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The U.S. Trade Deficit in 1999: Recent Trends and Policy Options

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Summary

The U.S. trade deficit has risen steadily since 1992. It reached \$331.4 billion in 1999, an increase of \$118.4 billion over the 1998 deficit, and a rise of about \$286 billion since 1992. The deficit's growth in 1999 was proximately the consequence of a sharp acceleration of import purchases. Exports rebounded from their decline in 1998, but were greatly outpaced by surging imports, leaving the trade deficit at a record size. The deficit in the investment income component of the current account continued to rise in 1999, reaching \$18.4 billion. This is a telling sign of the accumulating burden of the United States' persistent large trade deficits.

The size of the U.S. trade deficit is ultimately rooted in macroeconomic conditions at home and abroad. U.S. saving falls short of what is sought to finance U.S. investment. Many foreign economies are in the opposite circumstances with domestic saving exceeding domestic opportunities for investment. This difference of wants will tend to be reconciled by international capital flows. The shortfall in domestic saving relative to investment tends to draw an inflow of relatively abundant foreign savings seeking to maximize returns and, in turn, the saving inflow makes the higher level of investment possible. For the U.S., a net financial inflow also leads to a like-sized net inflow of foreign goods—a trade deficit. Absent the prospect of any major change in the underlying domestic and foreign macroeconomic determinants, most forecasts predict the continued widening of the U.S. trade deficit in 2000 and 2001.

The benefit of the trade deficit is that it allows the United States to spend now beyond current production. In recent years that spending has largely been for investment in productive capital. The cost of the trade deficit is a deterioration of the U.S. investment-income balance as the payment on what we have borrowed from foreigners grows with our rising indebtedness. Borrowing from abroad allows the United States to live better today, but the payback must mean some decrement to the rate of advance of U.S. living standards in the future. U.S. trade deficits do not substantially raise the risk of economic instability, but they do impose burdens on trade sensitive sectors of the economy.

Policy action to reduce the trade deficit is problematic. Standard trade policy tools (*e.g.*, tariffs, quotas, and subsidies) do not work. Macroeconomic policy tools can work, but have a limited scope for action in practice. It is most probable, however, that the trade deficit will correct itself, without crisis, under the pressures of normal market forces.

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The U.S. Trade Deficit in 1999: Recent Trends and Policy Options

Introduction

International trade continues to grow in importance for the world economy as well as the U.S. economy, enhancing economic well-being generally, but also imposing costs on some sectors of national economies. The importance of trade is well-recognized by Congress, which in recent years has paid close attention to many dimensions of the U.S. international trade performance. This report examines the much-watched trade deficit, paying special attention to why it continues to widen, why it may be a problem, and what can be done to correct it.

Trade Performance in 1999

The U.S. trade deficit as reflected in the *current account balance*¹ rose to \$331.4 billion in 1999, up nearly \$118.4 billion over 1998. As a percentage of GDP the 1999 trade deficit stands at 3.7%, exceeding the previous record of 3.5% set in 1987. The trade deficit rose more or less steadily from 1992 to 1997, then posted very large increases over the next two years. The deficit's increase in 1999 amounts to about 40 percent of the \$300 billion total increase since 1992. On its current path the deficit will likely approach \$500 billion in 2000. Table 1 shows the anatomy of recent trade trends.

Goods Trade.

Goods trade has been the dominant proximate source of change behind the surging trade deficit, with the 1999 deficit in goods trade rising to \$345.5 billion, a substantial increase of just over \$100 billion over the 1998 goods deficit. Since 1995 the goods trade deficit has increased nearly \$154 billion. Export sales had fallen in 1998 in response to slack demand in Asia. Goods exports in 1999 increased to \$684.3 billion from \$670 billion in 1998, resuming the steady rise that had been occurring prior to the Asian crisis. Imports of goods had decelerated their rate of advance in 1998, but sharply re-accelerated in 1999, rising to \$1,029.9 billion from \$917.1 billion in 1998.

¹ The current account is the nation's most comprehensive measure of international transactions, reflecting exports and imports of good and services, investment income (earnings and payments), and unilateral transfers.

Services Trade.

