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America's Growing Current Account Deficit: Its Cause and What It Means for the Economy

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America's Growing Current Account Deficit: Its Cause and What It Means for the Economy

Summary

The U.S. current account deficit, popularly known as the trade deficit, is on the rise.¹ Over the economic expansion of 1991-2001, it grew from 0.2% of GDP in 1991 to a record high of 4.3% of GDP in 2000, which exceeded the previous high of 2.8% reached in 1986. This growth was particularly rapid over the period 1998-2000. During 1997, the trade deficit was a modest 1.4% of GDP. Curiously, the deficit continued to rise during 2001- 2003, a period of economic contraction and mild recovery.

Four major reasons have been given for the growth of the deficit: the inflow of foreign capital motivated by either profit or safety, the dumping of foreign goods in the American market, recessions or slower growth in the economies of major U.S. trading partners, and barriers imposed against U.S. goods and services by foreign countries. A compelling case can be made, based in part on movements in the foreign exchange value of the dollar, that the dominant cause of the deficit and its growth is the inflow of foreign capital.

The inflow of foreign capital (and the related trade deficit) has a number of discernable effects on the U.S. economy. First, as a component of aggregate demand, a growing trade deficit reduces the growth of domestic demand as American spending is diverted from domestic goods to foreign substitutes. Second, because it represents foreign saving coming to the United States, it reduces American interest rates and encourages the growth of interest-sensitive domestic spending by businesses on such things as plant and equipment and by households on housing, automobiles, and appliances. On balance the net effect on spending is negative. A third and indirect effect is that lower interest rates in the U.S. encourage higher asset prices, such as stock market prices. Higher asset prices are thought to be an important determinant of consumer spending and, thus, a positive influence on aggregate demand. Fourth, the inflow of foreign capital enables the United States to put in place a larger capital stock than would otherwise be the case. Finally, while the expansions of the 1980s and 1990s have demonstrated that large trade deficits are no barrier to the attaining full employment, they do affect the type of jobs that are created in the United States.

Over the longer run, a growing foreign ownership of the American capital stock means that a growing fraction of U.S. income growth will have to be transferred abroad. And this is increasingly evident in U.S. data. Over the period 1979-1984, U.S. net earnings abroad averaged \$33.4 billion per year. In 2002, this had declined to \$1.3 billion, or a net shift of nearly \$32 billion. This report will be updated as events warrant.

¹ For purposes of this report, the current account deficit is measured by the excess of imports over exports in 1996 dollars as reported in the National Income and Product Accounts. In the text, it will be referred to as the trade deficit.

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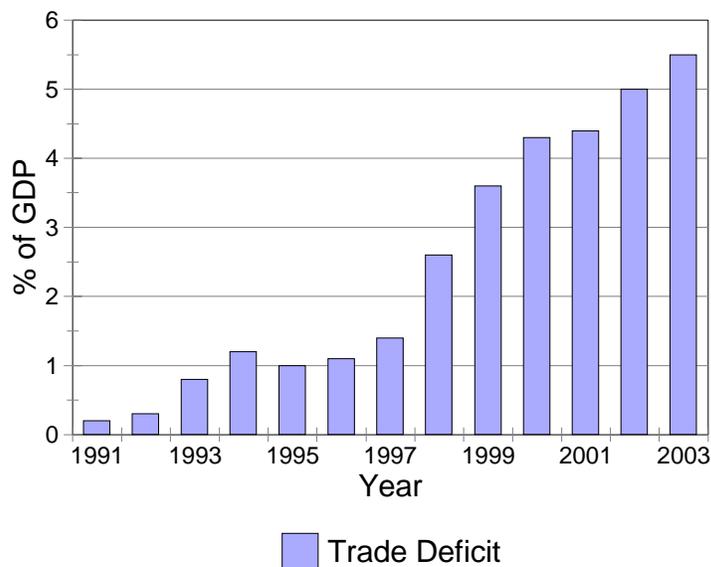
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America's Growing Current Account Deficit: Its Cause and What It Means for the Economy

