

Trade deficits and the US economy Part I

by Michael Knetter

Globalization is frequently identified as a primary force affecting the structure and development of the US economy as we enter a new millennium. How are trade deficits connected to globalization? Are those deficits really a problem?

Bilateral and overall trade deficits do not provide a reliable signal about the openness of markets or the health of an economy. It is commonplace to read alarming newspaper reports about our bilateral deficits with certain trading partners—Japan, China, and Mexico—and our overall trade deficit. The reporting would lead one to think that deficits are ‘bad’ and that countries with which we run deficits are not allowing us fair access to their markets.

Bilateral deficits do not provide a good signal about the openness of markets. The fact that Japan exported 56% more to the U.S. than it imported from the U.S. in 1997 (see Table 1) is often used to argue that Japan is closed to U.S. goods. However, the data also show that for that same year, the U.S. exported 145% more to Australia than we imported from Australia. Our percentage surplus with the Netherlands was even higher, at 158%. No reasonable person would argue that the U.S. is closed to Australian and Dutch goods. Therefore, we cannot use the imbalance with Japan to conclude they discriminate against us. It is still possible that they do, but the devil is in the details, not in the aggregate bilateral trade flows.

Table 1

1997 Bilateral Export/Import Ratios for Japan and the U.S.

	Japan	US
Australia	0.55	2.45
Germany	1.45	0.55
Netherlands	5.00	2.58
China (Mainland)	0.52	0.19
U.S.	1.56	
World	1.24	0.77

Note: Table entries shows the column country’s exports to the row country divided by the column country’s imports from the row country.

Source: International Monetary Fund’s Direction of Trade Statistics.

What causes variation in bilateral balances? The principle at work—comparative advantage—also explains your own ongoing deficit with your hairstylist. She offers a service that you demand, but she probably buys nothing from you in return. However, your deficit with her is probably more than offset by your surplus receipts elsewhere. Bilateral deficits are the rule in modern economies with extensive specialization.

The same principle works, to a lesser degree, with countries. Australia exports a huge bounty of natural resources to Japan (where such resources are scarce), but Australia demands much less from Japan. Meanwhile, the U.S. has no need for Australia's natural resources, we have our own. But Australia demands a good amount of U.S. output. Hence, the U.S. runs a surplus with Australia while Japan runs a deficit. In a world with many countries, it would be shocking to find bilateral balance. Free markets will generate bilateral imbalance.

What about the overall trade deficit? Is that a problem?

An overall trade deficit means that as a nation we are importing more than we are exporting. When we do this, we must make up the difference by selling assets to foreign residents or taking out loans from them. They don't give us goods for free!

This is the same principle that applies to a household: When we spend more than we earn in income, we must make up the difference by going into debt or selling off some worldly possessions. Most households run large deficits at certain points of the lifecycle—when buying a home, putting children through college, or other periods of extraordinary expense. It is clear why a household might go into debt, and seeing another household in debt should not alarm us. For one thing, it's their debt, not ours! And even if they are too far in debt, the main consequence is that they must tighten their belts in the future and perhaps that those who lent to them will need to do the same.

How about a country? When we add up the balance sheets of all households, firms, and governments in a country we might find that the country in the aggregate is borrowing from abroad—i.e., it is running a trade deficit. Our instinctive reaction should be 'So what?' If the individuals, firms, and governments who have gone into debt had their eyes open, then there is no reason for the rest of us to panic.

The same motives for household indebtedness apply to countries. Countries may go into debt when they are undergoing major industry restructuring. For example, many emerging market countries run overall deficits as foreign investment pours in (in the form of loans or equity stakes) to finance their industries of the future. Another reason a country could run a current account deficit is if many of its households find themselves at that point of the lifecycle where they are more prone to be net borrowers than net lenders.

Either of these explanations might fit the U.S. today. The U.S. certainly looks like it is developing many of the industries of the future—e.g., biotechnology, software, telecommunications, and e-commerce. When much of this activity is occurring at once, it might be natural for a country to borrow from other countries that lack sufficiently attractive investment opportunities. Furthermore, trading partners, such as Europe and Japan, have demographic trends that demand more saving than is needed in the U.S. (i.e., their retirement crises make our Social Security problem look minor by comparison).

Is the U.S. deficit 'too big'?