In contrast to goods, services trade showed a slowly rising surplus over the early years of the current economic expansion. That trend ended in 1998, however, with the services surplus shrinking from \$91.9 in 1997 to \$79.9 in 1998, but 1999 the services surplus rose slightly to \$80.5 billion. In 1999 exports of services rose to \$271.8 billion from \$263.6 billion in 1998. This modest gain reflects how pervasive economic weakness in most other economies has taken its toll on the travel and tourism component of U.S. services exports. Imports of services, however, increased to \$191.1 billion from \$182.6 billion in 1998.

Investment Income.

Another telling aspect of trade in this period, has been the steady fall and eventual turn to deficit in 1997 of the current account's investment income component. The deficit in this category rose substantially in 1999, up to \$18.4 billion from \$6.2 billion in 1998. Receipts from foreign investments rose to \$276.0 billion from \$256.5 billion in 1998, reversing two years of near stagnation caused by generally weak economic performance abroad. On the other hand, payments to foreign investors continued its brisk advance, rising to \$294.6 billion from \$264.6 billion in 1998.

The investment income sub-balance had been in continuous surplus from the end of World War II through 1997, but the magnitude of those surpluses has been in steady decline in recent years. Unlike other components of the current account balance, the deterioration of the investment income balance is a direct consequence of America's long string of large trade deficits and the attendant accumulation of debt obligations to foreigners. This is a consequence that acts to exacerbate the deficit trend in the current account. Most importantly, the deterioration of the investment income balance is a measure of the growing economic cost of America's persistent, large trade deficits.

The Tendency for Large Trade Deficits.

A rising current account deficit (or a falling surplus) over the course of a brisk economic expansion is not a remarkable event for the U.S. economy. In the 1960s, brisk economic growth steadily eroded a small current account surplus. In the 1970s, modest deficits occurred with each economic expansion. However, in the 1980s and 1990s, the size of the trade deficits increased greatly. Cyclical factors certainly play a role in this phenomenon, particularly in recent years with the U.S. growing rapidly relative to most major trading partners. Trend forces are also at work, however, inclining the U.S. economy toward widening trade deficits in all but recession conditions. The next section will examine in more depth the fundamental determinates of the trade balance.

Table 1. U.S. Current Account and Components
(BOP basis, billions of dollars, annual rate)

	1993	1994	1995	1996	1997	1998	1999
Current account balance	-85.2	-121.7	-113.6	-129.3	-143.5	-220.5	-331.4
Goods balance	-132.6	-166.2	-173.7	-191.3	-196.7	-246.9	-345.5
Exports	456.8	502.4	575.9	612.1	679.7	670.2	684.3
Imports	589.4	668.6	749.6	803.3	876.4	917.2	1029.9
Services balance	62.7	67.8	76.2	86.9	91.9	82.7	80.5
Exports	184.9	199.6	217.6	239.7	258.2	263.6	271.8
Imports	122.3	131.9	141.4	150.8	166.9	181.0	191.3
Investment income	23.2	16.0	19.4	17.2	3.2	-7.0	-18.4
Transfers (net)	-38.5	-39.1	-35.4	-42.2	-41.9	-44.0	-46.5

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Why the Trade Deficit Widens

The trade deficit widens as the economy expands, not because of trade barriers abroad, not because of foreign dumping of exports, and not because of any inherent inferiority of the United States goods on the world market, but primarily because of underlying macroeconomic conditions at home and abroad. In effect, the U.S. economy spends more than it produces, and this excess of demand is met by a net inflow of foreign goods and services leading to the U.S. trade deficit. Of course, the U.S. trade deficit is only possible if there are foreign economies that produce more than is absorbed by their current spending and are able export the surplus. Trade deficits and trade surpluses are jointly determined. International capital flows will allow a mutually favorable reconciliation of these domestic spending-production imbalances. These imbalances will be sensitive to the short-run effects of the business cycle (at home and abroad) as well as long-term effects of trends in spending and production.

A Saving-Investment Imbalance.

National spending-production imbalances are most usefully analyzed from the standpoint of national saving and investment behavior. Saving is just the flip side of the same phenomenon (an excess of spending essentially translates into a deficiency of savings) but has the advantage of more clearly rooting the phenomenon in the asset market transactions that are the key to understanding aggregate trade imbalances.

It is an economic truism that the amount of investment undertaken by an economy will be equal to the amount of saving — that is the portion of current income not used for consumption — that is available to finance it. However, neither the level of saving available nor the level of investment undertaken is necessarily limited by sources or uses in the *domestic* economy.² In a relatively open world economy with reasonably fluid and well functioning international asset markets, it is possible for domestic saving-investment imbalances to be reconciled by international capital flows. With a willing lender and a willing borrower, flows of capital from one nation to another can achieve *overall* saving-investment balance for both nations.

