Untangling the trade deficit

TIMOTHY TAYLOR

THE competition for most misunderstood economic statistic is hard-fought, but there is a clear winner: the trade deficit. No other number is interpreted so differently by professional economists and the general public. Common reactions to the U.S. trade deficit range from belligerence to dejectedness: It is thought that America's trade deficit exists either because of the skullduggery and unfair trade practices of countries that shut out U.S. products, or because American companies are failing to compete against their global competitors. In either case, the preferred solution is often to get tough in trade negotiations for the sake of protecting U.S. jobs. But, according to most economists, cutting across partisan and ideological lines, such mainstream beliefs about cause, effect, and solution are wrong. Even more bothersome, these popular beliefs are wrong not simply because the evidence is against them—although it is—but because they reflect fundamental misunderstandings of what the trade deficit is and how it interacts with the rest of the economy.

America's economic illiteracy on this subject may come to matter a great deal. The U.S. trade deficit has been on the rise, from $56 billion in 1992 to $155 billion in 1997. But the recent economic troubles in East Asia are prompting predictions that producers in those countries will flood U.S. markets with imports while reducing their purchases of U.S. exports, which will increase the 1998 trade deficit by $50 billion or more. In political terms, America's rising trade deficit will aid and abet the anti-free-trade forces, which run the gamut from Richard Gephardt on the left to Patrick Buchanan on the right, along with Ross Perot in some dimension all his own. There will be increased pressure for cutting back on U.S. imports from other countries, resistance to giving the president fast-track approval to negotiate trade agreements without fear they will be picked apart in Congress, and opposition to future free-trade agreements.

Along with most economists, I believe that the attempt to reduce global trade is both impractical and unproductive. But it would be especially foolish, verging on surreal, if America were to make the mistake of turning its back on free trade in part because of a lack of basic economic literacy about what a trade deficit is and what it means.

Components of the trade deficit

Part of the confusion about the trade deficit arises because the U.S. Department of Commerce reports several versions of the trade deficit, and the differences among them can be tens of billions of dollars. In mid February 1998, for example, the *New York Times* ran a story discussing a 1997 "trade deficit" of $191 billion. About a week later, I saw an Associated Press release discussing the 1997 trade deficit of $114 billion. Even as I read these articles, I knew that the Department of Commerce would not release its preliminary version of what most economists consider the most definitive measure of the 1997 trade deficit until mid March 1998; after being revised slightly in mid June, this measure of the trade deficit came in at $155 billion. None of these trade-deficit numbers are wrong; they are just defined differently. But, for the casual reader, the parade of different numbers must create some confusion.

The biggest trade-deficit number, which was revised in June

1998 from $191 billion to $198 billion for 1997, is calculated by taking America's exports of goods and subtracting America's imports of goods. The fact that it is a deficit, rather than a surplus, means that imports of goods are $198 billion larger than exports.

But, in the modern economy, it is surely too limiting to consider goods only. In 1997, just 36 percent of the U.S. gross domestic product (GDP) was goods while 55 percent was services. (The rest is structures and changes in inventories.) Some services are obviously difficult to trade internationally: It's not clear how one ships housecleaning or haircutting services overseas. But many services like finance, law, expert design, computer programming, and advertising, can be and are traded internationally. While the U.S. economy runs trade deficits in goods, it runs substantial and growing surpluses in services trade. The U.S. surplus in services trade increased from $27 billion in 1990 to $88 billion in 1997. The lowest figure reported above for the 1997 "trade deficit," $114 billion, was actually the preliminary estimate of the "goods and services" trade deficit, which adds the trade deficit in goods to the trade surplus in services. The goods and services deficit is clearly a better measure of the trade deficit than goods taken alone. There is no economic justification for arguing that goods like computers should be counted in the trade statistics, while services like computer programming should not be, or that goods like cars should be counted in the trade statistics, but the services of car advertising and providing loans to buy cars should not be.

For economists looking for a single statistic to capture the trade balance, two elements remain. The first is foreign investment income. To calculate the balance of investment income, one begins by calculating the return on investment paid to all foreign investors—government and private—who have put money in the United States. Conversely, one then calculates the return on investment received by all U.S. investors, whether government or private, who have put money abroad. America's investment income balance was consistently in surplus for decades—until 1997. That is, the foreign assets held by U.S. investors have typically paid them more than foreign investors received in payment on their investments in the

United States. But, in 1997, the United States ran a deficit in investment income for the first time in decades—$5 billion.

It may be objected that these interest income payments are not bought and sold in a way that should cause them to be lumped into the same category as trade in goods and services. Of course, investment income is less solid than a car or a computer, but tangibility alone does not settle the issue. After all, trade of services is intangible as well, and it's clear enough that services should be included in the trade statistics. Investment income is also a paid for intangible service; namely, the use of foreign capital. Thus investment income follows a pattern identical to that of trade. Returns flowing out of the United States to foreign investors are similar to U.S. imports from abroad: They both result in U.S. dollars being paid elsewhere. Similarly, returns flowing into the United States to U.S. investors who have put their money abroad has an effect similar to U.S. exports: They both result in payments flowing from foreign economies to the United States.