The Growing Trade Deficit and Its Importance to Congress

A noticeable phenomenon of the 1980s was the growth in the U.S. trade deficit to record proportions. From a slight surplus in 1981, the trade deficit grew to a record 2.8% of GDP in 1986. The trade deficit then declined to a low of about 0.2% of GDP in 1991. It then began to rise, reaching a record high of 4.3% of GDP in 2000, the last full year of the 1991-2001 expansion. The growth of the deficit was especially rapid over 1998-2000. During 1998, the deficit was 2.6% of GDP while in 1997 it was only 1.4% of GDP. The advent of the recession in 2001 and the

**Figure 1: Trade Deficit, 1991-2003
(as a % of GDP)**



Source: Bureau of Economic Analysis

Note: Observation for 2003 is the average for the first half year.

recovery of 2002-2003 did not produce a decline in the trade deficit. Rather it continued to rise, reaching 5.5% of GDP during the first half of 2003, for which data are now available.²

What Has Caused the Growth in the Trade Deficit?

Four major explanations have been offered for the growth in the deficit. Foreigners' desire to invest in the United States, the dumping of foreign goods in the American market, the recession or slow growth in the economies of Asia and the major trading partners of the United States, and barriers imposed on U.S. goods and services by foreign countries. While several of these explanations will be shown to have some possible validity, the capital inflow explanation is the only one consistent with the movement in the foreign exchange value of the dollar. This explanation for the growing trade deficit would receive support from most economists.

A. The Movement of Capital to the United States

The key to understanding this explanation for growth in the trade deficit is to realize that capital comes to a country not in the form of money, but in the form of a trade deficit. With that in mind, assume that foreigners decide to convert some portion of their wealth into U.S. assets. To do so, they must first buy American dollars. This will increase the net demand for dollars in the foreign exchange market and, all else held constant, the dollar should rise (or appreciate) in response. The appreciation of the dollar should raise the price in foreign countries of American goods and services and reduce the price of foreign goods and services in the United States. As a result, the total value of American exports should fall and the total value of imports into the United States should rise.³ The net result should be a rise in the U.S. trade deficit. In this explanation, the growing trade deficit goes hand-in-hand with an **appreciating** dollar.

B. Foreign Goods Are Dumped in the American Market

This explanation implies that foreigners, for whatever reason, offer their goods at cut rate prices. As a result, Americans switch from buying domestic substitutes to the now cheaper foreign goods. This shift in domestic demand to imports should increase the net supply of dollars in the foreign exchange market and, as a result, the

² In all of the computations above, exports, imports, the difference between the two, and GDP are measured in 1996 dollars. All the trade data are taken from the National Income and Product Accounts.

³ This need not be an absolute fall in the value of exports and rise in the value of imports. The analysis is consistent with a fall in the growth rate of exports and a rise in the growth rate of imports.

dollar should fall in price or **depreciate**.⁴ The net result should be a growing trade deficit that goes hand-in-hand with a **depreciating** dollar.

C. Recessions or Slow Growth Abroad Are Reducing U.S. Exports

Clearly, the economies of a number of Asian countries including Japan as well as those of the other major trading partners of the U.S. including the Euro area did not match the high growth rates enjoyed by the United States in the 1995-2000 period. When countries are in recession with falling incomes or their income growth is slow, their ability to buy goods is reduced (or slowed relative to American ability to buy their goods). Since some of these goods are made in America, it might be expected that U.S. exports will be adversely affected. However, this explanation requires that the growing American trade deficit be linked to a **depreciating** dollar. For if foreigners reduce their purchase of American goods and services they will also reduce their demand for dollars in foreign exchange markets. The reduced demand for dollars should, all else held constant, cause the price of the dollar to fall; the dollar should **depreciate**.⁵

D. Trade Barriers

On March 31, 2000, the Office of the U.S. Trade Representative issued a 434 page report, that, among other things, detailed various practices foreign governments use to discriminate against American goods and services of an exportable nature. The document implies that if these practices did not exist, U.S. exports would be larger and the trade deficit would be smaller.

