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Editor

NOVA

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Nova Science Publishers, Inc.
New York

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Telephone 631-231-7269; Fax 631-231-8175
Web Site: http://www.novapublishers.com

Library of Congress Cataloging-in-Publication Data

Available Upon Request

ISBN: 978-1-60692-090-9

Published by Nova Science Publishers, Inc. + New York

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PREFACE

The U.S. trade deficit has risen more or less steadily since 1992. In 2006, the trade imbalance reached $811.5 billion, an increase of $20 billion over the 2005 deficit, and a total increase of about $765 billion since 1992. The trade deficit's growth in 2006 was largely the consequence of increase of import purchases of nearly $210 billion, a slight deceleration from import growth in 2005. Exports in 2006 increased a smaller $162 billion, but this was an acceleration over the 2005 results. As a percentage of GNP, the trade deficit in 2006 was 6.1%, a decrease from 6.3% in 2005. The investment income component of the trade balance moved from a surplus of $10.3 billion in 2005 up to a surplus of $36.6 billion in 2006. The large and growing size of U.S. foreign indebtedness caused by successive trade deficits suggests that the investment income surplus is likely to soon be pushed toward deficit.

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 a higher level of investment possible. For the United States, a net financial inflow also leads to a like-sized net inflow of foreign goods — a trade deficit. Absent a major shift in the underlying domestic and foreign macroeconomic determinants, most forecasts predict the continued widening of the U.S. trade deficit in 2007, but the rate of increase of the trade deficit is expected to slow.

The benefit of the trade deficit is that it allows the United States to spend now beyond current income. 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 the United States has borrowed from foreigners grows with its 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 now substantially raise the risk of economic instability, but they do impose burdens on trade sensitive sectors of the economy.

Policy action to reduce the overall trade deficit is problematic. Standard trade policy tools (e.g., tariffs, quotas, and subsidies) do not work. Macroeconomic policy tools can work, but recent and prospective government budget deficits will reduce domestic saving and most likely tend to increase the trade deficit. Most economists believe that, in time, the trade deficit will most likely correct itself, without crisis, under the pressures of normal market forces. But the risk of a more calamitous outcome can not be completely discounted.

Chapter 1 - This report provides an overview of the current status, trends, and forecasts for U.S. international trade. The purpose of this report is to provide current data and brief explanations for the various types of trade flows, particularly U.S. exports, along with a short discussion of particular trends and points of contention related to trade policy.

The United States is now running record deficits in its trade with other nations. In 2006 the U.S. merchandise trade deficit reached $838 billion on a balance-of-payments (BoP) basis and $817 billion on a Census basis. A surplus in services trade of $80 billion resulted in a deficit of $759 billion on goods and services for the year — up $44 billion or 6.2% from the $714 billion deficit in 2005. While U.S. exports are highly competitive in world markets, these sales abroad are overshadowed by the huge demand by Americans for imported products. In 2006, U.S. exports of goods and services totaled $1,446 billion, while U.S. imports reached $2,204 billion. Since 1976, the United States has incurred continual merchandise trade deficits with annual amounts fluctuating around an upward trend.

Trade deficits are a concern for Congress because they may generate trade friction and pressures for the government to do more to open foreign markets, to shield U.S. producers from foreign competition, or to assist U.S. industries to become more competitive. As the deficit increases, the risk also rises of a precipitous drop in the value of the dollar and disruption in financial markets. Compared to a Federal Reserve index of currencies weighted by importance to U.S. trade, the dollar has lost a third of its value since 2002. In 2007, the dollar has fallen against major currencies such as the euro, yen, British pound, Australian dollar, and Canadian dollar.

Overall U.S. trade deficits reflect excess spending (a shortage of savings) in the domestic economy and a reliance on capital imports to finance that shortfall. Capital inflows serve to offset the outflow of dollars used to pay for imports. Movements in the exchange rate help to balance trade. The rising trade deficit (when not matched by capital inflows) places downward pressure on the value of the dollar which, in turn, helps to shrink the deficit by making U.S. exports cheaper and imports more expensive. Central banks in countries such as China, however, have intervened in foreign exchange markets to keep the value of their currencies stable.

