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

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Summary

The U.S. trade deficit has risen significantly in recent years. Over the economic expansion of 1991-2001, it grew from 0.2% of GDP in 1991 to a record high of 3.9% 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 1.2% of GDP. The deficit continued to rise during 2001-2006, a period of economic contraction, recovery, and expansion. During 2004-2006, it averaged 5.5% of GDP.

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 and in part on the necessity for the trade deficit to balance saving-investment shortfalls, that the dominant cause of the deficit and its growth is the inflow of foreign capital from both private and official sources.

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 United States encourage higher asset prices, such as those related to real estate and stocks. 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 attaining full employment, they do affect the types 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. During the period 1979-1984, U.S. net earnings abroad averaged $33.4 billion per year. During 2001-2006, the average net inflow had declined to $21 billion (in both 2005 and 2006, it was about $12 billion). This report will be updated as events warrant.

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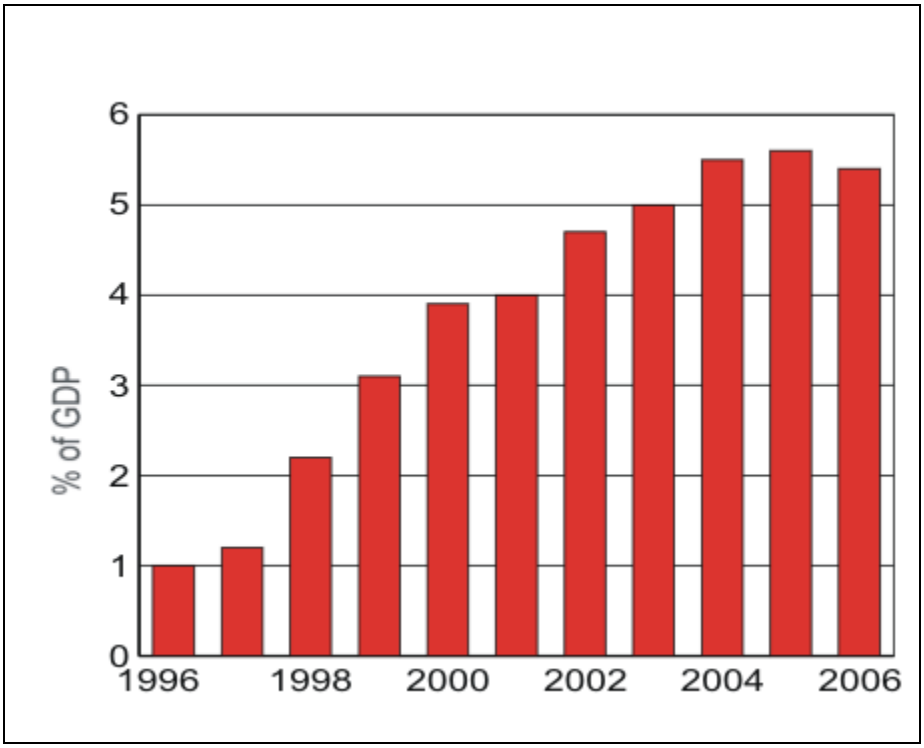
The Growing Trade Deficit and Its Importance to Congress

A noticeable phenomenon of the 1980s was the growth in the U.S. trade deficit to record proportions. From a slight surplus in 1980 and 1981, the trade deficit grew to a record 2.5% 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 3.9% 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 2.2% of GDP whereas in 1997 it was only 1.1% of GDP. The advent of the recession in 2001 and the subsequent recovery and expansion did not produce a decline in the trade deficit. Rather it continued to rise, reaching 5.6% of GDP during 2005 and 5.4% in 2006. (In all of the computations above, exports, imports, the difference between the two, and GDP are measured in 2000 dollars. All the trade data are taken from the National Income and Product Accounts.)

Figure 1. Trade Deficit as a Percentage of GDP, 1996-2006



Source: Bureau of Economic Analysis.