The final category in the overall trade picture is "unilateral transfers." This includes both government grants and money sent abroad privately (say, by an American worker to overseas relatives). Transfers from the United States function like imports; that is, if Americans buy coffee imported from Brazil, or if the government sends foreign aid abroad, the economic effect is that U.S. dollars end up in foreign hands. The American economy typically runs a deficit in unilateral transfers. It sends more abroad than it receives. But not always. During the Gulf War in 1991, for example, when other countries were sending money to the United States to help defray our military expenses, the U.S. economy ran a small surplus in unilateral transfers of $5 billion. In its economic effect, it was as if the United States had exported military services to the Middle East and was being reimbursed for that service by others. But, during most years in the 1990s, the United States has had a deficit in unilateral transfers of $35 to $40 billion.

Adding up the trade balances in goods, services, investment income, and unilateral transfers gives the broadest measure of the trade balance: what is known as the *current account balance*. In 1997, the $198 trade deficit in goods, the $88 billion

surplus in services, the $5 billion deficit in investment income, and $40 billion deficit in unilateral transfers, brought the U.S. current account balance to a deficit of $155 billion.

Popular myths

Much popular thinking about the trade deficit is based on a few well-known facts about the United States and Japan. The Japanese economy is more closed to trade than the U.S. economy. In certain areas, Japanese firms have made considerable inroads into U.S. markets. Japan runs trade surpluses while the United States has a trade deficit. Based on these facts, it might seem plausible to assume that the U.S. trade deficit results from some combination of foreign-trade barriers or U.S. firms being outsold by foreign competitors. But, if one looks either at data over time, or at trade statistics from around the world, one sees that any such conclusion is premature.

Consider, for example, the U.S. trade deficit during the three decades from the end of World War II to the mid 1970s. The U.S. current account was in deficit during only five years of that span. Yet this string of trade surpluses would hardly prove that America was leading the world in unfair trade practices and import restrictions. Indeed, the United States was moving the world during this time period, through the General Agreement on Tariffs and Trade (GATT), toward a greater degree of open trade and lower import barriers.

Conversely, for substantial portions of these postwar decades, nations like Japan and South Korea were running trade deficits. For example, Japan ran trade deficits from 1961 to 1964, in 1967, and again from 1973 to 1975. South Korea ran trade deficits every year from the 1960s into the early 1970s. Of course, these trade deficits do not prove that the Japanese and South Korean economies were very open to imports from the rest of the world at this time. Indeed, their economies were far more closed to imports at that time than they have been in recent years.

Or consider the roller-coaster ride of the U.S. current account balance in the last two decades. It sank from a surplus of $5 billion in 1981 to a deficit of $11 billion in 1982, and then the trade deficit dived to $44 billion in 1983, $99 billion in 1984, and so on down to $168 billion in 1987. The current

account deficit then rose to a deficit of only $6 billion in 1991, before collapsing again to a deficit of $155 billion in 1997 and heading even lower in 1998.

If one is to believe that trade deficits occur because of how well U.S. firms match up to foreign competition, then one must believe that the competitiveness of U.S. firms collapsed from 1981 to 1987, surged back toward equality from 1987 to 1991, and has collapsed again since then. But neither the productivity statistics nor the anecdotal evidence provides any support for such an argument. If one is to believe that trade deficits occur because of unfair trade practices, then one must believe the following: From 1981 to 1987, the rest of the world unfairly blocked U.S. exports; but, from 1987 to 1991, it allowed free trade, only to retreat to gross unfairness during the last six years. Again, there is literally no evidence that trade laws, whether here or abroad, have changed in the dramatic ways that would be needed to explain what has actually occurred.

The lack of a connection between trade surpluses and trade practices is apparent when one looks at different countries around the world, as well. True, Japan is running a trade surplus. But South Korea, Thailand, and India are now running trade deficits—a fact that hardly makes them exemplars of openness to imported products.

The true meaning of trade deficit

Thus to understand the *actual cause* of trade deficits, we must return to the question of what a trade deficit really is. All the items on the surplus side of the current account balance—exports of goods and services, investment income received by U.S. investors who have capital abroad, and unilateral transfers to the United States—involve money flowing from elsewhere into this country. Conversely, all the items on the deficit side of the current account balance involve money flowing abroad. It would be insufficient, however, simply to stop here. Something else must be considered.

