Trade Deficit Review Commission

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August 1999

Introduction

I would like to thank Mr Weidenbaum for inviting me to testify before the Trade Deficit Review Commission. I will begin by looking at the definition and measurement of the trade deficit - as both have significant bearing on the debate. I will then turn to causes of the U.S. trade deficit.

A) Definition of the Trade Deficit

The term "trade deficit" is one of the most widely cited and most poorly defined economic concepts in common usage. Yet, the precise definition matters. At least three different definitions are used interchangeably.

1. The trade balance in "merchandise" or "goods". This measures only trade in goods - which account for 72% of U.S. exports and 84% of U.S. imports.[1] The United States goods trade deficit was $247 billion in 1998 (see table below). Yet, this was at least partly because the United States exported other things to pay for those goods – namely services. In other words, the U.S. merchandise trade deficit was "caused" partly by comparative advantage. Indeed, being concerned about the goods trade deficit makes about as much sense in the United States at the dawn of the twenty-first century as being concerned about the U.S. trade deficit in leather products.[2] This measure is clearly too narrow and ignores important elements of U.S. trade.

2. The trade balance in goods and services. This is the best measure of what most people understand to be the trade deficit, as it includes trade in services (such as transportation and financial services) that are excluded from the merchandise figures. The inclusion of service trade is particularly important for this debate, as the United States is becoming a service based economy. Net exports of services made the

U.S. deficit in *goods and services* trade $164 billion in 1998, significantly lower than the deficit on goods trade (see table below).

3. The Current Account Balance. This is a broader measure that includes trade in goods and services, investment income and unilateral transfers (e.g. foreign aid payments). This figure tends to be more negative than the trade balance on goods and services for two reasons. First, the United States is a net provider of foreign aid and other unilateral payments ($44 billion in 1998). Second, the United States pays out slightly more on investment income to foreign residents than U.S. residents receive in income payments from abroad (a net outflow of $12 billion in 1998). In sum, the higher current account deficit of $220 billion was "caused" by net foreign aid payments and net payments to foreigners on investment income.

United States International Transactions, 1998[3]

	Billions of Dollars
Merchandise Exports	670
Merchandise Imports	- 917
1a. Merchandise Trade Balance	**- 247**
Service Exports	264
Service Imports	- 181
1b. Service Trade Balance	**83**
2. Balance of Trade in Goods and Services (Sum of 1a and 1b)	**- 164**
Net Unilateral Transfers	- 44
Net Investment Income	- 12
3. Current Account Balance	**- 220**

Source: Bureau of Economic Analysis, Department of Commerce

I will use the term "trade deficit" to refer to the deficit on goods and services.

B) Measurement of the Trade Deficit

One important, but often overlooked, "cause" of the U.S. trade deficit

is in fact statistical error. Simple mis-measurement of international trade is not relevant for the trade *deficit* debate unless the inaccuracy is *significant, persistent* and *biased* in terms of exports and imports. Yet, statistical inaccuracy does appear to meet all of these criteria in practice.

According to a recent study by the Census Bureau, U.S. goods exports are undercounted by 3-10% of the published value.[4] Applying this conclusion to 1998 data leads to the result that goods exports were undercounted by as much as $67 billion last year. That is, U.S. goods exports were $737 billion and not the $670 billion recorded in the official statistics. The same study also states that "there is no evidence of significant errors in the import data". This reflects the fact that all imports are recorded (regardless of value), while some low value exports are "estimated" (see below). The study did not look at trade in services.

The export undercount has important implications for U.S. trade deficit figures. The merchandise trade deficit for 1998 was $247 billion. Factoring in the export undercount, the merchandise trade deficit would have been $180 billion – 25% lower. Assuming that service exports and imports are measured accurately, **measuring goods exports more accurately would reduce the trade deficit on goods and services by more than a third (from $164 billion to $97 billion in 1998).**

The reasons for the undercount are in themselves informative. One reason is that exporters are not required to report transactions valued at less than $2,500. Instead, the Census Bureau estimates these exports using historical data. Indeed, the Census Bureau has not collected new data on trade transactions under $1,000 for over a decade. During that decade, widespread use of "just-in-time" inventory practices, increased trade with plants over the border in Canada and Mexico and the rise of small-business trade have all acted to increase the number of low-value trade transactions.[5] Using data from the 1980s to estimate these small-value transactions clearly understates important structural changes in the pattern of U.S. trade and consistently overstates the trade deficit.

