The Troubling Economics and Politics of the US Trade Deficit

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Why the trade deficit matters

Over the last four years the U.S. trade deficit has persistently set new records, hitting $716.7 billion in 2005, equal to 5.7 percent of GDP. The trade deficit has both real and financial effects. Real effects refer to impacts on employment, incomes, and manufacturing capacity. Financial effects refer to the impact of accumulated indebtedness resulting from borrowing to finance the deficit.

One important real effect has been the deficit's contribution to making the current economic recovery the weakest since World War II. The Commerce Department estimates that the trade deficit directly reduced GDP growth by over 25 percent between 2001 and 2003 by channeling spending to foreign rather than domestically produced goods. Moreover, this estimate excludes additional indirect losses stemming from the fact that lower spending on domestic production meant fewer jobs, in turn causing the U.S. economy to forfeit the spending and growth that those jobs would have generated. Furthermore, this adverse growth impact has continued in 2004 and 2005.

All economists acknowledge that economic growth is hard to come by, yet U.S. policymakers have casually ignored the trade deficit's negative growth effects. Over the period 2001 – 2005, the trade deficit directly reduced U.S. growth by an annual average of 0.47 percentage points, and that excludes the additional growth that would have come from spending and investment induced by faster job and output growth.

Robert Scott of the Economic Policy Institute in Washington, DC estimates that each billion dollars of imported goods embodies approximately 9,500 jobs. Stripping out the OPEC oil deficit of $92.7 billion, the goods trade deficit in 2005 was $695 billion. Using Scott's estimate, this implies the trade deficit embedded 6.6 million job opportunities.

Not only does the trade deficit negatively impact employment and output, it also has lasting adverse impacts on U.S. manufacturing capacity. Behind the trade deficit is a problem of lack of competitiveness, which is significantly attributable to undervalued exchange rates in the rest of the world. Such undervaluation makes foreign goods cheaper relative to US produced goods. Given this competitive disadvantage, many U.S. manufacturing companies have closed plants, which has reduced manufacturing capacity. Some companies have gone out of business, while others have re-located or sub-contracted production – particularly to China. Companies have also cut back on investment or re-directed investment elsewhere rather than building new modern capacity in the United States.

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American University economist Robert Blecker has examined the impact of the over-valued dollar on U.S. manufacturing investment spending. He estimates that the appreciation of the dollar from 1995 to 2004 lowered U.S. manufacturing investment by 61 percent. It also lowered the manufacturing capital stock by 17 percent relative to what it would have been in 2004 had the dollar remained at its 1995 level. This has structurally weakened the U.S. industrial base. It also makes the future task of trade deficit adjustment more difficult as the U.S. may now lack the capacity needed to produce many of the manufactured goods it currently imports.

These developments have implications for future U.S. living standards. Manufacturing is key to long run prosperity, being a major source of the innovations and productivity growth that drive increased

income. A reduced manufacturing base means a smaller base from which to draw such benefits. Additionally, when manufacturing moves offshore, associated research and development activities can move too, thereby diminishing future innovation.

The trade deficit also carries significant adverse financial implications. In particular, growing foreign indebtedness that results from borrowing to finance the deficit makes U.S. financial markets vulnerable to a loss of confidence in the dollar. If financial investors – foreign or domestic – decide they no longer wish to accumulate dollar denominated assets, the dollar stands to fall and interest rates will rise as investors exit the U.S. economy. Higher interest rates would then have severe adverse effects given the high indebtedness of American households. Additionally, a dramatic weakening of the dollar would likely accelerate inflation because of heavy reliance on imported goods and limited domestic manufacturing capacity to replace those goods.

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Lastly, the trade deficit also has national security implications. The heavy reliance on imports and the erosion of manufacturing capacity could potentially expose the U.S. to global economic disruptions. These economic security concerns are amplified by the special role of China, which now accounts for almost 30 percent of the deficit.

There is still considerable uncertainty as to whether China will evolve into a democracy that shares U.S. values, or whether it will remain an authoritarian state and become an outright hostile geopolitical rival. China is now the world's second largest holder of U.S. treasury debt, it has the largest trade surplus with the U.S., and many U.S. companies are investing heavily in production facilities in China and transferring state of the art manufacturing technology. These developments give China both real and financial leverage over the U.S. economy. Given the uncertainty surrounding the U.S.–China relationship, this leverage is a major national security risk.

What is the U.S. responsibility for the trade deficit?

What are the causes of the trade deficit, and what is the U.S. responsibility for the deficit? It turns out that these are hard questions to answer, because getting the correct answer requires clearing the decks of a host of economic misunderstandings. The U.S. has a deep responsibility for its trade deficit. That responsibility is one of profound policy failure whereby the U.S. has voluntarily entered into international economic arrangements that have fostered trade imbalances and lack procedures for dealing with them.

One mistaken argument is the "twin deficits" hypothesis that claims the U.S. trade deficit is the result of the U.S. budget deficit. This argument first appeared in the 1980s and it implicitly blames government for the trade deficit. The twin deficit hypothesis is both empirically and theoretically weak. At the empirical level, the budget was in record surplus in the late 1990s, yet simultaneously the trade deficit widened and set new records. Other countries also provide compelling empirical evidence against the hypothesis, with both Germany and Japan running persistent large budget deficits and persistent large trade surpluses.