I have been expressing all U.S. imports and exports in U.S. dollars, as is conventional to facilitate comparisons. But that holds true for only half the trade picture. Money flowing out of the United States is in U.S. dollars; money that is earned by U.S. exporters—say, when an American-built car is sold in

Germany—is not originally received in U.S. dollars but, instead, in foreign currencies. A U.S. company that earns foreign currency by exporting abroad will seek to convert that money to U.S. dollars at the prevailing exchange rate, and then use those dollars to pay off its American-based costs. Similarly, a Japanese or German company selling in the United States will convert its U.S. dollars to its own currency, and then use the yen or marks to pay off its own costs. After all, workers, suppliers, and investors generally desire to be paid in the currency of their own country. Banks—or more generally, the foreign exchange markets—act as middlemen, helping both sides to exchange the currencies they have earned by selling their products abroad for the currencies they need to pay their costs in their home economies.

This view of foreign trade, as involving both a two-way flow of imports and exports and a corresponding two-way flow of currencies being bought and sold in the foreign exchange markets, takes us near the crux of the matter. The U.S. trade balance can be viewed as a matter of comparing the amount of U.S. imports of goods, services, investment income, and transfers—all paid in U.S. dollars—with the value of U.S. exports of these items—all paid in the form of various world currencies—at the world's prevailing exchange rates. Again, the trade deficit means that imports are larger, by $155 billion in 1997.

But consider that description of the trade deficit for a moment, and a buried truth emerges. When the values of the imports and exports were added up, in their various currencies, and then were traded, the amount in dollars was apparently greater than the amount in foreign currencies, at the existing exchange rates. The existence of the $155 billion trade deficit in 1997 reveals that this many U.S. dollars were earned and not traded for foreign currencies by foreign companies and investors. They apparently remained in the form of U.S. dollars!

What happened to those dollars? Well, they didn't get spent on U.S. goods and services, since that amount was already counted into the trade balance. In the end, those U.S. dollars are invested in U.S. assets, like stocks and bonds and real estate. In economic terms, this is what the trade deficit really

means. The United States, like any nation with a trade deficit, is sending extra amounts of its currency abroad, currency that is then invested into U.S.-dollar-denominated assets. To put it another way, the amount of the current account deficit measures the net amount of investment received by the U.S. economy from abroad. Conversely, an economy with a trade surplus, like Japan's, is receiving extra amounts of foreign currency from its exports to other countries, and then investing those currencies abroad.

This insight might seem implausible, at least at first. The confusion and uncertainty over identifying trade deficits with investment flows often begins, I believe, with the habit of expressing all trade figures in U.S. dollars. It might be convenient, but the habit conceals the fact that trade happens in many currencies, not just one. For example, when Americans buy a car made in Japan, the dollars earned through U.S. imports are traded in foreign exchange markets, allowing the firm to cover its Japan-based expenses, measured in yen (the reverse process happens for U.S. exports). If we neglect such currency flows, which are the necessary counterpart of international trade, we overlook what other countries can do with their earnings from selling to U.S. consumers.

Now it's true that the Japanese exporter could just put the U.S. dollars in a bank account. But then the bank would invest the dollars in U.S. bonds, so that the bank account can pay interest to its depositors, which is a form of investing the money in U.S. assets. The Japanese firm could just keep the money. By investing it in a bank account or in U.S. property or stock, the foreign firm is indeed keeping the money—but that doesn't contradict the fact that they are putting it into dollar-denominated assets.

So why doesn't the Japanese firm just keep the money and invest it in Japan? The problem is that in Japan, prices are quoted in yen, and if one wants to invest U.S. dollars earned from exporting to the United States in Japanese stocks or property, one needs to convert them into yen. This means that a bank or foreign exchange trader holds the U.S. dollars, and then trades them to someone who wants to buy something with the U.S. dollars or invest them in a dollar-denominated asset—like those found in the United States. Nor does one

escape the connection from the trade deficit to international investment flows by pointing out that some deals around the world can be done in U.S. dollars. Of course, foreign cab drivers and hotels in many major cities around the world will take U.S. dollars and some foreign property can be purchased in U.S. dollars. But then the seller, whether cab driver or property owner, will take those U.S. dollars to the bank, or trade them to someone who will take them to the bank, where they will eventually be used to buy U.S. goods and services or be invested in the United States.

No matter what road the dollars in the current account deficit take, the ultimate destination is the same. By definition, the U.S. dollars in the current account deficit are money not spent on U.S. goods and services, not used to pay investment income, and not sent in unilateral transfers. Ultimately, through the twists and turns of the financial system, they end up invested in U.S. assets.

Capital flows are key

Because the point is central, and perhaps difficult to grasp, it will be worthwhile to examine two different ways of expressing trade deficits and capital flows. Begin by thinking in terms of what a nation produces and consumes. In a world without foreign trade, a nation can only consume what it produces. But in a world with trade, a nation can borrow from abroad, use the money to consume more goods and services than it currently produces, and promise to repay later. A nation like the United States which does this is running a trade deficit, and the amount of the trade deficit measures both the extra goods purchased from abroad and the inflow of capital from abroad. Conversely, economies like Japan with trade surpluses are producing more than they consume. They are taking the amount that they earn from producing more than they consume and investing it abroad.