Better yet, has the accumulation of years of trade deficits mortgaged our future? At this point, it seems the answer is no. We should begin to worry if the cost of servicing the debt is high or increasing rapidly. While the share of domestic national income going toward foreign debt service went from negative 2% (foreigners were paying net interest to us) around 1980 to about 3% today (we are paying them), the number is not at alarming levels. Considering that many households' debt service is 20% or more of annual income, it seems that the national debt has not yet reached frightening proportions. But this dimension is worth watching carefully.

As with any household or business decision to take on debt, it would be nice to do an analysis of whether the specific expenditures being financed by the national debt are justifiable.

Unfortunately, we cannot identify the extent to which U.S. foreign borrowing financed consumption, investment, or government spending. It is important to keep in mind that everyone who borrowed money did so voluntarily. Unless there is a market failure lurking in credit markets that leads people to borrow beyond prudent levels, we should all just worry about our own financial situation.

The one exception to this rule is perhaps government fiscal policy. There is a suspiciously high correlation between the rise of foreign indebtedness and the rise in the Federal government

budget deficit. It is in the nature of politics perhaps that our elected officials are tempted to provide us with what we want today and leave the bill for the future. Ideally, private actors would internalize the future tax liability that a government budget deficit represents—e.g., by increasing private saving today to meet these future obligations. The aggregate data suggest that this has not happened.

The messages so far are as follows. (1) Even in a perfectly open world economic system, some countries will run overall deficits and others will run overall surpluses. (2) We cannot look at deficits or surpluses to determine whether foreign markets are open. (3) There is nothing virtuous about balanced trade and nothing inherently wrong with deficits or surpluses. (4) What we must monitor is overall indebtedness and debt service in relation to the size of the economy.

If deficits don't imply trade barriers then what does?

Even though U.S. trade deficits are not a symptom of closed foreign markets, there are reasons to think that many countries protect certain sectors that particular U.S. firms might otherwise penetrate. The volume of trade is a poor indicator of trade barriers. Product prices are a much better indicator. The logic is simple. If a country erects a meaningful trade barrier, then we ought to find that prices for a given product are higher in that country. Trade barriers (whether overt or subtle) presumably keep out the most efficient suppliers or limit their access. This allows inefficient domestic producers into the market and increases prices.

High domestic prices are the legitimate smoking gun that signals protection of many markets in Japan. This fact has been documented in research by the U.S. Department of Commerce and MITI, Marcus Noland, myself, and others. Some contend that prices are higher in Japan due to high distribution costs, but some research has found that the problem is more than that alone. Therefore, I conclude that Japan does protect more of its domestic industries by a greater margin than most other advanced economies. Developing countries tend to have even more protection, but those barriers have fallen rapidly in recent years.

What would be the effect of reduced barriers to US exports?

Although foreign markets may be closed to varying degrees, the facts suggest that reductions in trade barriers in foreign markets would have a very limited effect on aggregate income and

employment in the U.S. What macroeconomic effect would a more open Japanese market have on the U.S.? In 1997, Japan had a trade surplus of about \$82 billion according to the IMF Direction of Trade Statistics. For sake of argument, let's imagine that the surplus would vanish if the Japanese market were open (even though that is an overstatement for reasons noted above). In 1997, the United States was responsible for 22.4% of all imports to Japan. If that share were maintained in the face of an \$82 billion increase in Japanese imports, the U.S. would experience an \$18.4 billion increase in its exports.

If we made the rather extreme assumption that this \$18.4 billion increase in exports represented a pure increase in GDP, that would still only amount to a one-time gain in real GDP of 0.2%. If we assume that these exports obey the standard split between labor and capital income in GDP (2/3 labor and 1/3 capital), it would increase labor income by about \$12 billion. If the average labor cost were \$50,000 per worker, this would generate about 240,000 jobs. That is about the number of new jobs added in a typical month in the U.S. economy.

Furthermore, there are two reasons to think that this calculation exaggerates the true impact. First, if the U.S. economy were operating near capacity, an increase in demand from Japan would probably increase prices of U.S. goods, rather than output. At present, the U.S. labor market is very tight. So tight that the Fed now contemplates raising interest rates to squelch any sign of an increase in demand for fear it will be inflationary. Second, there is the fact that Japan's increased imports would need to be offset by a reduction in Japan's net lending to the rest of the world. Presumably, this would increase U.S. interest rates somewhat, which would reduce demand from other sources and reinforce the crowding out.

The same reasoning we have applied to the Japanese market applies to other foreign markets. In fact, the argument becomes stronger as cumulative export demand increases since the crowding out issue will surely become dominant at some point.