

Causes of the Trade Deficit

Written Statement of

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to

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I am Barry Rogstad, President of the American Business Conference, a coalition of mid-sized high growth company CEOs. Throughout ABC's existence, our members have been leading advocates for constant liberalization of our nation's international trade and investment rules. Prior to joining ABC, I was a partner with Coopers & Lybrand, serving as the Firm's chief economist and Managing Partner of International Management Consulting. I received my AB in History and MA in Economics from Clark University, and a Ph.D. in Economics from Brown University with a specialization in International Trade and Capital Movements.

I am honored to have the opportunity to participate in the opening panel of the Trade Deficit Review Commission on the Causes of the Trade Deficit.

The perspective I want to bring to the panel is a view of the trade deficit as a snapshot of the current net value of all trade and investment flows between the United States and its trading partners. It is a result, at a point in time, of a very complex set of economic forces within the U.S. and throughout the rest of the world that determine overall levels and composition of economic activity, including trade flows and international capital movements.

When we talk about "concerns" with the size of the trade deficit, we are most likely addressing an inadequate level of some trade-related activity. Yet the trade deficit has very little, if anything, to do with the level of economic activity. It is part of an accounting identity contained within our national income accounting system. This balance of payments identity contains flows that serve to offset each other in terms of their impact on the overall levels of economic performance.

In the case of a trade deficit, the excess of imports over exports represents a leakage from the U.S. economy which by itself would reduce future growth. But the accounting system that defines the trade deficit recognizes an offsetting payment (for these net imports) most likely in the form of foreigners making investments in the United States. This new investment will have a stimulative effect on future growth which will make up for negative growth effects of the net imports.

I make this point because I think it is very important to avoid making normative statements about the trade deficit. For example, we should avoid describing the trade deficit as "too high". Doing so permits our national dialogue to blame the trade deficit excessively for the adjustments that are forced on U.S. households and businesses by all aspects of our dynamically changing economy.

To understand the trade deficit and the causes of changes in the trade deficit, it is helpful to have a broader framework concerning: the importance of trade and investment to overall economic activity, what accounts for the mix and level of trade activity, and how trade and investment flows interrelate.

The globalization of markets for goods and services is a fact of current economic life. American consumers, in addition to benefiting from the outputs of the American production machine, increasingly access markets throughout the world. American businesses place ever greater importance on penetrating international markets through exports as well as expanded in-country production capability. These international economic activities have contributed significantly to the growth in the overall standard of living of American citizens.

Consumers and businesses in the rest of the world are similarly engaged with their trading partners, and in particular benefit greatly from trade with and investment in the United States. All participants in world trade share in the gains from trade, and this fact underscores the value of continued liberalization of the world trading system.

What is the balance of trade? It is the difference in the total value of all goods and services purchased by residents of the United States from the

rest of the world (ROW) and the total value of the goods and services the ROW buys from the U.S. In any year in which the U.S. buys more from the ROW than they buy from us, the U.S. has a trade deficit.

The attached table shows the value of exports and imports and their share of GDP over the last 25 years. A few key points can be illustrated from this data.

- The importance of trade to overall U.S. economic activity has increased by about 50% over the past quarter century.**

- The growth in exports and imports has been quite stable over the period. With few exceptions the dollar values in both series have increased each year. Expressed in terms of shares of GDP we also can discern a positive trend in both series, but with greater year-to-year variability.**

- Since 1976, the United States has continually run a deficit in its balance of trade.**

- Significant swings in the size of the trade deficit can occur quickly and occur in years in which there is significant disparity in the business cycles in the U.S. relative to our trading partners.**

- The U.S. is a relatively closed economy in comparison to most of our trading partners, and therefore sudden changes in trade balances are more likely to result from reversals in their business cycles.

U.S. international competitiveness is determined by the productivity and efficiency of American technology, labor and capital, relative to that of our trading partners. These forces determine the relative comparative advantage of a trading country and determine the composition and overall pattern of trade among nations. The forces that drive international competitiveness evolve relatively slowly compared to the forces that drive trade deficits. Said another way, international competitiveness is a structural question whereas trade deficits have a much greater cyclical component, and, as we have seen, can rise and fall quite rapidly.