A nation with a “surplus” of domestic savings over domestic investment opportunities will likely see some portion of domestic saving flow outward to finance more profitable investment opportunities abroad. This net outflow of purchasing power, which generally can only be used to purchase goods (or assets) denominated in this country’s currency, will induce a like-sized net outflow of real goods and services — a trade surplus. Japan is an example of a nation that in recent decades has produced large net outflows of saving to the U.S. and other nations. Conversely, another nation that finds its domestic saving falling short of desired domestic investment, can attract an inflow of foreign saving to help support domestic investment. Such a nation becomes a net importer of foreign saving, using the borrowed purchasing power to acquire foreign goods and services, and leading to a like sized net inflow of goods and services — a trade deficit. The United States has been consistently in this category for the last 18 years.³

Recent Patterns of U.S. Saving and Investment Behavior.

A domestic saving-investment imbalance can occur as a result of either investment rising relative to saving or saving falling relative to investment (see Table 2). In the 1980s the saving rate and the investment rate both declined, but the saving rate fell substantially faster, inducing capital inflows and a rising trade deficit. The fall of the saving rate in this period was rooted in two occurrences. The first was a substantial fall in the public saving rate caused by the run up of large Federal budget deficits (which amounts to negative saving or dis-saving). The second occurrence was the decline of the household component of the private saving rate. In the late 1980s this imbalance narrowed due to increased public saving (i.e., smaller deficits) and a sharp decline in the investment rate in response to a decelerating economy headed for recession.

² Saving in a macroeconomic framework is the portion of current income that is left after households, businesses, and government pay for their current spending. A household that diverts some amount of current income to a bank, mutual fund, or government bond is saving. Similarly the tax revenue that the government has left after paying for its spending is (public) saving.

³ For a fuller discussion of this analytical framework see: Mankiw, N. Gregory. *Principles of Economics*. Fort Worth, Texas. The Dryden Press, 1997, pp 659; and also, The Congressional Budget Office. *Causes and Consequences of the Trade Deficit: An Overview*. CBO Memorandum, March 2000.

After recovery from the 1991 recession, the U.S. saving-investment imbalance began to increase steadily, but the form of the imbalance had changed. The rates of saving and investment both rose, but the investment rate climbed faster. The turnaround in the overall saving rate has been the consequence of a sharp change in the public saving rate, where the steady move by the federal government from budget deficits to budget surpluses has increased the public saving rate from -2.5% (i.e., dis-saving) in 1992 to 3.9% in 1999. Dampening the rise of the overall saving rate, however, has been the continued decline in the household saving rate, falling from about 6.5% in 1992 to 1.8% in 1999. The rise of the overall saving rate in the 1990s has not, however, brought that rate to the level that prevailed in the 1950s, 1960s, or 1970s. Further, the rate has fallen well short of the 1990s' briskly ascending rate of domestic investment. The predictable consequence of a widening savings-investment imbalance has been a rising inflow of foreign savings to close that gap, and in turn, an ever larger trade deficit. In 1999 the investment- saving gap widened to a record size *and so did the trade deficit.*

Two questions may come to mind. One, why has the household saving rate collapsed over the last 20 years? Other factors unchanged, a higher rate of household savings would have likely meant the generation of smaller trade deficits. Two, why did U.S. investment spending boom in the 1990s? Other factors unchanged, a rate of investment at the lower level typical of other expansions would have also led to smaller trade deficits.

The fall of the household saving rate has been the object of much economic research, but the reasons for the decline remain problematic. No single theory can fully account for the phenomenon, but three have considerable plausibility. First, capital gains on real estate, stocks and other investments, particularly in the 1990s, have greatly increased household wealth. Economic theory predicts that a rise in wealth reduces the need to save and increases the tendency to spend. Second, increased government outlays for Medicare and Social Security transfer income from a relatively high saving segment of the population to a relatively low saving segment. Third, more streamlined credit market vehicles, such as credit cards and home equity loans, have removed constraints on household liquidity and prompted increased spending (and reduced saving).⁴

The reasons for the investment boom in the 1990s also remain somewhat unclear, but three plausible forces have been suggested. First, the wealth induced spending mentioned just above also provides a stimulus to business investment, as new plant and equipment is needed to meet the rising demand for output. Second, it is argued that recent deregulation, liberalization of trade, and massive integration of ever cheaper and more powerful computers into the production process have boosted productivity and raised the profitability of investment in the United States. Third, and perhaps most plausible, pervasive economic weakness abroad, most

⁴ See: U.S. Library of Congress. Congressional Research Service. *The Collapse of Household Saving: Why Has it Happened and What Are its Implications?* By Brian Cashell and Gail Makinen. Report No. RS20224. March 3, 2000

recently in Asia, has made the United States a singularly attractive destination for foreign investment.

