U.S. TRADE DEFICITS: *Trade Legislation Is Not The Solution*

by Bashir A. Qasmi

Since 1983, the U.S. has experienced unprecedented trade deficits. These trade deficits are no longer limited to Japan and Canada. Instead, U.S. trade deficits are widespread. In fact, in 1987, the U.S. experienced trade deficits with all major trading partners except Australia, Egypt and the Soviet Union.

Growing trade deficits have precipitated increased protectionist sentiments in this country. Consequently, many commodity and industry groups and legislators are eager to pass trade legislation aimed at balancing U.S. trade or at least reducing trade deficits with various trading partners.

■ U.S. trade deficits are large and widespread. Proposed trade legislation aimed at balancing trade with major trading partners doesn't address the underlying problem that Americans spend more than we produce. In the end, the gap between what we spend and what we produce is closed by borrowing from foreigners. Given that domestic private savings cannot be increased substantially, in order to reduce this gap. The federal budget deficit must be cut through some combination of higher taxes and lower government expenditures. Elimination of the trade deficit without the correction of the budget deficit would force the Federal Reserve to choose between policies leading to inflation or other policies causing a recession. Both of these alternatives are obviously unattractive to U.S. farmers and most other Americans.

Much has been written for and against these trade legislation proposals. Most of the arguments have dwelled on the benefits and costs of "free trade" versus so-called "fair trade". This approach, however, is too narrow and does not focus on the underlying causes of trade deficits. Instead, the U.S. trade deficit remedies should be considered within the context of our balance of payments, the federal budget deficits, and monetary policy alternatives.

By taking this broader approach, we can see that U.S. trade deficits in recent years have actually helped finance U.S. federal budget deficits. The logical extension of this relationship is that balancing trade without reducing federal budget deficits will present monetary policy alternatives which are far less desirable than the trade deficits.

Two Major Accounts

First it is important to understand what transactions affect the U.S. balance of payments. The balance of payments accounts are transactions between domestic residents and the rest of the world over a specified period of time. The balance of payments accounts can be divided into two major accounts, namely, the current account and the capital account.

The current account keeps track of exports and imports of merchandise, services, and unilateral transfers. In calculating the current account balance, exports are counted as positive items; imports and unilateral payments to foreigners are counted as negative items. The merchandise account balance (of exports and imports) is the most visible and dominant component of the current account. However, the financial impacts of the merchandise balance is the same as the impacts of the other components of the current account.

The capital account measures the changes in net indebtedness between the domestic economy and the rest of the world. The capital account involves the transfer of financial claims of various kinds, including stocks, bonds, bills, and bank deposits. The export of capital, generally referred to as "capital outflow" is counted as a negative item. This is the case because when U.S. residents invest in foreign securities, they import foreign securities, and make payments to foreigners. Conversely, import of foreign capital is generally referred to as "capital inflow" and is counted as a positive item. An example would be a Japanese firm buying U.S. securities or making dollar denominated deposits in the U.S. banks.

In addition to capital flows, capital accounts also count changes in U.S. official reserves. An increase in U.S. official reserves is counted as a negative item, while a decrease in U.S. official reserves is counted as a positive item. For example, a sale of gold or foreign currency out of U.S. official reserves would be an example of a U.S. official reserve transaction.

Official reserves provide a useful tool to offset occasional imbalances in the current account. Since these reserves are limited, they can't be used to offset large current account deficits year after year.

Because of measurement errors and leakages, however, the actual accounts add in a "statistical discrepancy". This statistical discrepancy is estimated for each period to ensure balancing of the balance of payments accounts.

Positive statistical discrepancies primarily reflect U.S. dollars held by foreigners. Sooner or later, these U.S. dollars show up in the international financial market or in the U.S. underground market, and then in the U.S. capital market. Therefore, the total net capital flow can be measured by the sum of capital inflows, capital outflows, and statistical discrepancies.

By definition, the sum of all components of balance of payments accounts must be equal to zero. This relationship among components of the balance of payments reflect the way international transactions take place. As shown in the table, in 1987, the U.S. trade in agricultural products was surplus by \$8.0 billion, while the U.S. trade in non-agricultural products was deficit by \$170.0 billion. In turn, on the whole, the U.S. current account for the year showed a deficit of \$160.7 billion.