Yet another way to phrase the same idea is to think in terms of how much a nation saves and invests. In a world without trade, a nation can only invest what it saves. But, in a world with trade, a national economy has two potential sources of capital: domestic savings and capital flowing in from abroad. The trade deficit means that the U.S. economy is able to

invest more than it saves domestically, because it can rely on foreign investors sending us some of the U.S. dollars they have earned by exporting to the United States. Conversely, Japan's trade surplus means that its economy is investing less than it saves domestically, because some of its savings from export income are flowing overseas to the United States and to other countries.

Thus a trade deficit means that a nation is receiving net investment from abroad. Equivalently, a trade deficit means that a nation is consuming more than it is producing. Again equivalently, a trade deficit means that a nation is investing more than its domestic savings. A trade surplus would reverse these statements.

These connections between trade deficits and international flows of capital are not a "theory" of economics. Economists disagree on many subjects. But since economists of all stripes share a common definition of basic terms—like what the current account balance is—they agree that a trade deficit reflects the net inflow of capital from foreign investors.

Perhaps the most vivid misunderstanding of the trade balance occurs when one hears a politician announce that he wants his country to have both a trade surplus and an inflow of foreign investment. These two desires are flatly inconsistent: The only way to have a net inflow of foreign investment is to run a trade deficit. If the nation runs a trade surplus, it is necessarily a net investor abroad.

Understanding the connection between trade deficits and capital flows also helps to explain the position of the United States as a debtor economy. That the United States ran trade surpluses for most of the years from World War II to the mid 1970s meant it was a net investor abroad in those years. U.S. investors as a group gradually built up a surplus of the money they invested abroad. In 1982, for example, U.S. investors owned $1,100 billion in direct investments abroad while foreign investors owned $736 billion in U.S. assets. Thus the U.S. economy viewed as a whole had built up a surplus position of $364 billion.

However, the large U.S. trade deficits since the early 1980s have meant that the U.S. economy was receiving net investments from abroad. By 1986, according to the U.S. Depart-

ment of Commerce, U.S. assets abroad were equal to foreign investment in the United States, at about $1,300 billion. By 1996, U.S. assets abroad had climbed to $3,720 billion, but thanks to the trade deficits, foreign assets in the United States had reached $4,591 billion. Instead of being an international creditor, the string of trade deficits had turned the U.S. economy into an international debtor to the tune of $870 billion. As an inevitable consequence of running large trade deficits year after year, the U.S. economy has for some years now had the largest debt of any economy in the world. (However, in proportion to the enormous U.S. economy, the accumulated U.S. foreign debt is still a much smaller proportion than that of many other countries.)

Most of this foreign debt is not owed or guaranteed by the U.S. government. Thus it can be misleading to refer to the "U.S. foreign debt" or "America's debt." American taxpayers aren't on the hook for the money, and much of this money need not even be repaid in any direct way. For example, if foreign investors bought U.S. stocks or land, and those investments decline in value, the investors have no recourse for retrieving their original investment. The U.S. foreign debt simply refers to the fact that the magnitude of investments made by some foreigners in the U.S. economy exceeds the amount of investment by some Americans in foreign economies.

Concerns over the trade deficit often seem to become intertwined with concerns over the effects of foreign trade in general, but, as a logical matter, these two subjects should be treated separately. Foreign trade poses policy concerns, whether or not it results in a trade deficit, because it is a source of stress to an economy. Of course, a market economy has many other sources of stress: pressures of competition from domestic firms, new technologies, management fads, managers who are incompetent or tyrannical or unlucky, rapid shifts in consumer preferences, and others. These stresses can pose grave difficulties for companies, workers, and regions if skills and efforts no longer bring in the expected economic return. But the paradox of capitalism is that these stresses and dislocations produce pressures for improvements in products and technology which, over time, raise the general standard of living.

The trade deficit is not directly linked to these stresses. If

America had a trade deficit of zero but exports and imports continued at something similar to present levels—roughly 12 percent to 13 percent of gross domestic product—then U.S. workers and companies would still face the stresses of competition from abroad, both from low-wage countries like Mexico and China and from high-technology competitors like Japan and Germany. The trade deficit is a separate issue: It matters simply because it means that an economy is relying on inflows of foreign capital while a trade surplus reveals that a country is a net investor abroad.

Good jobs at good wages?