This overall scenario leaves one with two strong impressions. One, U.S. trade deficits appear to be largely rooted in macroeconomic forces in the domestic economy. And two, these forces may not be easily manipulated by policy.

Table 2. U.S. Saving-Investment Balance
(percent of GDP)

	Ann. Avg. 1975 to 1982	Ann. Avg. 1983 to 1990	1993	1994	1995	1996	1997	1998	1999
Saving	19.7	17.1	14.5	15.5	16.0	16.6	17.4	17.3	18.6
Investment	20.3	19.5	16.5	17.5	17.2	17.7	18.6	21.2	21.8
*Net lending(+) or borrowing(-)	-0.6	-2.4	-2.0	-2.0	-1.2	-1.1	-1.2	-2.9	-3.2

* Net lending, in concept, should equal the current account balance. Statistical discrepancies prevent a precise matching, however.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Policy Responses to Trade Deficits

So long as domestic saving in the U.S. falls short of domestic investment and an inflow of foreign saving is available to fill all or part of the gap, the United States will run a trade deficit. This suggests that the use of trade policy tools to alter the flow of exports or imports, while imposing significant efficiency effects on the domestic economy, would not *over time* change the domestic investment-saving imbalance and therefore, would not change the size of the trade deficit.⁵ Macroeconomic policy tools have the potential to alter the saving-investment balance and the trade balance, but the realistic scope for their use is limited.

Trade Policy Responses.

Trade policy involves actions to directly stimulate or retard the flows of imports and exports such as the erection or removal of tariffs and subsidies. Such actions will have significant impacts on the level of trade and economic efficiency (positive or negative) but will not change the balance of trade. In each instance action aimed at

⁵ Similarly, the removal of U.S. trade barriers, while conferring significant efficiency gains, would not change the domestic investment-saving imbalance and, therefore, would not widen the trade deficit.

altering one side of the trade equation will lead to induced effects via the exchange rate that will cause the other side of the equation to change in the same direction and by an equal amount. For example, using a tariff or quota as a barrier to stem the flow of imports into the U.S. will also reduce the demand for foreign exchange needed by the U.S. to purchase imports, appreciate the dollar's exchange rate, and induce an equivalent curtailment of export sales. With this policy the level of trade has been reduced along with the economic *gains from trade* and economic well-being, but the trade deficit is unchanged. Alternatively, getting our trading partners to remove trade barriers will stimulate export sales, but will also increase the demand for dollars by foreigners, appreciate the dollar exchange rate and induce an equivalent increase of imports. In this case the level of trade is increased along with the gains from trade and economic well-being, but the trade deficit is still unchanged. Finally, an export subsidy will also stimulate export sales but an exchange rate induced rise of import sales will also leave the trade balance unchanged. (In the case of the subsidy, a higher level of trade does not lead to an increase in economic welfare as the gains from trade are more than offset by the economic inefficiency of distorting the allocation of resources towards the export sector.)

Macroeconomic Policy Responses.

The mechanics of the saving-investment relationship in an open economy suggests that there are essentially three ways the trade gap can be reduced. One, the rate of domestic investment falls. Two, the level of domestic savings rises. Or three, some combination of one and two occurs. Macroeconomic policy, the use of monetary and fiscal policy tools, can in theory effect changes in these variables. Monetary policy, by raising domestic interest rates and braking economic activity, can lower the rate of domestic investment and likely narrow the trade deficit. (At the extreme, a recession would likely dramatically reduce the trade deficit.) Decreasing the rate of domestic investment is not generally considered the most desirable economic course to follow, however.