Out of this current account deficit only \$9.2 billion was financed by decreasing the U.S. official reserve and the remaining \$151.5 billion was financed by total net capital inflows. During the year 1987, capital outflow was \$73.0 billion, while the capital inflow was \$202.6 billion. The statistical discrepancy for the year was a positive \$21.9 billion.

Trade Deficits and Capital Flows

The yearly U.S. trade deficits for goods and services, and total net capital inflows for 1965 to 1987 are shown in Figure 1. The net capital inflows are inversely related to the trade deficits. With minor exceptions, the U.S. recorded a continuous goods and services trade surplus from 1965 to 1982. During these years, the U.S. also generally experienced a negative total net capital flow, indicating that the U.S. was a net creditor country—American investment in other countries exceeded

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U.S. Balance of Payments, 1987

	(billion dollars)	
1. Agricultural merchandise balance	8.0	
2. Non-agricultural merchandise balance	-170.0	
3. Services balance	14.8	
4. Unilateral transfers	-13.5	
Balance on current account		-160.7
5. Changes in U.S. assets abroad (increase -)	-73.0	
6. Changes in foreign assets in U.S. (increase +)	202.6	
7. Changes in U.S. official reserves (increase -)	9.2	
Balance on capital account		138.8
Statistical discrepancy (sum of 1 through 7)		21.9

NOTE: Unilateral transfers include net remittance of pensions and other transfers including U.S. Government military grants.

Source: *U.S. Department of Commerce.*

the foreign investment in the United States.

Since 1983, however, these trends have reversed. Imports have greatly exceeded exports, and the U.S. has registered increasingly large net capital inflows. As a result, the U.S. has become a net debtor country—foreign investment in U.S. has exceeded the American investment in other countries.

The consequences of this alarmingly large foreign debt are far reaching. First, a large foreign capital investment in the U.S. means larger payments of interest and dividends by Americans to foreigners in the future and, therefore, more difficulties for the United States in balancing the current account in future years. Second, foreign investors are sensitive to changes in U.S. interest rates relative to interest rates in other

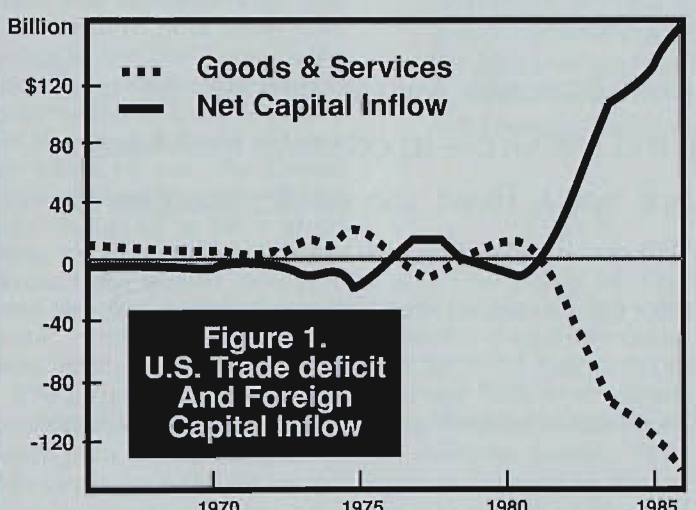

Figure 1. U.S. Trade deficit And Foreign Capital Inflow

industrialized countries, as well as to prospective changes in exchange rates. As a result, the U.S. capital market is increasingly vulnerable to investment decisions by foreign investors and foreign governments.

Trade Deficits Tied To Federal Budget

There are basically two ways to finance the federal budget deficit. First, it can be financed domestically if people and corporations save more than they invest—a private domestic surplus exists—and/or state and local governments run a budget surplus. Second, the federal budget deficit can be financed by borrowing from foreigners. But, as explained earlier, in order to borrow from foreigners, the U.S. must have an equivalent deficit in the current account—Americans must import more than they export.

Until 1981, private savings and state and local surplus were usually enough to finance federal budget deficits (Figure 2). In 1982, however, the federal budget deficit finance needs exceeded the available surplus from private domestic and state and local government sources by $1 billion. Since 1982, this gap has been increasing, and federal budget deficit financing has become increasingly dependent upon borrowings from citizens and institutions in other countries.

The 1986 federal government budget deficit was $204.1 billion. But the surplus available from state and local governments and private savings was only $56.8 billion leaving a gap of $147.3 billion. During that year, total net foreign capital inflow into the U.S. was $141.3 billion.

