

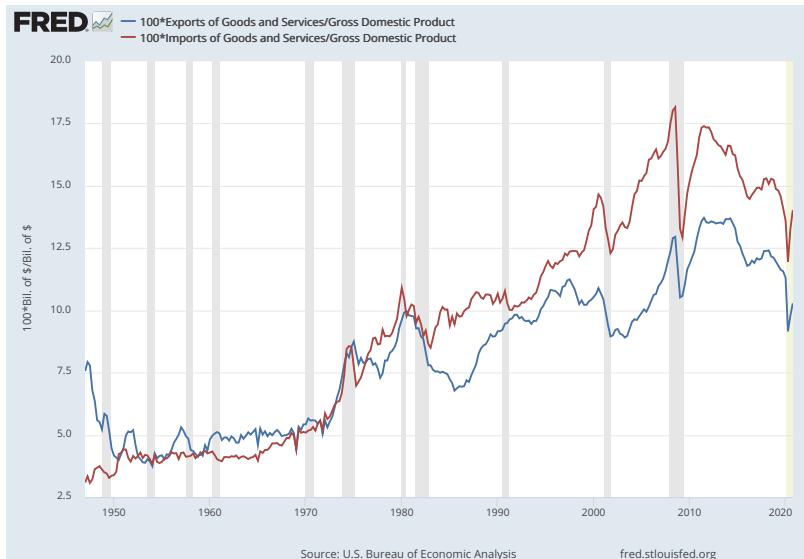
The Trade Deficit and Foreign Debt

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Econ520

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The U.S. Trade Balance



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

Issues

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 **borrow**s against future income.

Exactly analogous to borrowing and saving by individuals.

Country budget constraint

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

- ▶ $\text{saving} = \text{income} - \text{expenditure}$

At the country level:

- ▶ $\text{income} = \text{GDP } (Y)$
- ▶ $\text{expenditure} = C + I + G$
- ▶ $\text{saving} = Y - (C + I + G)$

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.

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

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:

$$Y = C + I + G + EX - IM \quad (2)$$

Rearrange as

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

T : tax revenues.

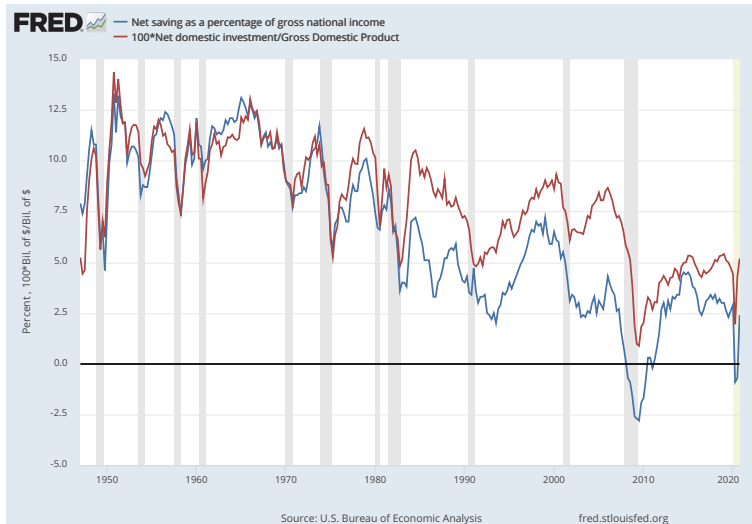
Reasons for trade deficits

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

We get a trade deficit when we have:

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

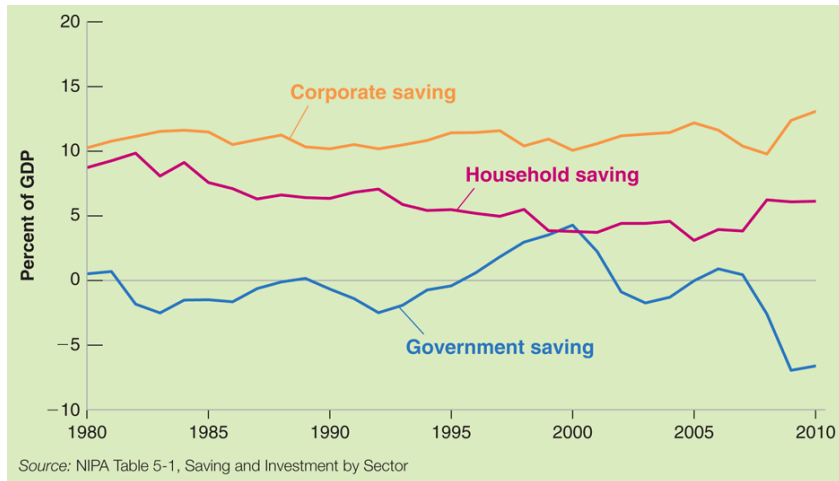
The U.S. trade deficit



I/Y has been roughly constant.