What Has Caused the Growth in the Trade Deficit?

A first step in seeking an answer to this question is to look at the National Income and Product Accounts of the United States. In this framework, a foreign trade deficit is equal to the difference between domestic saving and domestic investment, where domestic saving includes the net budget position of the government (or public sector). This situation arises because resources used for domestic investment can exceed the resources made available as a result of domestic saving

only by obtaining the shortfall from abroad, which is the essence of a trade deficit.[1] Similarly, any excess of domestic saving over domestic investment must be sent abroad, which is the essence of a trade surplus. As explained below, the mechanism for ensuring that this happens involves domestic interest rates relative to those in foreign countries and changes in the foreign exchange value of the dollar. Thus, any explanation for the trade deficit must show how it causes domestic saving to be different from domestic investment. If it cannot do so, then it not a valid answer to the question of what has caused the trade deficit and its behavior over time.

Four major explanations can be found for the growth in the trade deficit: (1) foreigners' desire to invest in the United States, (2) the dumping of foreign goods in the American market, (3) different rates of economic growth in the economies of Asia and the other major trading partners of the United States, and (4) barriers imposed on U.S. goods and services by foreign countries. Although some of these explanations will be shown to have possible validity, the first explanation is the only one consistent with the requirement imposed by the National Income and Product Accounts that the trade deficit arise from an imbalance between domestic saving and domestic investment. The alternative explanations fail to meet this test.

1. The Movement of Capital to the United States

Capital flows from one country to another as individuals, in pursuit of the highest yield available in the world economy, purchase foreign assets. This sets in motion a chain of events, the end result of which is a trade deficit (or a reduced surplus). For example, assume that the government budget in the United States moves from balance to deficit, decreasing the saving available in America. All else held constant, American interest rates will rise, as less saving is available relative to the demand for it for investment or capital goods purposes. This rise in interest rates will attract foreign capital.

However, before foreigners can buy these now higher yielding American assets, they must first buy dollars. This increases the net demand for the dollar in the foreign exchange market. As a result, the dollar will rise in price or appreciate. With appreciation, the prices of American exports will rise in foreign countries and import prices will fall in the United States. Thus, American exports will tend to fall and imports rise. In short, a trade deficit will emerge, the essence of the net capital inflow, and be equal to the shortfall in domestic saving relative to domestic investment.

The same phenomenon can be set in motion by alternative circumstances in which Americans want to add to the domestic stock of capital at a faster rate than previously. In this case, domestic investment would rise relative to domestic saving. Domestic investment would now exceed domestic saving, leading to a rise in American interest rates above those in the outside world. This rise would then attract foreign capital, and the sequence explained above would again come into play to explain the emergence of a trade deficit equal in magnitude to the excess of domestic investment over domestic saving.

[1] Technically, borrowing from abroad is equal to the current account deficit, which consists of the trade deficit plus net investment income plus net unilateral transfers. In 2006, the current account deficit equaled $811 billion, and the trade deficit comprised 93% of the current account deficit. Thus, for layman's purposes, the trade deficit and net foreign borrowing can be thought of as equal.

2. Foreign Goods Are Dumped in the American Market

This explanation suggests that foreigners, for whatever reason, offer their goods at below-market prices. As a result, Americans switch from buying domestic substitutes to the now cheaper foreign goods. This increases imports and, given exports, a trade deficit, it is argued, will result. However, this shift from domestic goods to foreign substitutes does not affect the domestic saving-domestic investment balance and, hence, cannot be a cause of a trade deficit. Rather, the shift in demand is self-correcting. Although it does lead to more imports, it also increases the net supply of dollars in the foreign exchange market. As a result, the dollar should fall in price or depreciate.[2] The depreciation will be large enough to generate additional net exports and reestablish balance between exports and imports. Thus, what this explanation neglects is the behavior of the foreign exchange rate subsequent to the shift in domestic demand from American goods and services to foreign substitutes.

