"The U.S. Trade Deficit: A Sign of Good Times"

Testimony before
The Trade Deficit Review Commission

Submitted by Daniel T. Griswold
Associate Director, Center for Trade Policy Studies
Cato Institute

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Before discussing the cause of the U.S. trade deficit, let me spend a moment on two alleged causes that in reality have no direct connection to the deficit.

One alleged cause is a lack of "competitiveness." The immediate problem with this explanation is that competitiveness, on a nation-to-nation level, is an imprecise term, one almost devoid of meaning. What does it mean for a nation's economy to be competitive? If it means "more productive," then this is just another term for "wealthier." It makes no sense in theory or in practice why a nation's trade deficit should shrink as the overall productivity of its workers rises. Indeed, the opposite effect may be more plausible.

A second, empirical problem with this explanation is that, by almost every measure of productivity and wealth, the U.S. economy is performing well at the end of the 1990s at a time when the trade deficit is reaching record levels. Compared to the other major developed economies, our economy is growing faster, productivity is rising more briskly, and innovative new products and services, from medical drugs to Internet communications, are being developed more rapidly here than anywhere else. Yet we run persistently large and growing trade deficits.

The other alleged cause of the trade deficit is unfair trade barriers abroad. But this theory also runs aground on the rocks of reality. The rest of the world is more open to U.S. exports today than it was 30 years ago, thanks to two more rounds of GATT negotiations as well as unilateral trade liberalization abroad. Yet our overall trade deficit is also larger.

Bilateral trade deficits also fail to show a cause-and-effect link to foreign trade barriers. The United States runs bilateral trade deficits with Mexico and Canada, two countries that are almost completely open to exports from the United States. Yet we run a

trade surplus with Brazil, a country that still maintains significant barriers to U.S. exports.

We run a far bigger deficit with Japan today than 30 years ago, even though Japan's economy is much more open today. And U.S. exports to member states of the European Community face a common external tariff, yet we run our largest bilateral surplus with the Netherlands and our third largest bilateral deficit with Germany. Clearly, trade barriers or some half-baked measure of competitiveness cannot account for these differences.

The Savings-Investment Gap

The fundamental cause of the trade deficit in the United States today is the gap between what we save as a nation and the level of domestic investment. To cover this shortfall of savings, we allow foreign savers to invest in American assets, using the surplus of incoming capital to pay for the import of goods and services over and above what we export. The result is a trade deficit (or more precisely, a current account deficit).

For a nation such as Japan, where savings exceeds investment, the excess of capital flows overseas, enabling foreigners to buy more exported goods and services from the country than they import to it. The result is a trade surplus.

So the variables in the trade-deficit equation are not industrial competitiveness or trade policies, but how much a nation saves and invests. If a nation's rate of savings rises or if investment falls (as it usually does during a recession), its trade deficit will shrink. Conversely, if savings fall or investment rises (as it typically does during an expansion), the trade deficit will grow.

For this reason, trade deficits tend to be pro-cyclical, rising and falling with the general health of the economy. Simply put, *the U.S. trade deficit is not the cause of bad things in our economy; it is the result of good things, chief among them rising investment.*

The fundamental reason why the U.S. trade deficit has grown so rapidly in the 1990s has been a dramatic increase in domestic investment. Since 1992, annual real private investment in plant and equipment in the United States has risen 81 percent, from $557.9 billion to an annual pace of slightly more than $1 trillion so far in 1999. Real, price-adjusted investment in computers and peripheral equipment during that same period has increased more than 10-fold.

As evidence, consider the relationship between America's economic performance and the trade deficit since 1973. As Figure 1 indicates, the U.S. trade balance typically peaks in the direction of a surplus during recessions, and bottoms out in the negative (or deficit) direction in the midst of economic expansions.[1]

The Trade Deficit and Economic Performance

A survey of the U.S. economy since 1973, when the era of floating exchange rates and free capital flows began, only confirms that rising trade deficits generally accompany periods of rising investment and expansion for the U.S. economy.

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[1] Daniel T. Griswold, "America's Maligned and Misunderstood Trade Deficit," Trade Policy Analysis no. 2, Cato Institute, April 24, 1998, p. 7.

In the 26 years surveyed, America's current account deficit as a percentage of GDP grew larger (or, in the parlance of the typical news report, "worsened") in 15 of them and shrank (or "improved") in 11. By almost any measure, America's economy has performed better in years in which the trade deficit rose compared to years in which it shrank.

During years of rising deficits, the growth of real gross domestic product averaged 3.2 percent per year, compared to 2.3 percent during years of shrinking deficits. In other words, our economy typically grows about 40 percent faster in years in which the trade deficit grows compared to years in which it shrinks.

On the issue of jobs, the story is much the same. During years of "worsening" trade deficits, the unemployment rate has, on average *fallen* by 0.4 percentage points. During years of "improving" deficits, the unemployment rate has, on average, *risen* by 0.4 percentage points.