Other causes of the export undercount include missing or incomplete data on export paperwork and misreporting. Such errors do not influence the overall trade deficit figure significantly but they do affect more detailed commodity analyses.

It is important to note that mis-measurement of trade statistics is likely to increase with greater activity in new fields such as e-commerce. For example, trade in software downloaded on-line is not captured in current trade statistics. Such activities reduce the accuracy of import data as well. From the point of view of the United States, such transactions are unlikely to balance in terms of exports and imports. Indeed, as a world leader in many of these new high-tech industries, the United States is almost certainly a net exporter of these goods and services. Hence, the undercount of such activities is likely to overstate the U.S. trade deficit.

Clearly, then, one "solution" to the trade deficit is improved data collection and dissemination. This could be achieved through a thorough overhaul and modernization of the trade data system, applying modern information technologies such as filing on-line for exporters. One model for this is the International Trade Data System (ITDS) which has yet to find federal funding.[6]

C) The U.S. Trade Deficit

Relative Size: In 1998, the U.S. deficit on trade in goods and services was $164 billion. This was 1.9% of U.S. GDP. While this is a sizeable deficit, it is less than the 1980s when the trade deficit exceeded 3% of GDP over several years.

Trend: For the first five months of 1999, the U.S. trade deficit on goods and services was $94 billion. On this trend, the U.S. deficit for 1999 will be $240 billion – a third larger than in 1998. Even allowing for mis-measurement, this still leaves the United States with a significant trade deficit.

D) Interpretation of the Trade Deficit

The simple meaning of a trade deficit is that the United States is buying more from abroad than it is selling to foreigners. In other words, foreign residents are accepting dollar bills in exchange for the goods and services they send to the United States, rather than U.S. products. Those dollar bills are then being used to invest in dollar-denominated U.S. stocks, bonds and other financial assets.

This linkage between trade and international financial assets is

essential to understanding the trade deficit. The United States is currently consuming more than it is producing. It has to finance this pattern of consumption. It could be using foreign assets to pay for the imports but we have seen that it is also running a deficit on investment income. Hence, it must be borrowing from abroad. The United States is thus running a current account deficit (i.e. deficits on trade, investment income and unilateral transfers) and a capital account surplus.[7] Indeed, a current account deficit and a capital account surplus are opposite sides of an accounting identity. **A nation can only run a current account deficit if it is also a net borrower from the rest of the world and vice versa.** The question we are analyzing could thus be posed "what is causing the United States to be a net borrower from the rest of the world?"

It is important to note that trade deficits and their accompanying capital account surpluses are not, per se, either "bad" or "good" for the economy. Like all borrowing, whether a capital account surplus is beneficial depends on what the United States is doing with its borrowed capital. If foreign capital is being used to finance productive investment, the U.S. economy will benefit from greater productivity, output and income in future. The United States would then be able to use some of its extra output to pay back its debt. Conversely, if the borrowing is being use to finance government budget deficits (as in the 1980s), the deficit will eventually have a negative effect on the economy – through a reduction in aggregate consumption.

E) Causes of the Trade Deficit

One obvious candidate is the value of the dollar. A strong dollar makes exports more expensive to foreign consumers and makes imports cheaper. Hence, it encourages imports and discourages exports, increasing the trade deficit. Indeed, the dollar has appreciated by 8-15% against the Canadian Dollar, the Euro and the Yen since 1996.[8] However, the value of the dollar is in itself a dependant variable. It, like any other price, is determined by supply and demand.

The fundamental factor underlying both the strong dollar and the U.S. trade deficit is the relative strength of the U.S. economy. The United States has exhibited strong economic growth over the past three years - particularly in relation to the weakness of the other major economies in the world (mostly in Asia and Europe).[9] This has two reinforcing effects.