The second course to a smaller trade deficit, raising the domestic saving rate, while having considerable economic merit, is a very problematic goal for macroeconomic policy. As explained above, fiscal decisions on taxing and spending influence the deficit or surplus position of the federal budget and the rate of public saving. We have seen in recent years a rise in the U.S. overall saving rate as a consequence of a rising public saving rate stemming from the sharp swing of the federal budget from deficit to surplus. This contribution from public saving has probably gone about as far as it is going to go and, therefore, does not offer much promise for boosting the overall saving rate much further. Can macroeconomic policy lift the low private saving rate? Proposals have been made to use the tax code to raise incentives for saving by households. Careful analysis most often reveals that such proposals have uncertain effects on the private saving rate as they tend to raise both saving and investment.⁶ Other proposals, such as individual retirement accounts, may

⁶See U.S. Library of Congress. Congressional Research Service. *Saving in the United States:* (continued...)

just redistribute saving, raising the household rate (a little), but lowering the public rate an offsetting amount.

Sustainability of the Trade Deficit

With little prospect at home or abroad for any *dramatic* reversal of the forces determining the trade deficit, it is unlikely that the deficit will shrink any time soon. In fact, most projections out over the next one to two years see a further widening, with the current account deficit rising to the \$450 to \$500 billion range.⁷ Nevertheless, a rapidly increasing trade deficit is not likely to be a phenomenon that is sustainable indefinitely. There are automatic adjustment processes that will work to dampen the willingness of borrowers to borrow and of lenders to lend, and which can effect a more or less orderly reduction of the trade deficit.

Borrower's Constraint.

The central issue for a borrower country like the U.S. is the “ability to pay,” that is the capacity to meet the interest and principal payments on the accumulated stocks of foreign debt. Such payments must come at the expense of other forms of national expenditure and therefore will not increase without bound. For the U.S. the Net International Investment Position (NIIP) is the measure of our stock of obligations and GDP is the measure of our ability to pay. Therefore the ratio NIIP/GDP is a possible proxy of the borrower's constraint. Because we do not have much experience with a rising foreign debt to GDP ratio it is difficult to judge at what value this ratio would begin to sharply deter more borrowing. Between 1992 and 1999 this ratio has risen from 7.3% to 18.1%, a substantial gain, but still well short of the debt burden of many households, and apparently not high enough to sate the appetite for foreign capital. Evidence from other industrial countries does not clearly point to a value at which this ratio would be binding on borrower behavior.

An alternative measure of constraint is the ratio of the current account balance (CA) to GDP (CA/GDP). This measure lays more stress on the size of the annual flow of foreign obligations relative to GDP as an initiator of borrower behavior. The value of CA/GDP for the U.S. has risen from 0.8% in 1992 to 3.7% in 1999. Evidence from industrial economies indicates that, on average, when the CA/GDP ratio exceeds 4.2% the current account begins to narrow.⁸ This suggests that the U.S. may be getting close to a point at which borrowers may begin to slow their rate of debt accumulation. We must also consider, however, that there are special attributes

⁶(...continued)

Why Is It Important and How Has It Changed? By Brian Cashell and Gail Makinen. Report No. 98-580.

⁷ See forecasts by: DRI/McGraw-Hill. *The U.S. Economy*. April, 2000.

⁸ See: Mann, Catherine L. *Is the Trade Deficit Sustainable*. Washington D.C., Institute for International Economics, 1999, pp 156.

of the American economy that would allow it to prudently push borrowing beyond this benchmark ratio.

Lender's Constraint.

The willingness to lend to a particular destination will be influenced by the risk-return profile of a borrower's assets *relative* to other available assets. A broad array of alternatives with comparable risk-return prospects would tend to reduce the willingness to lend to a single borrower. Similarly, a paucity of alternative investment opportunities would have the opposite effect. In addition, the desire by investors for some degree of portfolio diversification will tend to limit their willingness to become overly saturated in assets from one destination. Beyond the willingness to invest is the issue of ability to invest. The ability to sustain a large or rising outflow of capital will be limited by the size of the lender economy and its wealth portfolio. Other economies are substantially smaller than the U.S. economy and may be unable to sustain the magnitude of outflow the U.S. can apparently readily absorb. Also limiting cross-border lending is the observed preference in most economies to hold a high percentage of wealth in home assets.

Special Considerations for the United States.