While there is no doubt that U.S. exporters face trade barriers imposed by foreign governments, there is substantial doubt that these barriers are either responsible for the trade deficit itself or for the growth in the deficit over the 1990s. The reason for this conclusion is straightforward. Suppose that trade between the United States and the rest of the world is balanced: the dollar value of U.S. exports is equal to the dollar value of U.S. imports. Suppose now that the rest of the world imposes barriers on U.S. exports (a tariff) such that export earnings fall. As export earnings fall in value, in the face of an unchanged value of imports, a trade deficit will emerge.

⁴ Note that the fact that foreign goods are offered at a lower price in the United States is not dispositive of a conclusion of dumping. The fall in the dollar price of foreign goods is a part of the adjustment mechanism in **A** above by which foreign capital comes to the U.S.

⁵ Explanations B and C cannot, technically speaking, produce a persistent current account or trade deficit. If there were no capital movements, the exchange rate would depreciate by a sufficient amount to eliminate the deficit. Thus, the existence and persistence of a current account deficit is itself evidence that a net capital inflow to the U.S. has occurred.

Individuals who argue in this way are holding constant a vital price: the exchange value of the dollar. And it is because they do that they draw an incorrect conclusion. With the decline in foreign spending on American goods comes a decline in the demand for dollars in the foreign exchange market. As a result, the dollar will fall in value or depreciate. And depreciation will restore equilibrium to the trade balance. It will do this in two ways. First, by lowering the price of U.S. goods abroad, it will encourage some additional spending by foreigners on those goods. Second, by increasing the price of foreign goods in the United States, Americans will be induced to spend less on imports. And it is primarily through a reduced spending on imports that balance will be restored to the trade accounts.⁶

The net effect of the imposition of trade barriers is not a trade deficit, but reduced spending by Americans and foreigners on each others goods and services or on the *level* of spending on imports and exports.⁷

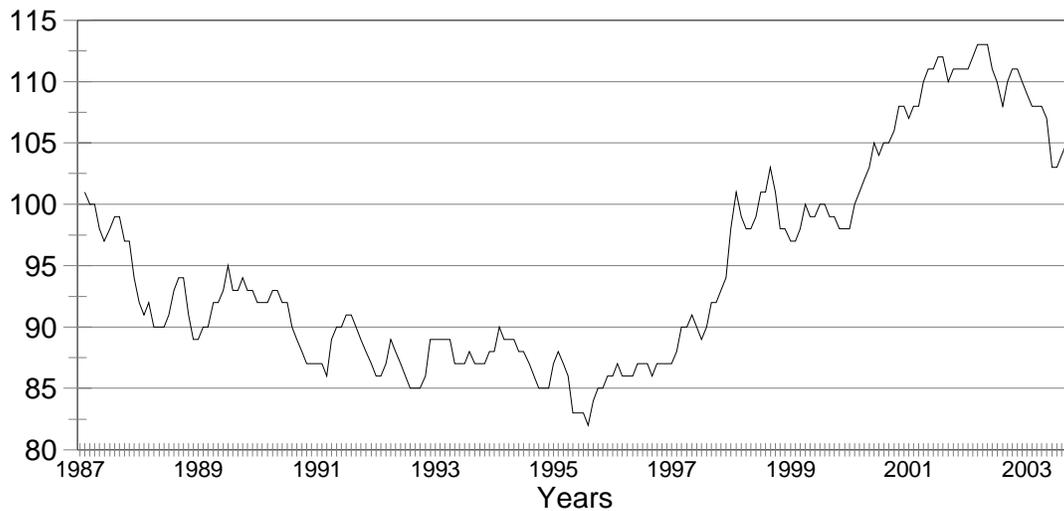
If the trade barriers explanation has any relevance to recent U.S. trade statistics, it implies that dollar **depreciation** should go hand-in-hand with a reduced level of trade, not a trade deficit. The data do not agree with this interpretation.

Summary

The behavior of the foreign exchange value of the dollar is an important piece of evidence in resolving the controversy over the growth in the trade deficit. The data in figure 1 show that since mid-1995 the dollar has been *appreciating*. This is consistent with the “movement of capital to the U.S.” explanation and implies that the rise in net capital imports is the dominant explanation for the growing trade deficit. It does not preclude the other explanations from having had some effect on U.S. foreign trade. The movement in the exchange rate seems to preclude them from having had a dominant effect.