The broadest measure of U.S. international economic transactions is the balance on current account. In addition to merchandise trade, it includes trade in services and unilateral transfers. In 2006, the deficit on current account rose to a revised $811.5 billion from a revised $754.8 billion in 2005. In trade in advanced technology products, the U.S. balance improved slightly from a deficit of $44 billion in 2005 to a deficit of $38 billion in 2006. In trade in motor vehicles and parts, the $145 billion U.S. deficit in 2006 was mainly with Canada, Japan, Mexico, Germany, United Kingdom, and South Korea. In crude oil, major sources of the $225 billion in imports were Canada, Mexico, Saudi Arabia, Venezuela, and Nigeria. This report will be updated periodically.

Chapter 2 - The U.S. trade deficit has risen more or less steadily since 1992. In 2006, the trade imbalance reached $811.5 billion, an increase of $20 billion over the 2005 deficit, and a total increase of about $765 billion since 1992. The trade deficit's growth in 2006 was largely the consequence of increase of import purchases of nearly $210 billion, a slight deceleration from import growth in 2005. Exports in 2006 increased a smaller $162 billion, but this was an acceleration over the 2005 results. As a percentage of GNP, the trade deficit in 2006 was 6.1%, a decrease from 6.3% in 2005. The investment income component of the trade balance moved from a surplus of $10.3 billion in 2005 up to a surplus of $36.6 billion in 2006. The large and growing size of U.S. foreign indebtedness caused by successive trade deficits suggests that the investment income surplus is likely to soon be pushed toward deficit.

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Policy action to reduce the overall trade deficit is problematic. Standard trade policy tools (e.g., tariffs, quotas, and subsidies) do not work. Macroeconomic policy tools can work, but recent and prospective government budget deficits will reduce domestic saving and most likely tend to *increase* the trade deficit. Most economists believe that, in time, the trade deficit will most likely correct itself, without crisis, under the pressures of normal market forces. But the risk of a more calamitous outcome can not be completely discounted. This report will be updated annually.

Chapter 3 - The U.S. trade deficit is equal to net foreign capital inflows. Because U.S. investment rates exceed U.S. saving rates, the gap must be financed by foreign borrowing. Net capital inflows have grown over recent years to a record 6.6% of gross domestic product (GDP) in 2006. Economists have long argued that the low U.S. saving rate, which is much lower than most foreign countries, is the underlying cause of the trade deficit and that policies aimed at reducing the trade deficit should focus on boosting national saving. The most straightforward policy would be to reduce the budget deficit, which directly increases national saving.

In an often-cited speech in early 2005, Ben Bernanke, now the chairman of the Federal Reserve, argued that the underlying cause of the trade deficit was not insufficient domestic saving, but rather a "global saving glut." He argued that there was too much saving worldwide and not enough investment demand, and that the United States was the natural destination for this excess saving. As a result of the global saving glut, the trade deficit increased, interest rates remained low, demand for capital and residential investment rose, and the incentive to save decreased in the United States. He argued that because the trade deficit was not "made in the U.S.A.," policy steps to reduce the budget deficit or raise private saving were unlikely to significantly reduce the trade deficit until the global saving glut ended.

The conventional view and the global saving glut view are not necessarily mutually exclusive. To an extent, the difference between the two is tautological — the conventional view stresses that U.S. saving is too low relative to foreign saving, and the global saving glut view stresses that foreign saving is too high relative to U.S. saving. It is important to acknowledge foreign causes for international capital movements, but in doing so, changes in domestic conditions should not be neglected. Although neither view leads to any hard conclusions about whether the trade deficit is good or bad, the global saving glut implies that reducing it is largely out of American hands.

Contrary to the global saving glut hypothesis, data show that world saving is close to its lowest level in decades. However, low interest rates (although not unusually low by historical standards) suggest that worldwide investment demand is probably low as well. Data also show that the rise in saving in the developing world (notably among oil producers and East Asian countries) over the past few years has gone hand-in-hand with the significant accumulation of official foreign exchange reserves. At the same time, there has been a decrease in government saving in the United States since the 1990s. In recent years, a large fraction of U.S. net capital inflows have been the result of foreign reserve accumulation by other countries rather than coming from private sources, which suggests that global imbalances are not primarily the result of decisions by private investors and that (because of the fall in U.S. government saving) the trade deficit to a great extent may indeed have been "made in the U.S.A."