3. Slower Growth Abroad Is Reducing U.S. Exports

Clearly, the economies of several Asian countries including Japan (but excluding China and India) 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 and 2002-2006 periods. When the income growth of foreign countries slows, 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. Thus, the argument runs, the decline in export growth combined with the acceleration in import growth will generate a trade deficit for the United States. Again, what is wrong with this argument is that it provides no explanation why a decline in demand for U.S. goods caused by differential growth rates between the United States and its trading partners should cause an imbalance between domestic investment and domestic saving. Because it does not, relative differences in growth rates by themselves should not lead to a trade deficit. As in the preceding explanation, what the proponents of this explanation neglect is that the exchange rate does not stay constant. Any tendency for U.S. imports to grow more rapidly than exports means that the net supply of dollars on the foreign exchange market rises, leading to dollar depreciation. As described above, dollar depreciation leads to sufficient additional net exports to reestablished balanced trade.[3]

4. Trade Barriers

Each year, the Office of the U.S. Trade Representative issues a lengthy report, that, among other things, details various practices foreign governments use to discriminate against American goods

[2] 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 **Section 1** above by which foreign capital comes to the U.S.

[3] There are two possibilities by which differential growth rates can lead to a trade imbalance. The first is if they are associated with different interest rates in the respective countries. Thus, should faster growth in the U.S. be associated with higher interest rates than in the slower growing countries, world capital would tend to flow to the U.S. and a trade deficit would occur. However, the cause of the differential growth rates is likely to be differential rates of investment growth and, if so, explanation A above is relevant. Thus, faster growth is correlated with—but not the ultimate cause of—an increase in the trade deficit. The second occurs if the exchange rate between the faster and slower growing countries is fixed rather than floating. This case is covered in the section above entitled "Some Additional Thoughts on the Nature of Capital Movements."

and services of an exportable nature. It might be concluded that if these practices did not exist, U.S. exports would be larger and the trade deficit would be smaller.

Although 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 and beyond. The reason for this conclusion is straightforward. Trade barriers do not lead to an imbalance between domestic investment and domestic saving. Instead, they lead to dollar depreciation and a smaller volume of trade between countries. To see this, 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 exports fall. As exports fall in value, the net demand for dollars falls in the foreign exchange market, leading to dollar depreciation. As explained above, a cheaper dollar leads to a fall in imports sufficient to restore balance to the trade accounts. The net result is that whereas the trade barriers reduce exports, the subsequent depreciation of the dollar reduces imports, resulting in an overall fall in world trade.

A Summary of the Evidence for Competing Explanations

The behavior of America's trade deficit has been a matter of congressional concern since the early 1980s. A number of explanations have been forthcoming to account for its origin, size, and continuation. Many sound convincing, and it is often difficult to discern the valid ones from those that sound convincing but are not. To be tenable, the explanation must contain some reason why it produces an imbalance between domestic saving and domestic investment (which is equal to the trade imbalance). Unless it can do so, it is not an explanation for the trade deficit. Among those reviewed above, only the "movement of capital to the United States" that begins with an imbalance between domestic investment and saving, produced either by a fall in domestic saving or a rise in domestic investment, passes the test imposed by the National Income and Product Accounts. The other explanations given above are really explanations for the expected behavior of the exchange rate incorrectly claiming to be explanations for the trade deficit.

Some Additional Thoughts on the Nature of Capital Movements

Although for balance of payments accounting purposes, trade deficits must be offset by capital movements (or the movement of financial assets and the claims to real assets), 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, which 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's net autonomous capital inflow increases, 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 United States grew more rapidly than its trading partners and thus spent more on imports than the partners spent on American exports.[4] Under normal circumstances this would lead to a depreciation of the dollar and a closing of the trade imbalance as discussed earlier. This need not be the case. If all of these goods and services were paid for by checks, and foreigners did not use the proceeds to purchase U.S. goods and services, foreign banks 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. Also, oil is priced internationally in terms of dollars. The rising price of oil has increased the amount of dollars spent abroad on oil imports. This has resulted in an increase in foreign ownership of U.S. assets. These so-called petro-dollars can be thought of as an induced capital movement.