In the politically sensitive sector of manufacturing, the trade deficit again proves to be a companion of better times. During years of rising deficits, manufacturing output grew an average of 4.5 percent a year. During years of shrinking deficits the average growth rate of manufacturing output was 1.4 percent—less than one-third the rate of growth during years of rising deficits. As to manufacturing jobs, those years in which the trade deficit grew saw factory employment *increase* by an average of 13,100 workers per year. Those years of shrinking deficits were accompanied by an average annual *loss* of manufacturing jobs of 116,700.

Focusing on motor vehicles and parts—long a symbol of American industrial might—domestic output grew by an average of 8.6 percent during years of rising deficits while employment grew by an average of 21,900. During years when the deficit shrank, domestic output of motor vehicles and parts fell by an average of 3.4 percent annually and employment fell an average of 25,000 per year.

Americans on the margins of poverty also appear to fare somewhat better when the trade deficit expands. In years when the deficit grew, the poverty rate in America fell an average of 0.1 percentage points a year. In years when it shrank, the poverty rate rose by an average of 0.3 points. In terms of real people, years of "improving" trade deficits saw the number of Americans living below the poverty line increase by an average of 907,000 people a year, compared to an 81,000 increase during years of "worsening" deficits.

The only major economic indicator out of sync was the stock market. On average, the New York Stock Exchange Composite Index rose 8.7 percent during years of rising deficits, lagging behind the 12.3 percent rise in years of shrinking deficits. Perhaps it should be Wall Street, not organized labor, that should be complaining most loudly about a rising trade deficit.

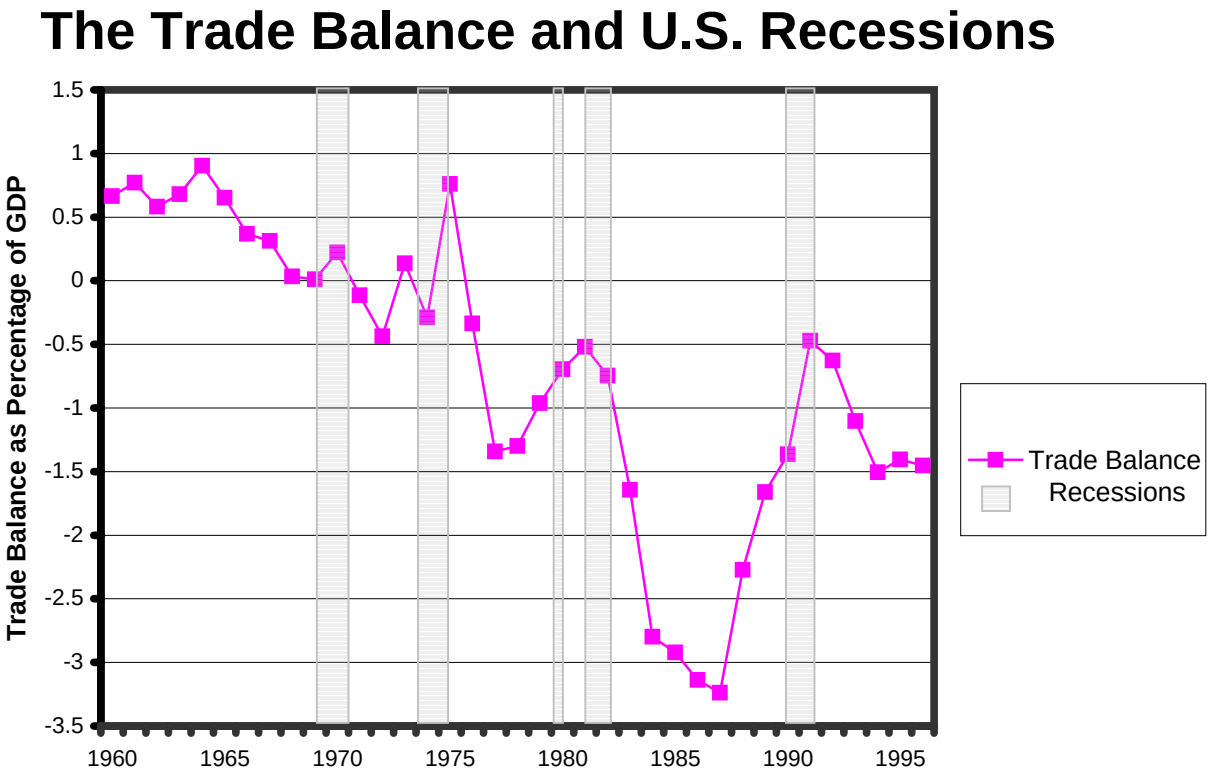
Conclusion

Of course, none of this evidence argues that the trade deficit is the cause of economic blessings. What it does indicate is that rising trade deficits are often caused by the same underlying factor, namely rising domestic investment, that drives a number of other economic indicators—employment, production, poverty rates—in a positive direction.