Chapter 4 - The U.S. merchandise trade deficit is a part of the overall U.S. balance of payments, a summary statement of all economic transactions between the residents of the United States and the rest of the world, during a given period of time. Some Members of Congress and other observers have grown concerned over the magnitude of the growing U.S. merchandise trade deficit and the associated increase in U.S. dollar-denominated assets owned by foreigners. This report provides an overview of the U.S. balance of payments, an explanation of the broader role of capital flows in the U.S. economy, an explanation of how the country finances its trade deficit or a trade surplus, and the implications for Congress and the country of the large inflows of capital from abroad. The major observations indicate that:

Foreign private investors sharply increased their purchases of U.S. Treasury securities in 2007 as they reduced their purchases of U.S. corporate bonds. At the same time, foreign official purchases of U.S. Treasury securities plummeted in 2007 as foreign governments curtailed their purchases of such securities.

The inflow of capital from abroad supplements domestic sources of capital and likely allows the United States to maintain its current level of economic activity at interest rates that are below the level they likely would be without the capital inflows.

Foreign official and private acquisitions of dollar-denominated assets likely will generate a stream of returns to overseas investors that would have stayed in the U.S. economy and supplemented other domestic sources of capital had the assets not been acquired by foreign investors.

Chapter 5 - Petroleum prices have risen sharply since early 2005. At the same time the average monthly volume of imports of energy-related petroleum products has fallen slightly. The combination of sharply rising prices and a slightly lower level of imports of energy-related petroleum products translates into an escalating cost for those imports. This rising cost added an estimated \$70 billion to the nation's trade deficit in 2005 and \$50 billion in 2006. Imported energy prices moderated in early 2007, before rising again through the summer and more sharply in the fall, following a pattern of rising energy import prices in the spring and summer. This report provides an estimate of the initial impact of the rising oil prices on the nation's merchandise trade deficit.

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In: United States Trade Deficit Issues
Editor: Carl T. Yankovich
ISBN: 978-1-60692-090-9

Chapter 1

UNITED STATES INTERNATIONAL TRADE: TRENDS AND FORECASTS*

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SUMMARY

This report provides an overview of the current status, trends, and forecasts for U.S. international trade. The purpose of this report is to provide current data and brief explanations for the various types of trade flows, particularly U.S. exports, along with a short discussion of particular trends and points of contention related to trade policy.

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* This is an edited, reformatted and augmented version of a CRS Report for Congress publication dated January 2008.

goods and services for the year — up $44 billion or 6.2% from the $714 billion deficit in 2005. While U.S. exports are highly competitive in world markets, these sales abroad are overshadowed by the huge demand by Americans for imported products. In 2006, U.S. exports of goods and services totaled $1,446 billion, while U.S. imports reached $2,204 billion. Since 1976, the United States has incurred continual merchandise trade deficits with annual amounts fluctuating around an upward trend.

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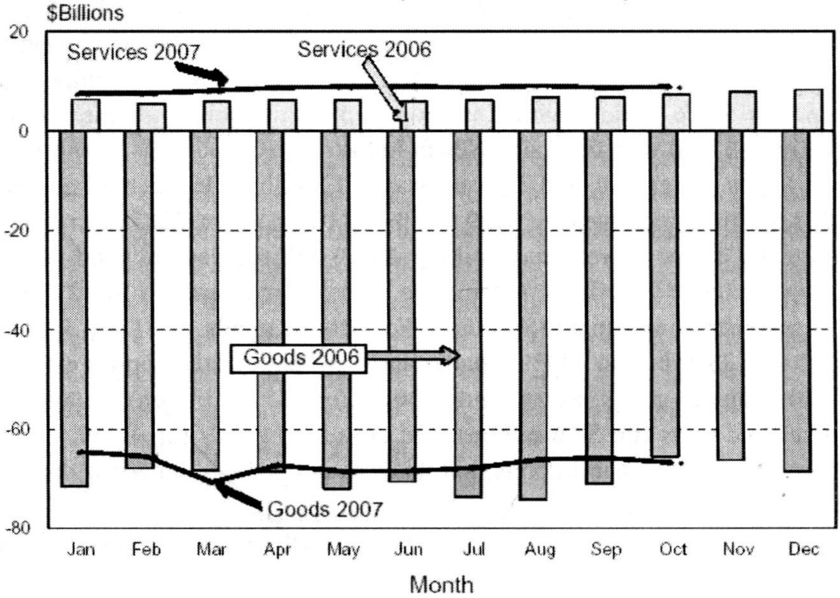
MOST RECENT DEVELOPMENTS