It is widely believed that the trade deficit reduces the number of jobs. Sometimes one hears estimates that every $1 billion of the trade deficit costs 15,000 to 20,000 jobs. The basis for such claims can be understood with a calculation so casual that it barely deserves to be dignified as back-of-the-envelope. In 1997, the U.S. GDP was $8 trillion. Total employment was 130 million. As a matter of proportions, if an $8 trillion GDP results in 130 million jobs, then every $1 billion works out to 16,250 jobs. Tinker with the formula and the job loss estimate will quiver, but the basic idea is that expanding exports or contracting imports will raise the GDP, and thus increase the number of jobs.

The connection from the trade deficit to jobs may seem clear; surely more exports would reduce the trade deficit and increase the number of jobs. Moreover, we all know that Japan has trade surpluses, and Japan has had a relatively low unemployment rate. But this is a shaky basis for showing an economic connection. A respectable theory should hold true for many different countries and across time, even if we allow a few exceptions for peculiar circumstances. By that standard, the connection between trade deficits and the total number of jobs in the economy is small or nonexistent.

Consider the U.S. economy since the mid 1980s. The enormous growth in current account deficits in the 1980s was matched by a surge in the number of jobs from 100 million in 1982 to 112 million in 1987. The shrinking U.S. trade deficit from 1988 to 1991 occurred at roughly the same time that U.S. job growth stagnated. Employment was roughly the same

in 1991 as in 1989, at about 117 million jobs, which probably cost George Bush a second term in office. The rising trade deficit since 1991 has been accompanied by an economic surge that has increased the number of U.S. jobs from 117 million in 1991 to 130 million in 1997.

Or consider various European economies. Germany ran substantial trade surpluses through the 1980s and in part of the 1990s; France has run large trade surpluses in the 1990s. But, in both countries, unemployment rates have been stuck above 10 percent. Or look at the recent experience of Japan: The trade surplus remains as high there as ever, but Japanese unemployment has been rising as its economy has slowed in the last few years.

In light of such evidence, it is difficult to argue that trade deficits result in fewer jobs and trade surpluses result in more jobs. Unemployment springs from other causes. For example, high unemployment rates in Europe probably result from the large number of regulations affecting the labor market. Load up potential entrepreneurs with regulations about when and where and how they must operate, and how many licenses and government approvals they must have, and job creation will slow down. Load up existing employers with social taxes and burdens for everyone they hire, and with rules prohibiting firings and layoffs, and they will become reluctant to hire. Enact generous unemployment and welfare benefits that last for years, and the incentive of workers to find jobs is diminished. These factors explain why Europe has high unemployment, despite frequent trade surpluses, while the United States has low unemployment, despite its trade deficits.

Another potential cause of unemployment occurs when the level of aggregate demand in an economy is so low that the economy sinks into recession, and businesses cut back on production and hiring. The standard economic remedies in this case are to pump up demand, perhaps with a tax cut or higher spending by the government, or with lower interest rates from the central bank to encourage borrowing and buying. The arguments for connecting trade deficits and jobs often seem to be based on the assumption that higher exports and a lower trade deficit, with all else constant, will mean more demand in the economy. One reason that U.S. politicians have recently

been telling Japan to stimulate its economy, for example, is that they believe it will add to demand for U.S. products.

But the assumption that U.S. exports will rise and nothing else will change is misplaced. The Federal Reserve under Alan Greenspan continually monitors the amount of demand in the economy, trying to keep it moving forward, while avoiding inflation. If other countries stimulated their economies and increased the amount of demand for U.S. goods, the Federal Reserve would counterbalance that increase in demand with slightly higher interest rates. As long as the Federal Reserve wants to keep the amount of demand in the economy at a certain level, it will offset any effects that occur through trade. As a result, changes in trade balances will not affect the overall demand or the number of jobs in the economy.

Even if the trade deficit does not affect the number of jobs, concerns have been expressed that trade may affect America's wage levels; in particular, some economists have argued that trade with low-wage producers in countries like China and Mexico is contributing to the rise in wage inequality in the United States. A mainstream estimate is that trade might account for one-fifth of the increase in wage inequality that has occurred over the last few decades, although there are disputants on both sides of the debate. However, for purposes of focusing on the trade deficit, the argument over how trade affects wages is not relevant, because as already noted, the level of trade and the trade deficit are not the same thing.

If an economy has lots of trade, then that trade will have some impact on wages in that economy, regardless of whether the trade is in surplus or deficit. If an economy has relatively little trade, then trade will have a smaller impact on wages, regardless of whether the trade is in surplus or deficit. The amount of trade overall relative to the size of the economy is what affects wages, not the balance between exports and imports. The claims that the trade deficit is causing lower wages for unskilled workers or that reducing the trade deficit would help wages for unskilled workers are mistaken. Economists in countries with large trade surpluses, like France in recent years, are just as worried about how trade might reduce wages for low-skilled workers as their counterparts are in the United States.

Solutions to the trade deficit

The solution to the trade deficit may seem obvious; either reduce imports or increase U.S. exports. But economics is a study of sometimes unexpected interconnections and tradeoffs, and when the likely consequences are taken into account, these seemingly obvious solutions may not work at all.

