The Trade Deficit and Foreign Debt

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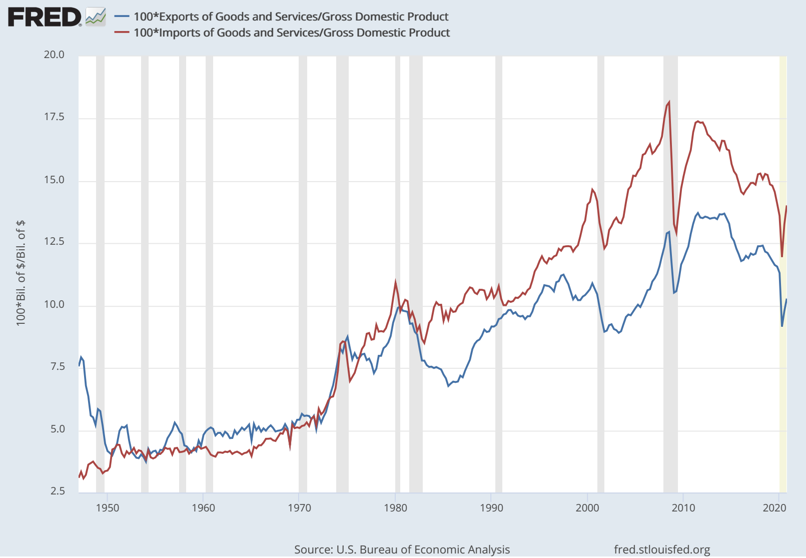
The U.S. Trade Balance



The U.S. trade deficit has been rising...

Implications

> *The current prosperity . . . has a precarious foundation. It is based to a very large extent on borrowing—both from America's own future and from the rest of the world.*
> *—C. Fred Bergsten, America in the World Economy: A Strategy for the 1990s (1988)*

> *The fact that the U.S. remains an oasis of prosperity assures continued deterioration in its trade deficit, as imports grow amid weak foreign demand.*
> *—James C. Cooper and Kathleen Madigan, Business Week (8 February 8, 1999)*

These are the openings quote from Mann (1999), ch. 8

Questions

1. What is the role of trade deficits and surpluses?
2. Is a deficit a problem?
3. Is a "large" deficit sustainable?

The main point:

- A trade surplus means the country **saves** for future consumption.
- A deficit means a country **borrows** against future income.

Exactly analogous to borrowing and saving by individuals.

There is nothing inherently good or bad about trade deficits.

Country budget constraint

Like a household, each country has a budget constraint of the form

- saving = income - expenditure

At the country level:

- income = GDP (Y)
- expenditure = $C+I+G$
- saving = $Y-(C+I+G)$

The country budget constraint is just the **sum** of the individual budget constraints.

National saving

What happens if Americans, on average, want to save more than I?

- In a closed economy: interest rates fall until $S = I$
- In an open economy: we buy foreign assets.

$$\text{Net foreign asset purchases} = Y - (C + I + G) \tag{1}$$

Foreign Saving and the Trade Balance

Now recall another identity:

- $Y = C + I + G + NX$
- $NX = EX - IM$ is the trade balance

Therefore:

Foreign asset purchases $=$ NX

- When the country produces more than it eats, $EX - IM > 0$.
- In return for selling goods, the country must acquire foreign assets.
- $EX - IM$ is **saving** by the country.

Trade Balance and Saving

Trade surpluses export a country's excess savings.

Trade deficits import savings from abroad.

Politicians often want trade surpluses and foreign investment.

- This is not possible.

What Causes Trade Deficits?

What Causes Trade Deficits?

- Why do countries run trade deficits?
- What could / should be done about them?
- How large a deficit can be sustained?

NIPA

Recall the NIPA identity:

$$Y = C + I + G + EX - IM \tag{2}$$

Rearrange as

$$\underbrace{Y - T - C}_{private \ \ saving} + \underbrace{T - G}_{public \ \ saving} + \underbrace{IM - EX}_{foreign \ \ saving} = I \tag{3}$$

T: tax revenues.