⁶ To the extent that there are lags and market imperfections, there may be temporary imbalances, but in time this adjustment will take place.

⁷ Interestingly, the effectiveness of trade barriers can be increased without the need for legislative action. Tariffs, for example, are often “specific” in nature, such as 10 cents per ounce or \$5 dollars per ton, etc. Should prices fall, the real level of protection offered by specific tariffs will increase as the world discovered during the Great Depression of 1929-33. This is not true for tariffs that are expressed as a percent of value or that are “ad valorem” in nature.

Figure 2. Real Dollar Exchange Rate, 1987-2003

Source: Board of Governors of the Federal Reserve System

Some Additional Thoughts on the Nature of Capital Movements

Although for balance of payments accounting purposes, trade deficits must be offset by capital movements, not all economists concede that capital movements drive the trade balance, as the above analysis suggests. Those holding this view argue that cause and effect are the other way around: the trade balance drives capital movements. And, this fact renders the above analysis incorrect. What is the nature of this argument and is it relevant to recent American experience?

The type of capital movement noted in the previous section is referred to in the literature as an *autonomous* capital movement or one motivated by such factors as a desire to earn a higher rate of return abroad or a fear of capital loss if it is retained at home. As such, they are associated with movements in the exchange rate of the type presented above. When a country is a net recipient of an autonomous capital inflow, its currency appreciates in value and the net inflow of capital is represented by a trade deficit.

There is, however, another type of capital movement. It is often referred to in the literature as an *induced* capital movement because it is induced by prior movements in exports and imports. Suppose, for example, that the U.S. grew more rapidly than its trading partners and thus spent more on imports than the partners spent on American exports.⁸ Under normal circumstances this would lead to a depreciation of the dollar and a closing of the trade imbalance as discussed earlier.

⁸ Even more to the point, this imbalance could be caused by the imposition of trade barriers on American goods and services by foreigners.

This need not be the case. If all of these goods and services were paid for by checks, foreign banks and/or central banks would acquire a net claim on U.S. banks represented by the trade deficit. These balances are a capital flow in the same sense as if foreigners had purchased U.S. bonds or equities. They are, however, an *induced* capital inflow. This inflow would not have occurred without the prior trade imbalance in goods and services.

Is the growing inflow of capital to the United States dominated by an *induced* inflow? A case can be made that it may have been a factor in the past couple of years.⁹ The reason being that an induced capital inflow should have very little effect on the exchange rate – it is, in effect, exchange rate neutral. As the above analysis makes clear, an induced capital inflow prevents the exchange rate from depreciating to restore equilibrium between the value of exports and imports. Thus, if induced flows dominate the net inflow, one would expect the growth in the trade deficit to go hand-in-hand with little movement in the exchange rate. And, from figure 1, it can be seen that this is the case. The growth in the trade deficit in the past couple of years has been associated with not much change in the value of the dollar. And this is the movement suggested by a net inflow dominated by *induced* capital movements. In the late 1990s, by contrast, the rise in the trade deficit was accompanied by an appreciating dollar, consistent with capital inflows that were primarily *autonomous*.

How Does the Purchase of U.S. Assets by Foreigners Affect the Economy?

When foreigners want to hold a larger value of American assets, the resulting trade deficit (or growth in the trade deficit) has four discernable effects on an economy.

1. Aggregate Demand or Spending

The direct effect of a trade deficit (or the growth of a trade deficit) is to reduce aggregate demand (or the growth in demand) for American goods and services. This is because spending on imports represents a demand by Americans for foreign output. Since a trade deficit means that that demand is not offset by foreign spending on American output (U.S. exports), on balance, the net demand for American output must be lower than it would be without the deficit. Thus, the direct effect of a growing trade deficit is a reduction in the growth in aggregate demand in the United States.