1. In the "real" economy, strong economic growth in the United States means high demand – for all goods and services, including imports. Conversely, weak demand in Asia and Europe has depressed demand for U.S. exports. Indeed, U.S. exports to Japan were 12% lower in 1998 than in 1997 and U.S. exports to the Asian NICs fell by nearly 20% over the same period. Conversely, U.S. imports have been rising at an annual rate of 5-10 % since the 1980s. [10]

2. On the financial side, the relatively strong U.S. economy is encouraging an inflow of foreign capital into all types of U.S. stocks, bonds and financial assets. This inflow of capital is further fueling the stock market boom, which in turn increases the net wealth of U.S. households. These U.S. households are thus increasing consumption (and decreasing saving).[11] Since some of this consumption is spent on foreign goods, imports increase and the trade deficit worsens. Similarly, the inflow of foreign capital is increasing demand for the dollar. This increased demand is driving the appreciation of the dollar, making imports cheaper. In effect, the capital account surplus is driving the trade balance.

An important question resulting from this analysis concerns how long the capital inflow and the strong dollar will last. As the economies in Asia recover from the recent crisis and as Europe pulls out of recession, the capital inflow into the U.S. will decline. This will slow (or even reverse) the recent stock price boom and put downward pressure on the dollar. A weaker dollar combined with slower wealth accumulation in the United States will discourage imports and improve the balance of trade in goods and services. The real question is whether this readjustment will occur gradually or in a sudden, more disruptive shock. However, it is notoriously difficult to predict the precise timing and magnitude of such a realignment.

Conclusion

The large and growing U.S. trade deficit has recently been the cause of many headlines and it will no doubt continue to be so in the coming months. Before leaping into an analysis of the "cause" of such a figure, several points need to be made. First, many different figures are quoted in the media and in public debate and it is important to use an accurate figure. Talking about a deficit in goods makes as much sense as pointing out that the United States has a large and growing deficit in leather products and, from that, inferring something about the state of the U.S. economy. Second, trade data is widely inaccurate – and will

become increasingly so unless significant attempts are made to improve data collection and dissemination.

Bearing these points in mind, the United States appears to have a large and growing trade deficit in goods and services with the rest of the world. It is currently projected to be $240 billion in 1999 - more than 3% of GDP. The main cause of this is the strong economic growth of the U.S. economy (compared to the rest of the world) and the concomitant attractiveness of the United States as a place to invest. The sustainibility of this deficit thus depends on one's view of the likely path of the U.S. economy and stock market and economic recovery in the rest of the world. A decline in the capital inflow into the United States and a depreciation of the dollar seem likely. Both would act to improve the U.S. trade deficit. Predicting when and by what magnitude such a readjustment takes place is beyond the scope of this paper.

Notes

1. 1998 figures.

2. The U.S. had a deficit in leather and leather products of $13.8 billion in 1998.

3. A negative sign denotes a net outflow.

4."Understatement of Export Merchandise Trade Data", July 1998, Foreign Trade Division, U.S. Census Bureau. Available on the web at www.census.gov/foreign-trade/aip/expunder2.htm

5. According to a study by the Small Business Administration, small businesses account for 96% of all U.S. exporters and 30% of the value of U.S. exports. *"Exporting by U.S. Firms"*, April 1998 available on the web at www.sba.gov/advo/stats/exp_rp.htm

6. For more information see www.itds.treas.gov

7. In 1998, the United States ran a capital account surplus of $210 billion. Allowing for a $10 billion statistical discrepancy, this balances the current account deficit.

8. The dollar has obviously appreciated by even greater amounts against currencies affected by the recent financial crisis such as South Korea (50%), Thailand (50%) and Brazil (80%) .

9. The United States averaged growth of 3.9% for 1998, compared to -2.8% in Japan, 2.8% in the European Union and -1.5% in newly-industrializing Asian economies.

10. With the exception of 1991. Note that this should act to depreciate the dollar (as there is reduced demand for dollars to buy U.S. products).

11. Personal savings rates in the United States fell below 4% in 1997 - the lowest rate since the second World War.