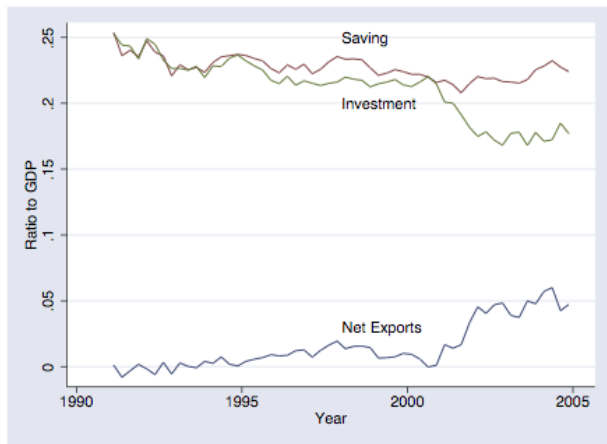
S/Y has been falling.

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)

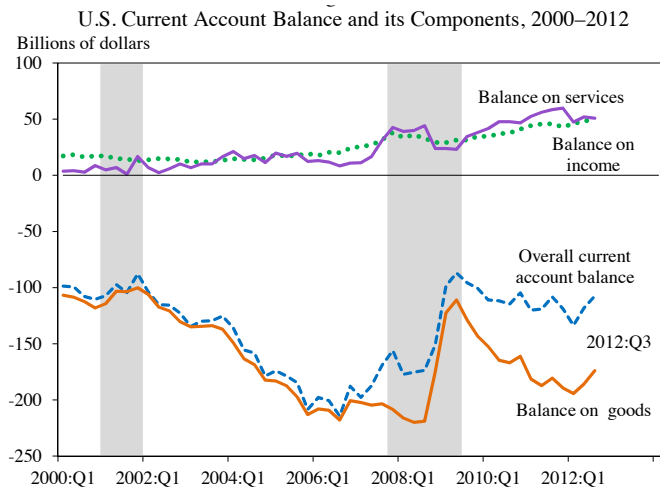
One reason for our deficit: surpluses in other rich countries.

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.

How could the trade deficit be reduced?

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

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.

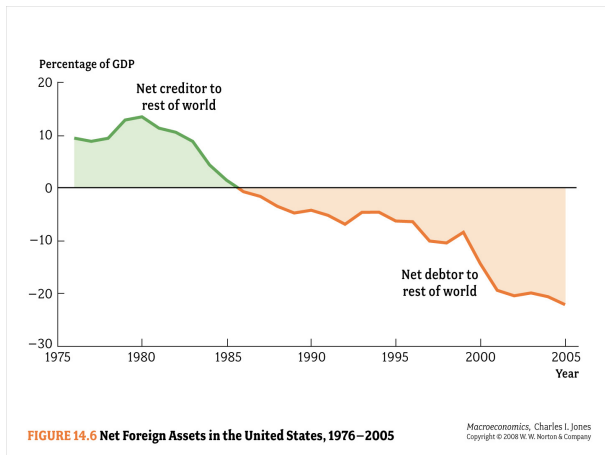
Popular causes of the trade deficit

- ▶ 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

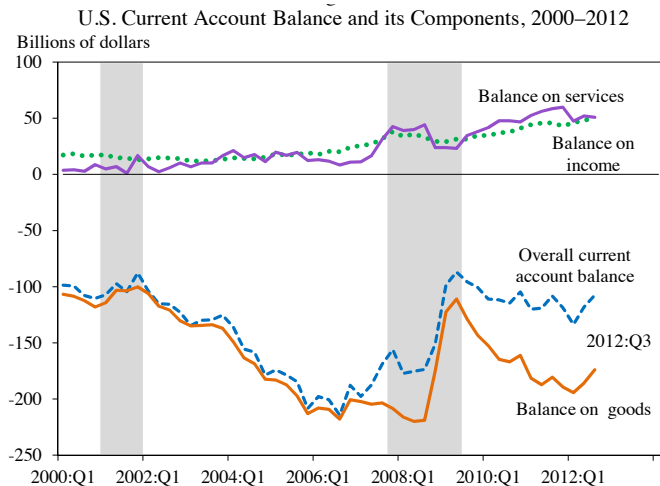
Net foreign assets



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.
- Blanchard, O. and D. Johnson (2013): *Macroeconomics*, Boston: Pearson, 6th ed.
- Feldstein, M. (2008): “Resolving the Global Imbalance: The Dollar and the US Saving Rate (Digest Summary),” *Journal of Economic Perspectives*, 22, 113–125.
- Hausmann, R. and F. Sturzenegger (2006): “Why the US Current Account Deficit is Sustainable,” *International Finance*, 9, 223–240.
- Jones, C. I. (2013): *Macroeconomics*, W W Norton, 3rd ed.