In 2006, the **trade deficit in goods** reached a record \$838.3 billion (balance of payments [BoP] basis), up \$51.1 billion from \$787.1 billion in 2005. The 2006 deficit on merchandise trade with China was \$232.6 billion (Census basis), with the European Union (EU-27) was \$117.2 billion, with Japan was \$88.6 billion, with Canada was \$71.8 billion, with Mexico was \$64.3 billion, and with the Asian Newly Industrialized Countries (Hong Kong, South Korea, Singapore, and Taiwan) was \$11.8 billion. **Imports of goods** of \$1,861.4 billion increased by \$179.6 billion (10.7%) over 2005. Increases in imports by sector were: crude oil up \$40.9 billion, capital goods except automotive up \$38.9 billion, automotive vehicles and parts up \$17.2 billion, and consumer goods up \$35.4 billion. **Exports of goods** of \$1,023.1 billion rose by \$128.5 billion (14%), particularly of industrial supplies (up \$43 billion), capital goods except automotive (up \$51.6 billion), automotive vehicles and parts (up \$8.6 billion), and consumer goods (up \$13.9 billion). Exports grew faster than imports, but this was not enough to narrow the trade deficit.

Figure 1 shows the latest monthly balance data for both goods trade and services trade. The services balance remains positive for the entire period. The goods trade balance fluctuates each month. For January and February 2007 the deficit on goods trade was less in 2007 than the corresponding months in 2006. This reversal of the previous trend of steadily increasing trade deficits began in August, 2006. In March 2007, however, the deficit level exceeded that in March 2006, but again receded in April through September 2007. The October 2007 deficit in goods exceeded the deficit for a year earlier. In goods and services, total imports in October 2007 of \$199.5 billion were the highest in the year and in U.S. history. Also in October 2007, total exports of goods and services of \$141.7 billion were the highest in the year and U.S. history. This produced a deficit on goods and services for that month of \$57.8 billion, below the record high set in August 2006 of \$67.6 billion. For July through October 2007, the trade deficit remained below the \$60 billion monthly level. Although U.S. imports increased by 9.2% from September to October 2007, exports increased by an even greater amount of 13.7%. At \$141.7 billion, U.S. good and services exports for October set a record high for 2007.

In services, as shown in **Figure 1**, the U.S. surplus in 2006 increased by about \$2 billion from the beginning to the end of the year, reaching \$8.3 billion in December. The trade surplus in services for January through October of 2007 was greater than over the corresponding months in 2006. Service imports reached $31.7 billion for October 2007 and exports totaled $40.6 billion, yielding a services surplus of $8.9 billion.[1]



Source: CRS with Data from the U.S. Department of Commerce

Figure 1. Monthly U.S. Balances of Trade in Goods and Services, 2006 and 2007 (in Current Dollars)

For 2006, the trade deficit on goods and services reached a record $758.5 billion or 5.7% of U.S. gross domestic product (GDP, $13.2 trillion in 2005), up slightly from 2005. U.S. consumer demand remains strong and continues to pull in imports at a rapid pace. For 2007, it appears that the trade deficit will decline slightly from that in 2006. Preliminary statistics for 2007 will be released on February 14, 2008.