At the theoretical level, the budget and trade deficits are significantly independent of each other. The budget deficit is principally determined by spending policies; by tax policies that determine tax revenues; and by the state of the economy that also influences tax revenues. The trade deficit is principally determined by trade policies; the exchange rate that influences the price of imports and exports; and by the state of the economy relative to the rest of the world. When the U.S. economy is booming, it tends to suck in imports; and when the rest of the world is booming it buys more, which raises exports.

That said, there is an indirect linkage between the two, and that linkage is used to muddy public understanding and push twin deficit politics. The linkage is the state of the economy, which affects both the trade and budget deficits. Thus, tax cuts worsen the budget deficit, but they also increase spending on both domestic output and (to a far lesser degree) imports.

A second mistaken argument is the saving shortage hypothesis, which asserts that the trade deficit is due to inadequate household saving and excessive

consumption. However, suppose Americans were to reduce spending and increase saving. That would immediately cause a recession. The trade deficit would show some improvement because about one-sixth of each dollar of spending goes to imports, but the overall reduction would be marginal and achieved at brutal economic cost. Put bluntly, increasing saving by reducing the number of meals consumed at McDonald's will do little to improve the trade deficit.

This shows that the primary problem is the composition of spending. Too much of U.S. spending is on imports rather than domestically produced goods, which points to exchange rates as the principal cause. Lowering the international value of the dollar will raise the price of imports compared to domestically produced goods, thereby shifting spending toward the latter. Changing prices is how market economies shift spending and production. The U.S. is a market economy and the exchange rate a critical price, making exchange rate adjustment key.

This brings us to the real contribution of the U.S. to the trade deficit, which is international economic policy. Over the last twenty-five years successive Republican and Democratic administrations have assiduously created a global economy in which goods, capital, finance, and corporations are free to move. This new system has boosted profits by allowing companies to establish export-production platforms in low wage countries and batter America's unions into submission. Big box retailers, such as Wal-Mart, have also supported the new arrangements since they benefit from global sourcing. The purpose of the new system has always been access to cheap, low wage production. It has never been expanded, balanced trade.

The Federal Reserve and big finance (Wall Street) have supported the new system. Former Federal Reserve Chairman Alan Greenspan is a self-admitted proponent of laissez-faire globalization. However, beyond this personal intellectual inclination, Greenspan also threw the Fed's support behind the globalization project because low cost imports and fear of outsourcing help hold down inflation – which is the Federal Reserve's primary policy goal in the new order. This anti-inflation effect also explains the Fed's support for an over-valued dollar despite its adverse impact on the trade deficit and jobs.

Wall Street has also benefited as shown by its enormously increased profitability. Wall Street benefits from trade deficits because deficits need to be financed, and Wall Street makes money borrowing low and lending high. The strong dollar supports this business model by creating trade deficits. It also makes foreign assets cheap so that Wall Street and multinational companies have been able to buy foreign assets even as the U.S. has been falling deeper into debt.

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The bottom line is that U.S. policymakers, working in bi-partisan fashion, have created an international architecture that inevitably produces trade deficits. This architecture suits the economic interests of the most powerful players – multinational corporations, big retail, Wall Street, and the Federal Reserve. The problem is that it harms the interests of America's working families.

The growing U.S. trade deficit has been entirely predictable, with each trade agreement being followed by a worsening deficit. Today's exchange rate problem with China was also predictable. In 1994, immediately after the inauguration of NAFTA, the Mexican peso collapsed in value relative to the dollar, contributing to an exodus of U.S. manufacturing to Mexico. Yet despite this history, attempts to include provisions protecting against under-valued exchange rates in trade agreements have been persistently rejected.

Needed policies

Today's international economic system is flawed and subject to de-stabilizing trade imbalances – as well as other problems such as the erosion of wages. That it is an American creation is no excuse. The system needs change.

The immediate need is for a new international agreement on exchange rates modeled after the Plaza Accord of 1985. Such an agreement can deliver a global re-alignment of exchange rates, thereby beginning a process of smoothly unwinding today's

global financial imbalances.

As the largest contributor to the U.S. trade deficit, China must significantly revalue upward its exchange rate. Chinese co-operation is key because other East Asian countries that also have surpluses with the U.S. will not revalue unless China does too. These countries legitimately fear that if they revalue and China does not, they will lose competitive advantage and the U.S. trade deficit will remain unchanged since Chinese exports will simply replace theirs.

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This realignment must be credible and markets must believe it will hold. Absent that, business will not relocate production and investment to the U.S. out of fear the dollar will revert to uncompetitive levels. Additionally, permanent exchange rate coordination is needed to void incentives for countries to devalue their exchange rates to gain competitive advantage. Exchange rates matter even more in the era of globalization, which calls for international co-operation to avoid destructive exchange rate competition such as occurred in the 1930s.

Finally, there is a need to change thinking about global economic development. In particular, policy should promote domestic demand-led growth in developing countries in place of the current export-led growth paradigm. This can raise global growth, stimulating U.S. exports and reducing the U.S. trade deficit. It will also establish more balanced global growth in which all countries' exports and imports grow together.

The difficult politics of trade deficit reduction

The trade deficit is a major economic problem that is the predictable outcome of the current model of globalization. Republicans and elite Democrats have both supported the current system. Though some - including former Federal Reserve Chairman Alan Greenspan - now acknowledge that the deficit is a problem, they continue to view it as a financial concern and deny its adverse wage, employment, and manufacturing effects. They also persist in maintaining that it is a saving shortage/twin deficit problem, which obstructs real solutions. The bottom line is that the economics of the trade deficit are misunderstood and the politics contested. That makes it difficult to resolve and increases the likelihood that change will come only through economic crisis. •

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