On a political level, consider the situation where the United States takes actions to reduce certain imports from abroad, and our trading partners retaliate by shutting out an equivalent level of their imports from the United States. As a result, both U.S. imports and exports fall by the same amount, and the trade deficit is left unchanged. (While it is true, by definition, that eliminating trade would eliminate the trade deficit, this would surely be a case of throwing out the baby with the bathwater.)

A similar counterbalancing can readily occur through purely economic forces. Imagine that after much harrumphing, U.S. trade negotiators succeed in persuading Japan to reduce some of its trade barriers. U.S. exports from a certain industry rise as a consequence, and income and production levels rise in that industry. Will the U.S. trade deficit fall? Maybe, and maybe not. Perhaps Japan buys more from one U.S. industry, but buys less from another U.S. industry. Then overall U.S. exports might not change. Or perhaps as a result of buying more imports from the United States, Japan now buys fewer imports from other countries, like Germany. As a result, German consumers have less income and buy fewer American exports. U.S. exports rise to Japan but fall to Germany, and the overall trade deficit does not change.

Or perhaps as U.S. exports to Japan rise, U.S. workers and shareholders take the extra money that they have earned from increased foreign exports and spend it on imported products. Then U.S. imports rise with U.S. exports, and the trade deficit doesn't change. It's unlikely, no doubt, that those who receive additional income from the rise in exports would literally spend all of that extra income on imported products. But say that those who receive the extra income spend some of it on imported products, and some of it on domestic products, like groceries or clothes. Then, those in the domestic economy who receive income from the groceries and clothes spend some

of the money on imports and some on domestic products. As the money cycles through the economy, with some proportion being spent on imported products in each cycle, it is quite plausible that the total amount spent on imports will counterbalance the rise in exports.

These examples illustrate that it is simply wrong to claim that any rise in exports or fall in imports will inevitably change the trade deficit. Sometimes it will, and sometimes it won't. It depends upon what else occurs in the economy. As it turns out, the argument that rises in exports or falls in imports will change the trade deficit depends upon a key missing factor—the amount of saving that occurs in an economy.

Once again, imagine that U.S. trade negotiators manage to lift some foreign trade barriers, and U.S. exports rise accordingly. Say that in Japan, the extra U.S. imports are purchased by reducing the level of saving in the Japanese economy. In this case, U.S. exports rise, there is no potential for an offsetting effect on other U.S. industries, and Japan's trade surplus will fall. Or consider what happens if, as U.S. exports rise, American consumers save the money instead of spending it. Now, none of that money cycles back into purchasing imported products, and the U.S. trade deficit will indeed fall.

In short, if higher U.S. exports result in increased saving in the United States, then the trade deficit will indeed change. But this argument proves more than expected. Actually, the original change in trade barriers that affected U.S. exports and imports isn't what is affecting the trade deficit; instead, the change in saving is doing the trick.

If the U.S. economy saved more, then it would be buying fewer imports and sending less money abroad, and the trade deficit would decline. Similarly, if the Japanese economy saved less, then it would be buying more U.S. products instead of investing dollars back into the U.S. economy, and Japan's trade surplus would decline. If the United States (or any country) saves more and spends less, it will borrow less from abroad and reduce its current account deficit; if Japan (or any country) saves less, then it will have less to invest abroad and it will reduce its current account surplus. The economic solution to a current account deficit is not to be found in trying to manipulate import and export levels through trade negotia-

tions; instead, it is to be found within a country's own saving and investment rates.

If this insight seems odd, recall the underlying meaning of a trade deficit. A trade surplus means that a country has money it has earned abroad, which is not being spent on foreign goods and services. If such a country spent that money on goods and services, instead of saving it and investing it abroad, its trade surplus would decline. In the opposite case, if a country saves more, instead of spending the money on imported products, it is relying less on capital from foreign investors, and these investors have earned less capital from their exports to lend it. Such a country is coming closer to consuming only what it produces, or investing only what it saves, or not receiving net foreign investment from abroad, any of which would imply a trade balance of zero.

To borrow or not to borrow

So is it an important policy goal for the United States to increase its level of savings for the purpose of reducing the trade deficit and, equivalently, avoiding a dependence on net inflows of foreign capital? The argument over trade balances often seems to presume that having a trade deficit must be bad for an economy while having a trade surplus is necessarily good. Adam Smith exploded this myth in *The Wealth of Nations*. All that a trade deficit means is this: A nation is receiving net investment from abroad. Whether that investment is economically sensible is another matter.