There are factors unique to the U.S. that may reduce the constraints on international lending or borrowing. First, over 90% of the U.S. international borrowing is denominated in dollars. This means that the pressures that other borrowing countries might face due to fluctuations in the value of debt service burden caused by volatile exchange rates is largely not an issue for the United States. Second, about 75% of U.S. foreign investment is in more stable long-term investments. Such investments tend to have a more enduring flow that is less prone to reversals in confidence. Third, about 50% of the investment in the U.S. by foreigners is in the form of equity (stock) holdings. Equity holdings tend to carry less strict payment requirements than debt holdings, working to lower the potential service payments (for a given level of NIIP), and extend the period over which the nation can prudently run current account deficits. Finally, the size and importance of the U.S. in global trade and finance puts the U.S. in a special position as a borrower.

Prospects.

A mid-1999 study by Katherine Mann of the Institute for International Economics evaluates the several factors governing the behavior of lenders and borrowers and estimates that the U.S. trade deficit is not on a sustainable course.⁹ Mann judges that the most probable path is one of expansion for two to three more years very likely reaching \$500 billion. By 2001 or 2002, however, the trade deficit will likely begin to shrink. This turnaround, in her estimation, will be forced by the tightening of the borrower's constraint as United States citizens retreat from further large increases in debt service expense. The lender's constraint is judged to be

⁹ Mann, Katherine, L. op cit, p. 149.

significantly less binding with foreign creditors likely willing to lend at high volume for a longer period of time. This projection is contingent on some moderate slowing of the pace of U.S. economic growth and a significant acceleration of growth in the rest of the world over the next few years. Absent an unexpected rise in domestic saving, a shrinking trade deficit must also mean a shrinking of the rate of investment in the United States.

Is the Trade Deficit a Problem?

A trade deficit is not necessarily undesirable. It confers benefits and carries some costs, and the former may exceed the latter. Trade deficits are a vehicle for extending the gains from trade, where lending and borrowing among nations can lead to a more efficient allocation of saving and a preferred pattern of consumption over time. Trade deficits do not cause slower economic growth or lead to any economy-wide loss of jobs. As seen in the 1980s and as is very evident in the 1990s, for the United States unemployment has fallen to record lows and the economy's growth rate has accelerated to record highs even as the trade deficit has risen. That deficit, therefore, does not necessarily come at the expense of current domestic economic activity. Of course, borrowing carries a cost as the lender demands that interest be paid on the funds borrowed and the principal one day be repaid. This "debt service cost" is a burden the borrower must carry tomorrow for living beyond his means today. One's evaluation of the desirability or undesirability of a trade deficit will hinge on the current benefits gained from that added spending relative to the future debt service burden that is incurred. Also, reliance on foreign sources of finance often raises concern that trade deficits carry an elevated risk of instability and disruption to the economy. Finally, trade sectors have differential effects on different sectors of the economy, often placing large burdens on exporting and import competing sectors.

Intertemporal Trade.

Gains from trade can arise from *intertemporal* exchanges. These are exchanges of *current* goods and services for claims on *future* goods and services, that is, an exchange of goods and services for an asset (*i.e.* cash in a bank account, stock, or bond). When the United States (or any trading nation) borrows from abroad to import materials for a current investment project, it is undertaking intertemporal trade. In such a transaction, the borrowing nation gains because it can support a higher rate of investment in capital goods than what current domestic saving alone could finance. The lending nation gains an asset yielding a higher rate of return than is available in the home economy. Because of the difference in their preferences for spending over time, the international asset market allows both parties to the transaction to raise their economic well-being. The borrower's economic well-being is raised by being able to spend more in the current period than current income allows. The lender's economic well-being is raised by being able to spend more in some future period. A country that is a net borrower will also run a trade deficit, while the country that is a net lender will run a trade surplus. This type of international asset transaction allows a more global utilization of the world's saving, a more efficient allocation of investment spending across nations, and a preferred distribution of spending over time.

As already noted, since the early 1980's the U.S. has incurred trade deficits of moderate to large size, using international borrowing to push spending beyond current production, pursuing desired consumption and productive investment now rather than later. Similarly, nations like Japan have been able to run trade surpluses, using international lending opportunities to earn higher returns on their excess national savings and expanding the prospects for spending in the future. Such net flows have not grown as fast as gross flows of capital so that external sources of finance still claim only a small share of the total funding of domestic investment in most industrial countries. For the U.S. in 1998, for example, the trade deficit represented about 3.5% of GDP and about 15% of domestic investment spending. The trend, nevertheless, has clearly been toward larger external imbalances (surpluses and deficits).

Debt Service Burden.