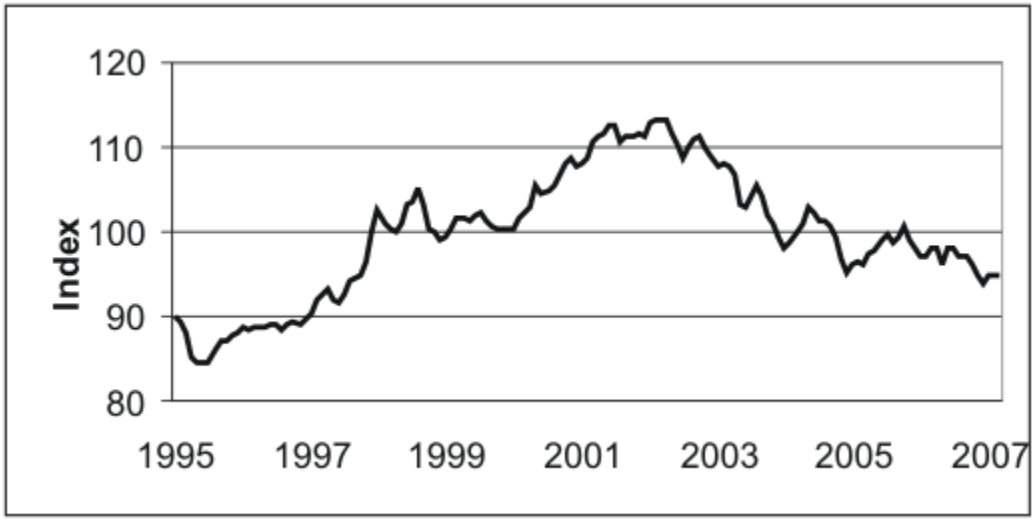
Is the growing inflow of capital to the United States dominated by an *induced* inflow? A case can be made that it may have been a factor in the past couple of years.[5] The reason being that an induced capital inflow should have very little effect on the exchange rate—it is, in effect, exchange-rate 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 (and, in the case of oil, it is paid for in dollars themselves). 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 2** it can be seen that this is the case. The growth in the trade deficit during 2003-2007 has been associated with little 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*.[6]

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

[5] The likely sources of the induced capital flows are East Asia (in particular, China and Japan) and the Middle East. From 2002 to 2006, the official foreign exchange reserves of China rose $860 billion and appear to have been motivated by a desire to maintain the existing yuan/dollar exchange rate. During that period, Japanese reserves rose by $485 billion. Large increases have also been recorded by India, Russia, South Korea, and Taiwan. 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 United States in U.S. assets.

[6] For greater detail, see CRS Report RS21951, *Financing the U.S. Trade Deficit: Role of Foreign Governments*, by Marc Labonte and Gail E. Makinen.

Figure 2. Real Dollar Exchange Rate, 1995-2007



Source: Board of Governors of the Federal Reserve System.

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 three discernable effects on the 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. Because a trade deficit means 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, because the trade deficit is the way foreign capital or saving comes to the United States, it reduces American interest rates from 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, which 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 current economic expansion.

In general, the trade deficit has usually been associated with periods of robust growth in aggregate spending in recent decades. The trade deficit has acted as a natural release valve that has allowed the economy to remain in equilibrium despite high spending growth. In the absence

of trade, high rates of spending growth would probably have led to inflationary pressures because spending was growing faster than productive capacity, but the trade deficit tamed those pressures by meeting demand through foreign production. Overall, the trade deficit did not prevent the economy from generating adequate aggregate spending and achieving an average growth rate in excess of 4.0% during the 1997-2000 period, when the deficit was growing rapidly.[7] That has also been the case from 2002 to the present.