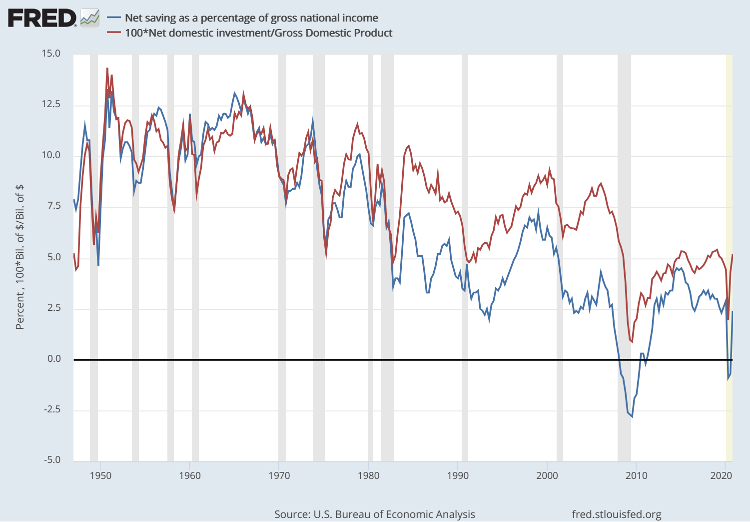
Reasons for trade deficits

$$\underbrace{Y - T - C}_{private\ \ saving} + \underbrace{T - G}_{public\ \ saving} + \underbrace{IM - EX}_{foreign\ \ saving} = I \tag{4}$$

We get a trade deficit when we have:

1. High investment I.
2. Low private saving
3. Large government deficits

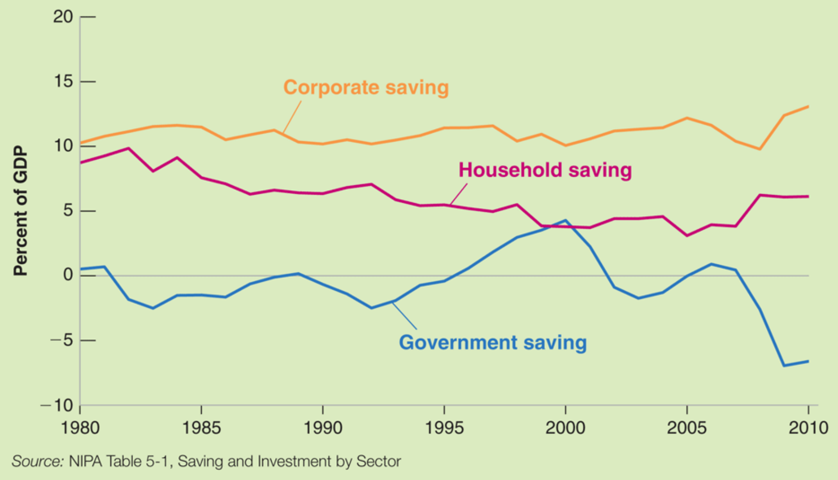
The U.S. trade deficit



I/Y has been roughly constant.

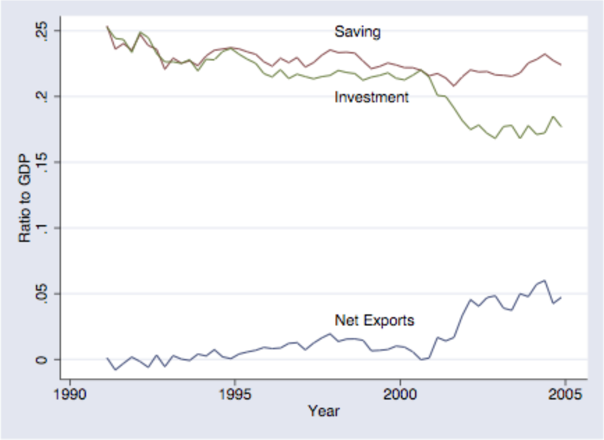
S/Y has been falling.

The Decline of U.S. Saving



Household saving has been falling - why? We'll come back to that...

Low Investment in Other Countries



Source: Backus et al. (2009)

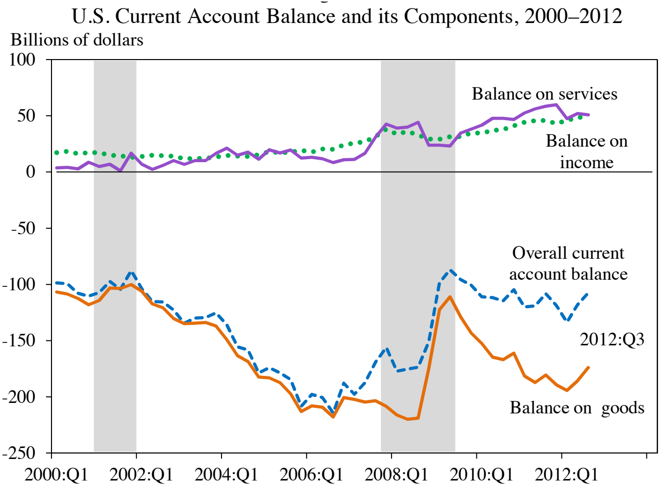
One reason for our defict: surpluses in other rich countries.