With each successive trade deficit the stock of foreign obligations grows. The current size of this stock is formally measured by the NIIP. In 1981 the United States was a *net creditor* with a net accumulation of assets from the rest of the world of \$374 billion. But a steady and substantial stream of net foreign borrowing has swung the NIIP to a *net debtor* position of about \$1,082 billion in 1999, or a cumulative swing of nearly \$1.5 trillion over this period.

The current debt service cost of America's stock of foreign debt can be roughly judged from behavior of the investment income component of the current account balance (See table 1.). That series is a measure of the nation's net payments and/or receipts on past investment and debt. If positive, the United States earned more than it paid; if negative, the U.S. paid more than it earned. Movement in this measure is reflective of changes in the stock of net indebtedness. We see in Table 1 that international investment income in 1999 was a deficit of \$18.5 billion, up from a deficit of \$6.2 billion in 1998. If the trade deficit remains on its current upward trajectory, it is quite credible to imagine U.S. international debt payments reaching the \$40 to \$50 billion range before the net borrowing stops growing.

A \$40 to \$50 billion transfer of real income to the rest of the world is significant, but it is not an overwhelming outflow for the world's largest economy. By the year 2001, the United States will likely have a GDP valued at over \$10 trillion dollars. For an economy of this size, a \$50 billion foreign debt service burden amounts to only 0.5% of GDP. Clearly, insolvency is not lurking just over the horizon. Nevertheless, a debt service payment of this size is significant, particularly if viewed in the context of the economy's average annual growth rate of real GDP. For a mature industrial economy like the United States the long-term growth rate can be expected to average about 2.5% per annum. Thus a yearly debt service burden of about 0.5% of GDP would mean that the rate of growth of domestic spending is reduced to 2.0%. That is a sizable erosion of the rate of expansion of the U.S. living standard. At a 2.5% annual growth rate national income doubles about every 29 years, whereas at a 2.0% annual rate, doubling occurs every 36 years. Put another way, growing at 2.5% for

29 years, GDP per capita would equal about \$60,000, whereas growing at 2.0% for that same period would bring per capita GDP to only \$53,000 or about 13% less.

The degree of burden actually incurred, however, will depend in part on how the nation uses what it borrows. If foreign borrowing is used to finance an increase in domestic consumption (public or private), there is no boost given to future productive capacity. Therefore, to meet debt service expense, future consumption must be reduced below what it otherwise would have been. Such a reduction represents the burden of foreign borrowing. This is not necessarily bad; it all depends on how one values current versus future consumption. If, on the other hand, foreign saving is used to increase domestic investment the burden could be slight. We know that investment spending increases the nation's capital stock and expands the economy's capacity to produce goods and services. The value of this added output may be sufficient to both pay foreign creditors and also augment domestic spending. In this case, because future consumption need not fall below what it otherwise would have been, there would be no true economic burden. It is difficult to assess to what extent U.S. debt service cost will be attenuated by the shift in recent years from using foreign borrowing to support, more or less exclusively, added domestic consumption to using those borrowings to also increasingly support rising domestic investment. (Keep in mind, that the accelerated rate of investment makes only a small net contribution to the size of the nation's huge capital stock. Thus its growth accelerating effect is commensurately modest.)

Instability.

Trade deficits often raise concern about the potential instability of external sources of finance. What if foreign investors begin to pull their funds out of the U.S., disrupting domestic capital markets and the wider economy. There are good reasons to doubt that a sharp turnaround in foreign capital flows is likely. Recent experience of other countries with the panic of foreign investors has shown that such behavior most often results from the growing likelihood that they would not be repaid, that debt service payments were doubtful. This occurred when a country's ability to pay debt service was imperiled by persistent weak economic growth or the rapid consumption of the nation's foreign exchange reserves in the defense of an overvalued currency. These are not risk factors that have much relevance to the circumstances of the United States.

In addition, a large proportion of investments made in the U.S. have been long-term in nature and not particularly prone to quick changes in commitment. It is very likely that many foreign investors generally see the U.S. economy as a bastion of long-run economic strength and will continue to invest for long-term gain. It is true that a sizeable share of the stock of U.S. foreign debt is in short term assets that can move quickly. That these types of assets will change direction as relative yields rise abroad is quite likely and does raise the risk of instability somewhat. But, given the absence of the risk factors noted just above, it is far more likely that such capital outflows will be part of an orderly adjustment process and not lead to undue economic instability. The impact of any exodus of foreign capital, if it did occur, would be muted by the

large size of the overall U.S. capital market relative to the scale of the foreign capital flows. In 1999, the current account deficit of \$331.4 billion was equal to about 15% of the \$2,222.8 billion raised in U.S. capital markets that same year.