However, a trade deficit has several indirect effects that tend to expand spending for American goods and services. First, since the trade deficit is the way foreign capital or saving comes to the United States, it reduces American interest rates from

⁹ The likely sources of the induced capital flows are China and the Middle East. In 2002, China net purchased \$24 billion in U.S. Treasuries; much of this purchase was likely by the central bank which must automatically buy and sell U.S. assets to maintain their fixed exchange rate. In the Middle East, high oil prices in the past couple of years may have led oil producing countries to hold the receipts from higher oil exports to the U.S. in U.S. assets.

what they otherwise would be. And lower interest rates stimulate interest-sensitive spending by American businesses and households. This includes spending on such durable goods as plant and equipment, housing, automobiles, and appliances. Second, lower interest rates tend to increase the prices of assets, including equities, and this augments the financial wealth of households. Feeling wealthier, households are supposedly induced to save less and spend a higher proportion of their disposable income. It has been argued that such consumer spending has played an important role in the continuation of the current economic expansion.

Overall, the general consensus is that a trade deficit, on balance is contractionary. Thus, the overall effect of a growing trade deficit is to slow the growth of aggregate spending in the United States. However, the contractionary effect of the growing trade deficit was offset by increases in domestic demand, and did not prevent the economy from achieving an average growth rate of 4.2% over the period 1997-2000, when the deficit was growing rapidly.

2. The U.S. Capital Stock

An important attribute of a growing economy is a growing net per capita capital stock. How much that stock can grow is basically determined by the **net** saving rate of a country or how much of its gross saving is left after being used to replace the capital that is depreciated or used up in the process of producing output. The net national saving rate of the United States has been falling over the post-World War II period and is now low — averaging about 6% of GDP over the last 4 years (versus about 11% during the decade of the 1960s and nearly 9% over the decade of the 1970s). With a trade deficit during the 1990s that averaged nearly 2% of GDP, the U.S. was able to add to its net capital stock at a much faster rate than without this net inflow of foreign capital.

Of course, a portion of the net capital stock is now foreign owned and the rewards to that capital will accrue to foreigners. This will require that a rising portion of U.S. output be transferred abroad.¹⁰ And, in fact, this is occurring. Before the large trade deficits that began in the mid-1980s, the U.S. received a net income from its foreign capital holdings that averaged about \$33.4 billion during the peak years 1979-1984. During 2002, this had declined to \$1.3 billion a year. This is a net shift of about \$31 billion a year.

3. The Nature of Job Creation

From the discussion above it can be seen that a growing net inflow of capital usually implies a rise in the amount spent on imports and a fall (either absolute or relative) in the amount spent on exports. This translates into a decline in jobs that are or would be created in the import competing and export sectors of the economy.

¹⁰ However, some of the rewards of foreign investment will accrue to American workers, enabling them to enjoy a higher standard of living than they otherwise would.

This is offset to a degree by jobs that are preserved or created in the interest sensitive sectors of the economy. This change in the employment *mix* should be distinguished from the *total* employment in the economy. During both the long expansion of the 1980s and the 1990s, the U.S. managed to achieve full employment, if not overfull employment.¹¹ The unemployment rate fell to a three decade low in 2000, at a time when the trade deficit was at a then record high of 4.3% of GDP. Thus, the large and, at times, growing trade deficits of those two decades have not been a barrier to achieving full employment in the United States.

The Trade Deficits of the 1980s, 1990s, and the 2000s: Are They Different?

The growth in the trade deficit during the 1980s closely paralleled the growth in the federal budget deficit giving rise to the so-called "twin deficit" theory. This was not the case in the 1990s. In fact, the opposite occurred. As the federal budget moved from deficit into surplus, the trade deficit grew absolutely and as a fraction of GDP. During 2001 and 2002, as the federal budget shifted from surplus to deficit, the trade deficit grew as a fraction of GDP.¹² What does this mean? It basically means that trade deficits can have several causes.