What are the causes of the current growth in our trade deficit? The current economic expansion in the U.S. has resulted in a significant growth in the standard of living of Americans. As a result we have been able to sustain a very high level of consumption which in part has been met by higher imports. During this same period we have witnessed downturns in the economic fortunes of countries to which we export. This slowdown in many of our traditional export markets, particularly the Asian crises, resulted in a flat level of export sales in 1998.

That the U.S. has had a continuous trade deficit for the last two decades is attributable to more than the interaction of our business cycle with those of our trading partners. The fact is that for this entire period the U.S. has experienced sustained improvement in living standards that have allowed the country's business and households to consume more than the nation produces.

We can acknowledge that this condition reflects very positively on the strength of the U.S. economy, yet at the same time we realize there are other factors to be considered. This brings us to the other elements of the balance of payments accounts.

- The balance of payments on current account reflects all current transactions between the US and the ROW. In addition to the net trade balance, it includes other financial payments, the most important being interest and dividends paid on foreign investments held by the U.S. and U.S. payments on foreign owned investments in the United States. The U.S. current account has been in continuous deficit since 1982.

- The balance of payments on capital account is made up of the sum of the total U.S. investment abroad and foreign investment in the U.S. We pay for a deficit in the current account balance in any given year through a

net flow of foreign capital to the U.S. Foreign citizens and their governments invest in the United States in the amount of the current account deficit.

Foreigners have been willing to place their saving in this country, because they recognize that it has been and continues to be a very attractive market for investment. Again this is reflective of the relative economic strength of the U.S. vis-a-vis the ROW.¹

The sustained deficits on trade and current account balances have required a continuous inflow of foreign saving into the U.S. In 1987 the U.S. became a debtor nation. Today our net foreign indebtedness is about two trillion dollars.

Is this situation a source of concern? Not necessarily. But there is considerable evidence that the capital inflows to the U.S. have become the determining factor in the size of our current international imbalances and that trade flows are the accommodating factor.

Foreign capital inflows may now be the major cause of the increased trade deficit.

Observers often express concern that the United States is becoming dependent on foreign saving to sustain growth. The U.S. is a low saving nation. Our tax laws in particular, encourage consumption over the saving uses of income. If these impediments to saving were corrected, we can say that a greater portion of our investment outlay would be financed from domestic saving and the dependence on foreign saving reduced.

Such adjustments would not automatically eliminate inflows of foreign saving (and the trade deficit). However, with our saving impediments removed, I would be much less inclined to make normative statements about the current trade deficit.

We will certainly see a return to trade surpluses and net foreign investment by the U.S. We are actively pursuing a world in which the increased strength of our trading partners and the developing nations will result in greater balance in overall trade relationships. This adjustment process is healthy and fully consistent with continued growth of the U.S. economy.

Earlier, I stated that changes in trade deficits did not impact the level of overall economic activity. However, when disaggregated to specific industries and communities, the adjustments to trade and investment flows can be very significant. Lost jobs, business failures, and an overall sense

¹ This description ignores all other forces that impact the balance of payments, in particular fluctuations in

of lost competitiveness can raise real and powerful concerns about the trade deficit. Overcoming these problems involves undertaking the structural readjustments that are an inevitable part of a dynamic economy. Attempting to understand or directly address these problems by "solving the trade deficit" is equivalent to killing the messenger.

Unfair trade practices are frequently cited as a major cause of the trade deficit. Since all countries are guilty, every nation's trade flows are influenced by such practices. Their elimination would make international markets more efficient and generate increased gains from trade for all participants. Affected sectors and regions could go through considerable adjustments, but the net effect on the trade balance of a country the size of the United States would be negligible. Again, these are important issues, but the trade deficit itself does not provide a useful framework for analysis or action.

By properly defining the trade deficit, its causes and implications, this Commission will bring about significant improvement in the public understanding of the role of international trade and investment in the United States economy. I applaud your efforts and look forward to your results.

exchange rates.

Thank you.