Why? - They don't grow / invest.

Foreign governments as buyers

- Since 2000: Deficits are financed largely by selling treasury bonds to foreign governments (Feldstein 2008).
- The likely motivation: sustain their own trade surpluses.

Trade Surplus in Services



Source: Economic Report of the President 2013

The US still has a surplus in services and receives net income.

What About the Exchange Rate?

Do we have a trade deficit because the dollar is too strong?

Or is it the other way around?

How could the trade deficit be reduced?

$$\underbrace{Y - T - C}_{private\ \ saving} + \underbrace{T - G}_{public\ \ saving} + \underbrace{IM - EX}_{foreign\ \ saving} = I \tag{5}$$

Anything that improves the TB must do one of the following:

1. Increase private saving.
2. Reduce the government budget deficit.
3. Reduce investment.

   This is a key point – whenever you hear a story about the trade deficit, check that S^P, S^G, I *are affected in the right way.*

Popular causes of the trade deficit

- Sluggish economic growth
- Too high cost of production
- Low wages in competitor countries
- Foreign trade restrictions or dumping
- "Overvalued" exchange rate

How do these relate to $NX = S - I$?

Consequences of Trade Deficits

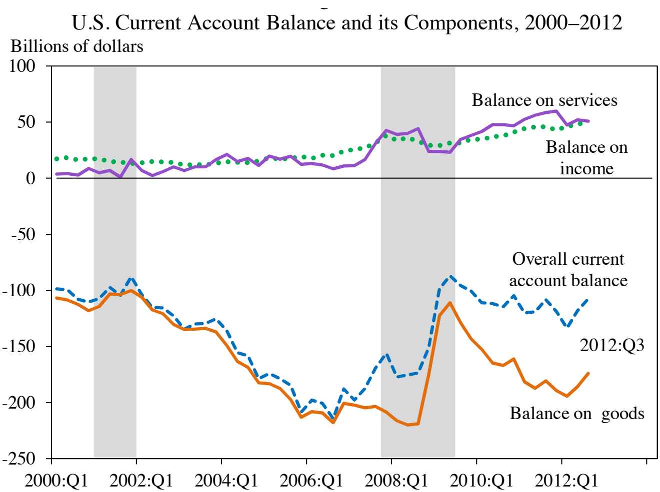
Net foreign assets

Source: The US is increasingly a net debtor nation. Should we worry?

Whenever the trade balance is in deficit, foreigners invest in the U.S.

The U.S. sells off assets.

U.S. Interest Income



Source: Economic Report of the President 2013

But: the US still receives net income on assets.

U.S. Interest Income

A strange fact

Even though our net asset position deteriorates, we pay no (net) interest.

In 2005, the U.S. had $5 trillion in net debt and **earned** about $17 billion in net income.

U.S. Interest Income

If we continue to borrow, why don't we pay interest to the rest of the world?

One reason: capital gains.

- BEA estimates about $2.3 trillion in capital gains (1982-2005)

Second reason: U.S. assets earn a higher return than do foreign assets in the U.S.

- Foreign direct investment is probably underestimated.
- U.S. assets are safer / more liquid.

Sustainability

As long as the U.S. enjoys a rate of return advantage, it can borrow from abroad without paying interest.

Even large deficits can be sustainable.

Sustainability

How much can a country borrow?

- There is no clear answer
- Some countries have large debts and no trouble borrowing (Japan)
- Other countries suddenly get into trouble (Greece)

Remember: countries do not borrow – individuals do.

- The country's trade deficit is simply the sum of individual borrowing.

What is the trade balance of North Carolina?

Does the trade deficit cost growth/jobs?

> *"It requires about 2.5 million full-time workers to produce $100 billion worth of exportable goods and services. Since the rest of the world has been running a $100 billion trade surplus with the United States, at least 2.5 million workers in the rest of the world owe their jobs to that surplus." – Lester Thurow*

Thoughts?

Reading

- Blanchard and Johnson (2013), ch. 19-6
- Poole, William (2003). A Perspective on U.S. International Trade. Federal Reserve Bank of St. Louis.
- Council on Foreign Relations: The U.S. Trade Deficit: How Much Does It Matter?

Advanced Reading

- Jones (2013), ch. 14.
- Economic Report of the President 2010, ch. 4. [on trade deficits and saving rates]
- Backus et al. (2009)
- Is the trade deficit sustainable: Feldstein (2008), Hausmann and Sturzenegger (2006)

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Backus, D., E. Henriksen, F. Lambert, and C. Telmer (2009): "Current account fact and fiction," Tech. rep., National Bureau of Economic Research.

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