In the 1980s, the prevailing view was that the growth in the federal budget deficit, by decreasing national saving, put upward pressure on U.S. interest rates. Other things constant abroad, this led foreigners to desire to buy American assets and, in the process of doing so, the dollar appreciated and the resulting trade deficit represented the net inflow of capital to the United States. As a result, domestic investment as a fraction of GDP did not decline as it would have in the face of a falling domestic saving rate. 2001 and 2002 are a repeat of the 1980s. The shift from a federal budget surplus to a budget deficit has once again caused the national saving rate to fall and the story is a repeat of that told above. The rise in the trade

¹¹ Macro economists define full employment relative to a stable rate of inflation. Thus, the full employment rate of unemployment is the unemployment rate compatible with a stable rate of inflation. Empirical estimation including data for the 1990s places that rate in a 5% to 6% range. Estimates using data through the 1980s would produce a similar range.

¹² The relationship between the budget and trade deficits is fraught with much misunderstanding. Largely this is because budget deficits or surpluses can be created by Congressional actions that affect taxes and expenditures and they can also be created because the budget responds to the economy. In recessions, for example, tax revenue tends to fall and expenditures rise. If the budget was near balance at the peak of the business cycle, it will move into deficit in a downturn even if there are no legislative changes affecting tax rates and/or expenditures. To clear up this ambiguity, the position of the budget in this discussion is relative to what would prevail if the economy were at full employment. In the literature, this is referred to as the *structural* budget deficit or surplus. Thus, in the discussion in this section, a shift from budget deficit or surplus or the reverse, must be understood as a shift in the full employment measure of the budget. They are not shifts caused by changes in the economy. The *structural* shifts are frequently referred to as a change in fiscal regime.

deficit occurred despite the decline in private investment as a fraction of GDP during 2001 and 2002.

The 1990s present a more complicated picture. The rise in the productivity of U.S. capital, not widely experienced abroad, is believed to have raised the desired level of investment in the United States. Since domestic saving was insufficient to accommodate domestic investment, foreign capital was drawn in to the country. Additionally, financial turmoil in Asia and Russia caused foreign saving to flee to the safety of the United States, making higher domestic investment possible. Through the same process the dollar appreciated and the trade deficit grew to reflect the enlarged net inflow of capital to the United States.

In both cases, the growth in the trade deficit resulted from a desire to purchase American assets. In that sense, the *proximate* cause of the trade deficit is the same. The motivation for doing so, or the ultimate cause, however, may have been different: in the 1980s and the early 2000s it was lower national saving that resulted from a shift in American fiscal regimes while in the 1990s it was primarily a desire to participate in the enhanced productivity of the American economy through investment (capital formation).¹³

Can the U.S. Continue to Run Such Large Trade Deficits?

Many observers have questioned whether the record-high trade deficit is sustainable. This report assumes that unsustainable means that the trade balance will shift back to surplus. Basically, the trade deficit is sustainable as long as foreigners are willing to continue buy American assets. The consequence is a growing foreign ownership of the U.S. capital stock and a rising fraction of U.S. income that must be diverted overseas in the form of interest and dividends to foreigners.

An assessment of whether American assets will continue to be attractive to foreigners in the future is beyond the scope of this report. As long as they yield a higher (risk-adjusted) rate of return than foreign assets, foreigners would presumably continue to find U.S. assets attractive. There are two hypothetical reasons why future U.S. assets might not be as attractive as they were in the past: if the U.S. was suffering from an investment bubble or a consumption boom during the trade deficit years. Do either of these explanations describe the U.S. economy in the late 1990s?

Many observers have made the case that the U.S. stock market experienced a bubble in the late 1990s. By traditional rule of thumb measurements, valuations were much higher than in the past. They take the subsequent sharp decline in stock prices from 2001-2002 to confirm the bubble hypothesis. While investors may not be able to enjoy the high rates of return of the late 1990s again in the future, this does not mean that investments in U.S. assets could not be profitable in the future. Whether foreigners would be willing to lend to the U.S. again in the future depends on how

¹³ For a more extensive discussion of this subject, see U.S. Library of Congress. Congressional Research Service. *Why the Budget Deficit and the Trade Deficit Haven't Been Moving Together*. CRS Report 97-985E by Marc Labonte and Gail Makinen.

high a rate of return foreigners would demand in return – the unusually high rates of return enjoyed in the late 1990s or rates more in line with the historical average.