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 1.2% of GDP during the period 2002-2006 (versus about 11% during the decade of the 1960s and nearly 9% during the decade of the 1970s). With a trade deficit during the 1990s that averaged about 1.1% of GDP, the United States was able to add to its net capital stock at a much faster rate than without this net inflow of foreign capital (the net inflow rose to 2.2% of GDP in 1998 and 3.1% in 1999).

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.[8] And, in fact, this is occurring. Before the large trade deficits that began in the mid-1980s, the United States received a net income from its foreign capital holdings that averaged about $33.4 billion during the peak years 1979-1984. During the period 2001-2006, the average inflow declined to $21 billion, an average annual decline of some $12 billion. Although the United States is a net debtor nation, it still receives net investment income because its foreign holdings earn a higher rate of return than the debt payments it makes to foreigners. The fact that the United States still receives net investment income suggests that the trade deficit has not become burdensome thus far.

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. 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 United States managed to achieve full employment, if not overfull employment.[9] The unemployment rate fell to a three-decade low in 2000, at a time when the trade

[7] The popular Mundell-Fleming open economy macro-model suggests that if the assets of the various trading countries are perfect substitutes for each other, then the trade deficit will have no effect on real GDP growth and employment. Since these assets are unlikely to be perfect substitutes, trade deficits might be expected to have some slowing effect on GDP growth.

[8] 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.

[9] 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 (continued...)

deficit was at a then record high of nearly 4.0% of GDP. Likewise, in the current economic expansion, the unemployment rate has again fell below 5%. 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 2001-2006, as the federal budget shifted from surplus to deficit, the trade deficit grew as a fraction of GDP.[10] 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. The period from 2001 to 2006 is reminiscent of the 1980s. The shift from a federal budget surplus to a budget deficit has once again caused the national saving rate to fall. This decline has been exacerbated by a fall in the household saving rate. These two declines make the story a repeat of that told above.[11] However, the rise in the trade deficit has been largely due to the large inflow of capital motivated by the purchase of dollar-denominated assets by foreign central banks and treasuries.

The 1990s presented 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

(...continued)

for the 1990s places that rate in a 5% to 6% range. Estimates using data through the 1980s would produce a similar range.

[10] 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.

[11] Between 2000 and 2003-2004, the federal budget went from a surplus of 2.8% of GDP to a deficit of 2.5% of GDP—a net shift of 5.3% of GDP (the deficit fell in 2005 and 2006). The personal or household saving rate between 2000 and 2006 declined from 1.7% of GDP to -0.8% of GDP, or a net shift of 2.5% of GDP.

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, whereas in the 1990s, it was primarily a desire to participate in the enhanced productivity of the American economy through investment (capital formation).[12]

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.

The discussion above implies that the current trade deficit is primarily a result of more attractive investment opportunities in the United States than can be accommodated by domestic saving alone. To reduce the trade deficit, this imbalance must be reduced. Obviously, a policy to reduce profitable investment opportunities in the United States 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 saving. It can increase the incentives to save through the expansion 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.[13] For instance, the taxation of saving has been reduced significantly in recent years, but the household saving rate has continued to decline. 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, all else equal, it results in more domestic saving being available for private investment.

Conclusion

The U.S. trade deficit is made possible by the net purchase of U.S. assets (stocks, bonds, real estate, etc.) by foreigners.[14] This deficit includes the traditional types of imported goods familiar

[12] For a more extensive discussion of this subject, see CRS Report RS21409, *The Budget Deficit and the Trade Deficit: What Is Their Relationship?*, by Marc Labonte and Gail E. Makinen.

[13] For example, see the symposia "Government Incentives for Saving" in the *Journal of Economic Perspectives*, vol. 10, no. 4, Fall 1996 and "Tax Policy: A Further Look at Supply Side Effects," *American Economic Review*, vol. 74, no. 2, May 1984.

[14] 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 (continued...)

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 1997-2006.

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 because 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.

Because 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.

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be the dominant factor given the size and persistence of the trade deficit.