Borrowing is economically sensible when it finances productive investment; it is less sensible when it finances past consumption. Thus borrowing for a college education typically makes economic sense, because college graduates earn enough more than nongraduates that the loan can be paid back while still leaving the borrower better off. A business borrows to buy new equipment in the hope that it will produce enough value to allow paying back the loan, with a profit left over. However, borrowing to dine out at fancy restaurants every night will typically not make economic sense, because eating expensive dinners will not generate a stream of income that will help to pay off the loan.

A number of nations, at different points in history, have run trade deficits, borrowed from abroad, invested that money sensibly to promote economic growth, and then were able to pay back the foreign borrowing with the fruits of economic growth. One example is the U.S. economy of the nineteenth century, which borrowed much of the money for infrastructure investment, like railroads, from European capital markets. However, the U.S. economy was able to pay back that money because of resulting economic growth. A more recent experience is that of South Korea, which ran substantial trade deficits in the 1960s and 1970s, borrowed from abroad, invested that money in developing its economy, and, until recent events in East Asia, was able to pay back the money.

Some nations have borrowed abroad unwisely. Perhaps the most vivid examples in recent memory are Latin American debtor nations like Brazil and Mexico in the late 1970s and early 1980s; they borrowed hugely, and their governments guaranteed that the loans would be repaid. However, the money was not invested in a way that generated sufficient economic growth. And when economic events (like higher interest rates) turned against them, they found themselves unable to repay on schedule. Consider the recent example of East Asia. These economies were running substantial trade deficits while receiving heavy foreign investment. Trouble started because they were unprepared for the possibility that the spigot of foreign investment might be turned off.

So the question of whether the United States in the 1990s should try to save more, reduce its trade deficit, and rely less on foreign capital turns, in part, on whether the inflow of foreign capital is financing consumption or investment. There is a plausible argument to be made along the lines that even if the U.S. trade deficit is worrisome in the 1990s, it is less worrisome than it was in the 1980s. The Council of Economic Advisers put it this way in its 1998 report:

> The Nation's current account deficit equals its borrowing abroad to finance any excess of investment over domestic saving. The current account is therefore a macroeconomic phenomenon that mirrors the gap between what we as a Nation invest and what we save. The large Federal budget deficits of the 1980s and early 1990s were a form of negative saving, or dissaving, which reduced the total amount of national saving available to cover the nation's investment in

plant and equipment. In an important sense, the Nation was overconsuming in the 1980s, financing its consumption binge by borrowing from foreigners. The result was a large and persistent current account deficit.

We still have a current account deficit today, but for a very different reason. The near elimination of the budget deficit has left more saving available for investment by plant and equipment by the private sector. National saving has risen. But because of the investment boom during this expansion, the gap between investment and saving has persisted. Once again, this shortfall is made up by borrowing from abroad, and the result is a current account deficit. But there is a big difference between borrowing to invest—as the Nation is doing now—and borrowing to consume as we did in the 1980s. In fact, running a trade deficit in order to expand productive capacity is not new to American history—we did much the same thing in the last century, to build up the Nation's infrastructure, most notably during the railroad construction boom. Ironically, therefore, today's trade deficit reflects the economy's current success in growing more rapidly than our trading partners and investing so much—and not our free trade policies.

This is the optimistic view of trade deficits: Borrowing to finance an investment boom may be a good thing. When people talk about eliminating the trade deficit, they must also mean eliminating the net inflow of foreign capital; the two inevitably go together. In 1997, for example, reducing the trade deficit to zero would have meant that $155 billion in investment capital was no longer available, which could have had a significant impact on the U.S. economy. Total U.S. investment was about $1,170 billion in 1997. Of this amount, about $330 billion went into residential housing, which is nice for the people living in that housing but which does little to raise the long-term growth rate of the economy. Of the remaining $840 billion, perhaps 60 percent went to replace worn-out capital, which would leave $336 billion as the investment in new capital. Thus subtracting $155 billion in investment capital—the amount America's economy received from the current account balance—would have meant that America was missing nearly one-half of the funding for new capital that it actually spent.

The peril of low saving

Having a trade deficit definitely beats lacking investment capital. But some enthusiasts go further, arguing that the trade

deficit should be viewed as a sign of strength. After all, they say, an inflow of capital confirms that the U.S. economy is the most productive and safest in the world for investing money. Those taking this point of view sometimes go on to point out that the language of "deficits" and "surpluses" is semantically misleading in the case of trade. It may seem obvious that a "deficit" is automatically a problem calling for a solution while a surplus is a worthy goal. However, many economists suspect that if the government and the media announced trade deficits as the "international investment surpluses," then public opinion might swing in favor of them. While it would be pleasant to whisk away concern over the trade deficit with this argument, I fear that it is, at best, a half-truth.