Sectoral Effects.

While large trade deficits do not necessarily reduce the total level of economic activity, they can alter the composition of domestic output. There is evidence that over the last 20 years persistent trade deficits may have caused a *small* reduction in the size of the domestic manufacturing sector.¹⁰ The trade deficit exerts some downward pressure on the size of the domestic manufacturing sector because the trade inflow cannot easily augment the full spectrum of goods and services that comprise the nation's increase in domestic demand. Domestic spending is predominantly spending on services, while trade is rich in manufactures and a poor vehicle for acquiring services. Therefore the trade deficit, largely a net inflow of manufactured goods, may not meet the augmented domestic demand for goods *and services*. In this circumstance relative prices can be expected to change so as to reallocate some resources out of the domestic manufacturing sector and into the production of services to help meet the added domestic demand for services. This, in turn, should induce a greater reliance on the net inflow of foreign manufactured goods to help meet the added domestic demand for manufactures. The outcome will be greater real output by the domestic service sector and smaller real output by the domestic manufacturing sector.¹¹

Recent surges of the trade deficit have clearly had a sharp negative impact on particular sectors. On the export side, agriculture and commercial aircraft experienced dampened export sales, mainly due to general weakness in other economies, particularly in Asia. On the import side, the steel industry and the textile and apparel industries came under considerable pressure from low price competition from the crises affected countries. Adjustment to such trade effects can be economically painful for workers in these harmed sectors. In most circumstances it is more beneficial to the overall economy to encourage adjustment than it is to protect sectors from the disruptive effects of trade. There are government programs which provide some amount of *trade adjustment assistance*, but there are important questions about the adequacy of these programs.

Conclusion

A trade deficit is not necessarily bad. It is most useful to see it as a vehicle to achieve an economic end, conferring some benefit at some cost. Whether the trade

¹⁰Rowthorn, Robert and Ramana Ramaswamy. *Deindustrialization: Causes and Implications. Staff Studies for the World Economic Outlook*, IMF, 1997.

¹¹This argument is not likely undermined by the development of U.S. trade surpluses in services in this period as *tradable* services are a small sub-set of the full spectrum of, largely non-tradable, services in domestic demand.

deficit is good or bad will hinge on how one weighs the benefit against the cost. The overriding benefit is the ability to borrow internationally so as to push current spending beyond current production. Trade deficits in the 1990s have been a means to help finance an elevated level of domestic investment. Investment augments the nation's future productive possibilities and is a boon to long-term economic welfare.

The cost of the trade deficit is the debt service that must be paid on the associated borrowing from the rest of the world. The U.S. debt service has grown steadily and will soon reach a size that could impose a significant decrement to the rate of growth of our living standard. It is a burden that is still well within the U.S. means to pay, but some might argue it is a burden that needs to be curtailed.

Reducing the trade deficit by policy actions is very problematic, however. It is clear that standard trade policy tools such as tariffs, quotas, and subsidies will not change saving or investment behavior and, therefore, will not reduce the trade deficit, but in most cases will create distortions that reduce national economic welfare. Macroeconomic policy can affect the saving-investment balance and can change the trade deficit, but how to do so without harming domestic investment remains unclear. Generating a sustained increase in the economy's rate of saving by reversing the steadily sagging rate of household saving would reduce the trade deficit, but how to raise that rate is uncertain.

There is also the very likely prospect that the trade deficit may correct itself without any inducement by economic policy. There are good reasons to expect that economic forces will work to sate the demand for foreign borrowing as well as reduce the supply of foreign funds being offered. The combination of a moderate slowing of the pace of economic growth in the U.S. (reducing domestic investment relative to domestic saving at home) and a significant acceleration of the rate of growth abroad (raising domestic investment relative to domestic saving abroad) would likely initiate such a process. A change in relative growth rates away from the current extreme differential would most likely alter rates of return between the U.S. and the rest of the world, redirect a larger share of international investment flows towards destinations other than the U.S., and shrink the U.S. trade deficit. A smaller trade deficit will, lacking an increase in the rate of domestic saving, likely lead to a reduction in the rate of domestic investment.