Can the growth of the trade deficit in the late 1990s be explained by a consumption boom? This explanation seems less compelling. Investment as a percentage of GDP rose in the last half of the 1990s, perhaps spurred by increases in the growth rate of productivity. Analysts point to the decline of the household saving rate as evidence a consumption boom was underway, but the increase in the public saving rate (the budget surplus) made up for most of the decline. Some analysts argued that the 1980s trade deficit was fueling a consumption boom since it was strongly influenced by the government budget deficit and most government spending is not dedicated to investment.

Some economists fear that a large trade deficit is symptomatic of wider economic imbalance. They see it as a leading indicator for future inflation because it is a proxy for either consumption outpacing production or an investment bubble. In developing countries, it has often been a leading indicator of financial and/or currency crisis, although the applicability of this comparison with the U.S. may be limited, especially since the U.S. has a flexible exchange rate regime. They would see a tightening of monetary policy as the appropriate response to an excessively large trade deficit – not because the trade deficit itself is detrimental but to prevent future inflation from occurring. But in the late 1990s, few other leading indicators warned of mounting inflationary pressures.

It is worth noting that today's trade deficits have a consequence for future trade balances. The future debt service that is generated by foreign investment in the United States today represents a capital outflow from the U.S. that would cause a trade surplus, all else equal. Each year that the U.S. trade balance is in deficit would increase this debt service, and hence, the capital outflow. This explains why U.S. net earnings abroad fell from an average of \$33.4 billion year from 1979-1984 to \$1.3 billion in 2002. Thus, for the U.S. to run trade deficits in the future, the U.S. would need to borrow more abroad than it is paying back in debt service. For this reason, two leading international economists used the debt owed to foreigners as a percentage of GDP as a rule of thumb guide to the sustainability of the trade deficit. They found that in 1999 this measure was about 20% of GDP, the highest it has been in U.S. history since the 19th century.¹⁴ Were trade deficits to continue at over 4% of GDP per year, U.S. debt to foreigners would reach 90% of GDP in a few decades. Although the yearly debt burden that this implies is relatively small, many countries that have experienced financial crises in the post-war period had smaller debt to GDP ratios, between 20-80% of GDP. They take this to be an indication that the U.S. trade deficit is unsustainable at its current size.¹⁵

It should be re-emphasized that economic theory does not suggest that a *slow decline* in the trade deficit would be troublesome for the overall economy. In fact,

¹⁴ By contrast, total financial capital was 425% of GDP in 1999.

¹⁵ Maurice Obstfeld and Kenneth Rogoff, *Perspectives on OECD Economic Integration: Implications for U.S. Current Account Adjustment*, working paper presented at Federal Reserve Bank of Kansas City Jackson Hole Symposium, August 2000, p. 24.

it would be expected to have an expansionary effect on the economy, since the increase in net exports would have a more stimulative effect on aggregate demand in the short run than the decrease in investment and interest-sensitive spending. Historical experience seems to bear this out – the trade deficit declined continually in the late 1980s from 2.8% of GDP in 1986 to near zero in 1990. Yet economic growth was strong throughout the late 1980s.

A possibly serious short run problem could emerge if foreigners *suddenly* decided to reduce the fraction of their saving they send us in the form of a capital inflow or if they suddenly decided to repatriate part of their liquid capital. The initial effect could be both a sudden and large depreciation in the value of the dollar as the supply of dollars on the foreign exchange market would increase and a sudden and large increase in U.S. interest rates as an important source of saving was withdrawn from the financial markets. It is doubtful that the *direct* effects of these shifts in lending patterns by foreigners could cause a recession. This is because the desire of foreigners to hold fewer dollar assets would lead via dollar depreciation to a trade surplus (or smaller deficit). And the move from trade deficit toward trade surplus is a move that expands aggregate demand. However, the *indirect* effects, which typically offset the direct effects only partially, could cause a recession if the change is sudden. Large increases in interest rates could cause problems for the U.S. economy as they reduce the market value of debt securities, cause prices on the stock market to fall, and raise questions about the solvency of various debtors. Resources may not be able to shift quickly enough from interest-sensitive sectors to export sectors to make this transition fluid.