The choice between either having a shortage of investment capital or borrowing from abroad does not exhaust the policy options. A third option would be to increase America's domestic saving in a way that decreases reliance on foreign capital. If the United States relied on domestic savings for a greater share of its investment capital, then the returns from that investment would be received in the United States, rather than shipped abroad. The United States has just started having a negative balance in its investment income in 1997, and on current trends, that balance will only drop from year to year. These payments flowing abroad are the price to be paid for relying on foreign sources of capital. Moreover, an increased reliance on domestic savings would reduce the risk that when the economic winds next shift, the foreign money that has been flowing into the United States will start flowing somewhere else. The enormous U.S. economy will not be whipsawed by speculation in quite the same way as much smaller economies like Indonesia, Malaysia, and South Korea. But even the U.S. economy is vulnerable to the cold-eyed judgments of global capital markets.

However, raising America's level of domestic saving is more easily said than done. The evidence is quite clear that tax incentives—e.g., through Individual Retirement Accounts and 401k accounts—will increase the amount of savings *in those particular accounts*. But considerable controversy and uncertainty exists over whether that money may have been transferred from elsewhere; for example, if households have more

mortgage debt for their homes and greater consumer borrowing, along with more money in their IRAs, then their overall amount of saving may not have increased. By international standards, America has been a low-saving society for decades, and it's not clear that a scattering of tax incentives can reverse that trend. A full-fledged consumption tax, which taxes only consumption and not return on investment, might raise overall savings—but such proposals always stumble politically because they would mean lower tax rates for the wealthy, who receive a relatively higher share of their income as a return on investment. The shortcomings of limited tax incentives as a tool for increasing savings help to explain why so many economists put so much weight on reducing the budget deficit. The economics profession wasn't overly confident that incremental tax policies could increase the savings rates, but it knew that reducing the deficit would free up more of America's savings to be funneled into private investment, not government borrowing.

For a similar reason, a number of economists now support having the government run budget surpluses; it's a way of increasing national savings. A higher level of domestic savings is also the hidden agenda behind privatizing Social Security. One political deal that might take shape is that Social Security payroll taxes rise, but people get to put some or all of that extra money in a private account with their own name on it. Strip away the terminology, and this is simply a legal requirement that people save more for their own future.

America's ability to raise its level of savings may well determine whether the U.S. economy can remain tops in the world in average standard of living during the next century. It's probably not America's educational system that will do in the economy, since our weaknesses at the K through 12 level are somewhat counterbalanced by America's superior colleges and universities. America is unmatched in its scientific and technological capabilities, and in its ability, thanks to a free market, to turn those new technologies into cutting-edge businesses. However, the looming problem for the U.S. economy is a lack of investment in physical capital.

Consider some of our leading international competitors. Since 1980 or so, Japan has been investing 27 percent to 32 percent of GDP; Germany, 20 percent to 23 percent of GDP; France,

20 percent to 24 percent. Meanwhile, U.S. investment levels have been ranging as low as 15 percent of GDP in the early 1990s, before getting up to about 19 percent of GDP during the recent investment boom. The U.S. economy has been able to overcome its relatively lower level of investment in recent decades because of a dynamic and entrepreneurial economy, but we may not be able to do so forever.

The trade deficit and America's dependence on foreign capital are symptoms; the underlying disease is a lack of U.S. domestic savings and the way in which it holds down U.S. levels of investment. Trying to treat the symptoms of the trade deficit by talking tough in trade negotiations, or restricting imports, isn't likely to reduce the trade deficit—not unless the nation also treats the underlying problem of low savings.

A domestic policy problem

Around the world, each country's trade surplus or deficit should be understood as representing the gap between that country's own level of domestic savings and domestic investment. U.S. trade deficits exploded in the 1980s because of the rise in U.S. borrowing that occurred through high budget deficits. U.S. trade deficits have remained high in the later 1990s because of the surge of foreign investment in the U.S. economy. Japan's trade surplus has been so high because the extremely high Japanese savings rate exceeds the amount of domestic investment in Japan's economy. The current economic troubles in Japan and East Asia seem to be leading to higher savings rates in those countries, as people brace to tough out the economic storm and to lower investment levels. As money flows out of those economies, their trade surpluses are likely to rise while the U.S. trade deficit will worsen.

Trade deficits are not a reason to rail against foreign trade barriers, nor to despair of the competitiveness of U.S. firms. Solutions to the trade deficit will not be found in manipulating trade barriers; freer trade will add to global economic efficiency, favoring some domestic industries and disfavoring others, but will have little effect on the trade deficit. Reducing the trade deficit will have little effect on the unemployment rate or on raising the number of jobs; in fact, it very

probably would not even reduce the ongoing tensions about foreign trade, since these tensions spring primarily from the disruptions posed by overall levels of imports and exports, not from the gap between imports and exports.

If America wishes to reduce its trade deficit, without suffering a shortfall of capital for investment, it will require an increase in domestic savings to replace the capital now being provided by foreign investors. Thus a final counterintuitive conclusion: The U.S. foreign trade deficit is not a matter of foreign policy; it's a problem of domestic policy.