The fact that the federal deficit decreased to $151.7 billion in 1987 while U.S. dependence on foreign capital actually increased illustrates how our trade deficits and aggregate spendings (government as well as private) relative to gross national product are interrelated. The main reason for this increased inflow of foreign capital was a drastic decline in domestic private savings. During 1987, personal savings were only 3.8 percent of personal disposable income—the lowest level since 1948. As a result, private domestic investment dur-

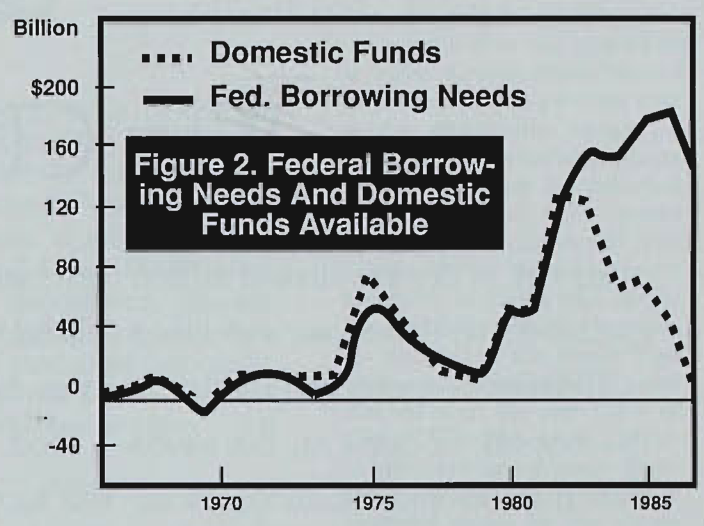

Figure 2. Federal Borrowing Needs And Domestic Funds Available

ing 1987 exceeded domestic private savings by $45.2 billion and private sector also started borrowings from foreigners. Therefore, the solution to this overspending lies in some combination of reducing federal budget deficits (by lowering expenditures and/or increasing taxes) and increasing private domestic savings.

Balancing Trade Without Reducing the Federal Budget Deficit

The above analysis demonstrates that the large trade deficit is not a problem, per se. The underlying problem is that Americans, as a nation, spend more than we produce. The trade legislation fails to address this basic problem of overspending.

Protectionist trade legislation has numerous adverse effects. Two important ones are higher prices for some goods as a result of decreased competition and retaliatory protectionism in other countries (resulting in increased momentum of worldwide protectionism leading to decreased world trade and a worldwide recession). Consequently, any trade legislation aimed at effectively balancing trade would probably result in a recession in the United States.

Even if we assume that trade legislation could achieve a balanced trade without any adverse effects on GNP, such a scenario would certainly result in loss of foreign capital inflows. The secondary effects of such a scenario would depend on the monetary policy followed by the Federal Reserve.

The Federal Reserve could follow a non-expansionary monetary policy (restraints on increases in the amount of money in circulation). This would substantially increase real interest rates, crowd out private domestic investments, and somewhat increase private domestic savings. On the whole, there would be a decrease in the aggregate expenditure in the economy leading to a recession. Decreased private investment would also result in lower productivity and lower growth in the future.

Alternatively, the Federal Reserve could adopt an expansionary monetary policy in order to accommodate federal borrowing (no longer financed by inflow of foreign capital) without crowding out private investment. However, such a policy would definitely result in a new round of inflation, especially when the unemployment rate is low and the economy is operating at close to full capacity.

Clearly, another period of high real interest rates and a recession would be devastating for U.S. agriculture. Admittedly, U.S. agriculture has benefited historically from moderate inflation. However, U.S. agriculture suffered a serious cost-price squeeze during the period 1974-1980—a period of high inflation. As we all know, stopping inflation was devastating for many people who had borrowed money to buy farmland. Therefore, a new round of high inflation is unlikely to benefit U.S. agriculture or those industries closely involved in supplying farm inputs and marketing, processing and distributing farm products.

Conclusions

The problem underlying the U.S. trade deficits is that Americans, as a nation, are spending more than what they produce. Solutions to the problem lie in a combination of measures that reduce the federal budget deficits and that increase private domestic savings. These measures may not provide catchy and popular headlines and they may not be popular with the electorate for in the end they mean Americans must spend less. But they constitute much more desirable ways to reduce foreign capital dependence and trade deficits than does restrictive trade legislation. C