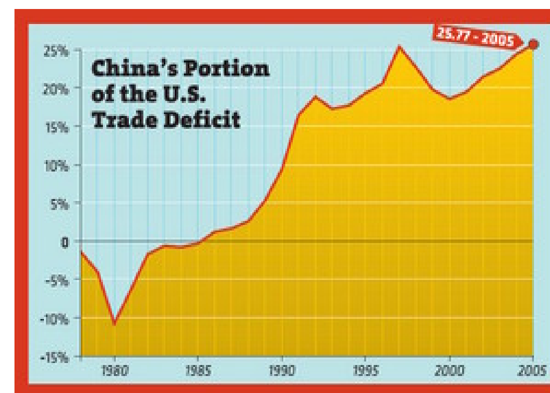
For now, however, it is clear that foreigners are investing in the United States in large part because our economy is attractive and

our bonds are safe. If those conditions—which in turn depend in part on continuing foreign investment—were to change abruptly, then we could indeed expect a hard landing.

10. Isn't China the major reason for our imbalance?

We've already seen that most of the growth of the current-account deficit is due to a soaring merchandise trade deficit, and the U.S. merchandise trade deficit with China is indeed large and growing.

That bilateral trade deficit in 2005 was $202 billion, or about a quarter of America's total deficit in merchandise trade.[3] Today's deficit with China is up from $10 billion in 1990, and $84 billion in 2000. China's portion of the trade deficit was less than 5 percent as recently as the late 1980s (Figure 3). Many people see China's large bilateral surplus on trade with the United States as a smoking gun—clear evidence that China is trading in a way that is unfair. If not, critics ask, why are they exporting so much to us and importing so little? But, in fact, China's rapid GDP growth has been accompanied by very high rates of import as well as export growth. In 2005, China was the second-largest source of U.S. imports (after Canada) but also the fourth-largest market for U.S. exports (after Canada, Mexico, and Japan).



11. Isn't the low value of the yuan one reason why the Chinese are so successful in exporting their goods to us? Wouldn't a stronger yuan help the U.S.?

An increase in the international value of the Chinese yuan would raise the price of Chinese goods in dollars and thus tend to reduce U.S. imports from China. However, a bilateral approach to the trade deficit neglects the fundamental source of the imbalance—the difference between what the United States spends and what it produces.

If the yuan rose enough, importers would switch their orders from China to other low-cost producers such as India, Vietnam, and Malaysia. This would almost certainly hurt the United States—since it would raise costs not just for consumers but also for businesses that use imported components and services in domestic manufacturing.

12. What about putting higher tariffs on goods from China?

In 2005, Democratic Senator Charles Schumer and Republican Senator Lindsey Graham made a proposal to put big tariffs on China's imports if its leaders refuse to let their currency rise in value against the dollar.

But whether Chinese goods become more expensive because of a stronger yuan or big tariffs, the main effect would be to switch U.S. imports from China to other low-cost producers from different countries. Neither policy is likely to save jobs in competing U.S. industries.

Moreover, trade policies such as antidumping, safeguards to protect the textile and apparel industries, and even some of the recent preferential trade agreements signed by the U.S. have an anti-China bias.

13. Doesn't the big trade deficit mean fewer jobs for Americans?

When clothing is imported rather than produced at home, the imports reduce demand for U.S. domestic labor and other inputs in the clothing industry; when U.S. clothing exports rise, the demand for domestic labor in the clothing market rises. Looking at these facts, some observers concur with the "mercantilist" view that imports are bad for the economy, while exports are good.

But that would be true only if labor not required in one sector had no other use in the U.S. economy. The clothing industry might be hurt by imports, but workers employed in that sector can move to other industries. In fact, total U.S. employment has grown significantly as the trade deficit has grown, and economists find no statistical evidence that big trade deficits mean big unemployment.

It's helpful to think of trade as representing a kind of new technology that allows us to get more or better output from the same available inputs—which is the definition of increased productivity. There is a clear overall benefit, but trade, like improved technology, does hurt some people in the process. Over time, however, our rising standard of living depends on higher productivity—whether achieved through improved technology or gains from trade.

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[1]Table 1 of Bureau of the Census (2003) “Occupations: 2000.”

[2]Bureau of Economic Analysis, National Income and Product Accounts Table 1.1.5. Gross Domestic Product.

[3] Bureau of Economic Analysis, U.S. International Transactions Accounts Data, Tables on U.S. Trade in Goods.