Given the traditional role the U.S. has played as an investment safe haven, however, sudden capital outflows seem unlikely.

Policy Options for Eliminating the Trade Deficit

If the U.S. government were to adopt a policy to reduce or eliminate the trade deficit, what policy tools could it use? The discussion above implies that barriers to trade would not affect the trade deficit – a reduction in imports caused by barriers would be replaced by an increase in net imports caused by dollar appreciation. Even if stronger economic growth abroad could reduce the trade deficit – and the analysis above suggests that it may not – it is doubtful that U.S. policy can do much to boost growth abroad.¹⁶

The discussion above implies that the current trade deficit is primarily a result of the fact that there are more attractive investment opportunities in the U.S. than can be accommodated by domestic saving alone. To reduce the trade deficit, one must reduce this imbalance. Obviously, a policy to reduce profitable investment opportunities in the U.S. would be counter-productive. Instead, a policy to reduce the trade deficit must aim to increase the domestic saving rate. The government may be able to do so by making saving more profitable and increasing the incentives to save. The government can make saving more profitable by lowering the taxes on

¹⁶ See U.S. Library of Congress, *Does the U.S. Economic Downturn Threaten World Economic Stability?* by Marc Labonte and Gail Makinen, CRS report RL31287.

saving. It can increase the incentives to save through the creation and extension of tax-favored savings accounts. The empirical evidence about the effectiveness of lower taxes and government saving incentives as policies to increase saving is mixed, however.¹⁷ However, there is a more direct way for the government to increase the national saving rate – it can return to a policy of *structural* budget surpluses. National saving is determined by households, corporations, and the government. When the government runs a surplus, economic theory holds that it results in more domestic saving being available for private investment.¹⁸

¹⁷ For example, see the symposia “Government Incentives for Saving” in the *Journal of Economic Perspectives*, v. 10, n. 4, Fall 1996 and “Tax Policy: A Further Look at Supply Side Effects,” *American Economic Review*, v. 74, n. 2, May 1984.

¹⁸ For more information, see U.S. Library of Congress, Congressional Research Service, *What if the National Debt Were Eliminated? Some Economic Consequences*, by Marc Labonte, CRS report RL30614.

Conclusions

The U.S. trade deficit is made possible by the net purchase of U.S. assets (stocks, bonds, real estate, etc.) by foreigners.¹⁹ This deficit includes the traditional types of imported goods familiar to American consumers (cars, stereos, cameras, etc.). Because the trade deficit is a component of aggregate domestic demand and sudden fluctuations in the deficit can cause sudden changes in income growth and employment, Congress has been concerned about its growth, especially the sharp increase during 1997-2003.

An increased desire by foreigners to purchase American assets can affect the economy in several ways. First, it directly reduces the growth in aggregate demand since the difference between the value of exports and imports is a component of demand. This is offset in part by the lower interest rates made possible by the capital inflow. As a consequence, it would be difficult for a growing trade deficit to actually cause aggregate demand to contract in the United States. Second, the inflow of capital makes possible a larger addition to the net national capital stock than would be possible from net domestic saving alone. Third, it can affect the composition of jobs that are created. But history has shown that the trade deficit is no barrier to achieving full employment.

Any sudden shifts in foreign preferences for American assets can cause potentially large changes in the exchange rate and domestic interest rates, both of which can be disruptive to the orderly growth of output and employment in the United States. If the large trade deficit made sudden shifts in foreign capital flows more likely, the large trade deficit represents a legitimate policy concern.

Since the trade deficit represents a shortfall between domestic saving and domestic investment, economic theory suggests that policies to increase the national saving rate are most likely to succeed in reducing the trade deficit. Reducing the government's (structural) budget deficit is the most straightforward way to raise the national saving rate.

¹⁹ This does not preclude the dumping of foreign goods in the American market and recessions abroad from playing a role. Trade barriers could possibly play a role provided that they induce capital movements, which is highly unlikely to be the dominant factor given the size and persistence of the trade deficit.