THE U.S. DEFICIT IN INTERNATIONAL TRADE

International trade in goods and services along with flows of financial capital affect virtually every person living in the United States. Whether buying imported clothes, gasoline, computers or cars, or working in an industry that competes with imports, or sells products abroad, the influence of international trade on economic activity is ubiquitous.

The United States in now running record deficits in its trade with other nations. In 2006 the U.S. merchandise trade deficit reached $817.3 billion on a Census basis and $838.3 billion on a balance-of-payments basis (BoP). A surplus in services trade of $79.7 billion produced a deficit of $758.5 billion on goods and services for the year — up $146.4 billion or 23.9% from the $612.1 billion deficit in 2004. While U.S. exports are highly competitive in world markets, U.S. sales abroad are overshadowed by the huge demand by Americans for imported products. In 2006, U.S. exports of goods and services totaled $1.446 trillion, while U.S. imports reached $2.204 trillion (BoP). Since 1976, the United States has incurred continual merchandise trade deficits with annual amounts fluctuating around an upward trend.

For the Congress, the trade deficit and other aspects of international trade enter into public policy considerations through many portals. At the macroeconomic level, trade deficits are a concern because they affect U.S. economic growth, interest rates, labor, and the debt load of the economy. As the trade deficit rises relative to the total economy, the risk increases that the dollar will weaken, raise prices, disrupt financial markets, and reduce the economic well being of the population. On the strategic level, trade ties often lead to a deepening of bilateral relations with other nations that can develop into formal free trade agreements or political and security arrangements. Trade also can be used as a tool to accomplish strategic objectives — particularly through providing preferential trading arrangements or by imposing trade sanctions.

On the microeconomic side, imports of specific products can generate trade friction and pressures from constituent interests for the government to shield U.S. producers from foreign competition, provide adjustment assistance, open foreign markets, or assist U.S. industries to become more competitive.

This report provides an overview of the current status, trends, and forecasts for U.S. import and export flows as well as certain balances. The purpose of this report is to provide current data and brief explanations for the various types of trade flows along with a brief discussion of trends that may require attention or point to the need for policy changes. The use of trade policy as an economic or strategic tool is beyond the scope of this report but can be found in various other CRS reports.[2] Further detail on trade in specific commodities, with particular countries or regions, or for different time periods, can be obtained from the Department of Commerce,[3] U.S. International Trade Commission,[4] or by contacting the authors of this report.

Savings Shortfalls and the Trade Deficit

Overall U.S. trade deficits reflect a shortage of savings in the domestic economy and a reliance on capital imports to finance that shortfall. A savings shortfall is the analogue of excessive spending that is financed by borrowing. Households borrow for consumption; businesses borrow to invest; and the government borrows to cover its budget deficit. At the international transaction level, the savings shortfall is manifest when the United States imports capital to pay for its excess of imports (trade deficit).

Whether this foreign borrowing is beneficial for the U.S. economy depends on how the imports of capital are used. If they are used to finance investments that generate a future return at a sufficiently high rate (they raise future output and productivity), then they may increase the well being of current and future generations. However, if the imports are used only for current consumption, the net effect of the borrowing will be to shift the burden of repayment to future generations without a corresponding benefit to them.

Implications of the Trade Deficit

U.S. trade balances are macroeconomic variables that may or may not indicate underlying problems with the competitiveness of particular industries or what some refer to as the competitiveness of a nation. The reason is that overall trade flows are determined, within the framework of institutional barriers to trade and the activities of individual industries, primarily by macroeconomic factors such as rates of growth, savings and investment behavior (including government budget deficits/surpluses), international capital flows, and exchange rates.[5]

Increases in trade deficits may diminish economic growth, since net exports (exports minus imports) are a component of gross domestic product. In the late 1980s and early 1990s, export growth was an important element in overall U.S. economic growth. In 2006, merchandise exports accounted for about 7.7% of GDP, compared with 5.9% in 1990. Recently, however, rising trade deficits have reduced total domestic demand in the economy, but the weakness in the trade sector has been offset by strong consumer, business, and government demand.

Many economists fear that the rising U.S. trade and current account[6] deficits could lead to a large drop in the value of the U.S. dollar. The current account deficit now exceeds 6% of GDP and is placing downward pressure on