Without a trade deficit, Americans could not import the capital we need to finance our rising level of investment in plants and new equipment, including the latest computer technology. The same appreciating dollar that expands the trade deficit helps keep a lid on inflation while lower import prices raise the real wages of the vast majority of American workers.

When the underlying causes of the trade deficit are understood, it should become clear that the biggest threat to our economy is not the deficit itself, but what politicians might do in a misguided mission to shrink it.

Figure 1



Sources: Trade balance data from Council of Economic Advisers, *Economic Report of the President 1997* (Washington: Government Printing Office, 1997), Table B-101, p. 414. Data on recessions from U.S. Department of Commerce, Survey of Current Business vol. 78, no. 3: D-43.

How the U.S. Economy Performs:

	in years when the trade deficit is "worsening," (1974, 1976-77, 1982-87, 1992-94, 1996-98)	… and in years when it is "improving." (1973, 1975, 1978-81, 1988-91, 1995)
Real GDP Growth	**3.2%**	**2.3%**
Change in Unemployment Rate	**-0.4**	**0.4**
Change in Manufacturing Output	**4.5%**	**1.4%**
Change in Manufacturing Jobs	**13,100**	**-116,700**
Change in Poverty Rate	**-0.1**	**0.3**
Change in NYSE Composite Index	**8.7%**	**12.3%**

Changes in the unemployment rate and manufacturing jobs are measured December to December.
Changes in the New York Stock Exchange Composite Index are measured Dec. 31 to Dec. 31.

Source: Economic Report of the President 1999, U.S. Census Bureau, New York Stock Exchange.

Economic Indicators and the Trade Deficit, 1973-98

Year	Change in C/A (as % of GDP)	Real GDP Growth	Change in Unemploy-ment Rate	Manufact. Output Growth	Change in Manufact. Jobs (1,000s)	Change in NYSE Composite	Change in Poverty Rate
1973	1.0	5.8%	-0.3	8.8%	726	-19.6%	-0.8
1975	1.0	-0.4%	1.0	-10.0%	-633	31.9%	1.1
1978	0.0	5.4%	-0.4	6.5%	890	2.1%	-0.2
1979	0.6	2.8%	0.0	3.6%	-35	15.5%	0.3
1980	0.1	-0.3%	1.2	-3.8%	-742	25.7%	1.3
1981	0.1	2.3%	1.3	1.6%	-493	-8.7%	1.0
1988	1.0	3.8%	-0.4	4.6%	226	13.0%	-0.4
1989	0.6	3.4%	0.1	2.0%	-168	24.8%	-0.2
1990	0.3	1.2%	0.9	-0.5%	-522	-7.5%	0.7
1991	1.5	-0.9%	1.0	-2.3%	-533	27.1%	0.7
1995	0.2	2.3%	0.1	5.5%	0	31.3%	-0.7
Averages	0.6	2.3%	0.4	1.4%	-116.7	12.3%	0.3
1974	-0.4	-0.6%	2.3	-1.5%	-1236	-30.3%	0.1
1976	-0.9	5.4%	-0.4	10.3%	622	21.5%	-0.5
1977	-0.9	4.7%	-1.4	8.9%	875	-9.3%	-0.2
1982	-0.5	-2.1%	2.3	-6.0%	-1697	14.0%	1.0
1983	-0.9	4.0%	-2.5	5.8%	934	17.5%	0.2
1984	-1.3	7.0%	-1.0	9.8%	529	0.7%	-0.8
1985	-0.4	3.6%	-0.3	2.3%	-350	26.8%	-0.4
1986	-0.5	3.1%	-0.4	2.8%	-225	14.0%	-0.4
1987	-0.1	2.9%	-0.9	5.3%	356	-0.3%	-0.2
1992	-0.7	2.7%	0.1	4.0%	-165	4.7%	0.6
1993	-0.5	2.3%	-0.9	3.7%	40	7.9%	0.3
1994	-0.5	3.5%	-1.0	6.0%	401	-3.1%	-0.6
1996	-0.2	3.4%	-0.2	4.7%	37	19.1%	-0.1
1997	-0.1	3.9%	-0.7	6.8%	303	30.3%	-0.4
1998	-0.8	3.9%	-0.4	4.2%	-227	16.6%	N/A
Averages	-0.6	3.2%	-0.4	4.5%	13.1	8.7%	-0.1

Note: Changes in the unemployment rate and manufacturing employment are measured December to December. Changes in the New York Stock Exchange Composite Index are measured December 31 to December 31.

Source: Economic Report of the President 1999, U.S. Census Bureau, New York Stock Exchange.