Parsons, 2007

Lecture #8: How Scary is the US Trade Deficit?

First, the facts: How big IS the US "deficit"? Well, if we look at the current account, whose largest component is the trade deficit, it was about 6% of GDP in 2007.

Is this large? Of course, US has had a trade deficit and current account deficit for more than two decades, but other countries have deficits too. How big are they?

According to the Corden handout (see Spring notes/website for pdf):

In 2005, the US had a CA deficit of

$805 billion

The UK and Spain also had CA deficits: **$58** and **$86** billion, respectively.

Of course the UK and Spain are much smaller economies. The UK GDP is about $2.3 trillion (2006) and Spain a little over $1 trillion. Thus, the above figures represent CA deficit as percentage of GDP for the UK of roughly 2.5% and for Spain of almost 9%.

Other less developed countries such as Mexico and Thailand have had CA deficits of 6, 7, 8% and even higher. Sometimes this results in a currency crisis; often it does not.

So, for a developed country it seems quite large, but not unique. Other developed countries have had deficits exceeding 5%. And many developing countries do too. (Recall that many countries have, and *must* have CA surplus. The sum total of all these deficits and surpluses must balance. That's why they call it the "Balance of Payments"!)

So why is America's CA deficit so worrisome?

A short answer is that in absolute terms it is **huge**. A second reason that some people are concerned is that the largest economy in the world (the US) is also a net debtor to the world. This was not the case for the US in the post-war period until the 1980s. Until then, the US was the largest creditor. This was also not true of the British Empire in the 19th century. At that time, Britain was a net creditor.

Is this a problem? Well, there are many prominent economists that think it is (Setser and Roubini) and many others who think it isn't (Levey and Brown are far less worried.) But before we discuss them, we must understand the underlying reasons why the US has a huge current account deficit.

Why is the US current (and trade) deficit so large? There are (at least) four possible explanations which could be, in part, or in whole correct, and all could (and likely are) explaining it simultaneously.

From our National Income (GDP) identities and Balance of Payments definitions, we know, roughly speaking, the following must be true:

X-M= (S-I) + (T-G)

For the US, the X-M (trade deficit, the largest part of CA) is a big NEGATIVE.

S-I is also NEGATIVE and T-G is also NEGATIVE. But why?

Several explanations:

1. T is less than G. The growing US budget deficit (T-G) is making the right hand side of the equation of a larger NEGATIVE, thus increasing the CA deficit (X-M)
2. S is less than I. Americans have low private savings (S), while the Investment demand opportunities in the US are still great (I), and so the US is "sucking in" (pulling in) capital (savings) from abroad because US savings isn't enough to meet that demand.
3. S is less than I. Related to (2), Investment demand (I) in the US may be so high because the US offers a more dynamic and innovative market to invest in as compared to Japan and Europe, which have been stagnant or with slow growth for many years.
4. Related to "T is less than G". This means that the US is constantly issuing a lot of new debt (government bonds). The Bank of Japan, the Chinese Central Bank, the ECB, are all buying (a lot of) US government debt (and holding it as a "reserve"). They are doing this, as many central banks do, to keep a "risk-free" debt on reserve in dollars. But, also some think that China and others are buying a great deal of US debt, to allow the US to consume more than it produces, and thus running a trade deficit in the US, but at the same time, a trade surplus in China. This view holds the belief that China may be willingly pursuing a "mercantilist" policy, encouraging US deficits, to support export driven surpluses at home in China.

Remember that they all (although the motivations of the Chinese central bank are more debatable) are probably true to some extent. And it is certainly true that US's X-M is negative, S-I is negative, and T-G is negative.

The question is: will one of the balances change suddenly because someone (private or government) thinks this situation cannot go on forever?

Or, put another way, most everyone believes the US trade deficit will get smaller eventually. And this will happen, at least in part, by a falling dollar (and most likely with related rising interest rates.)

The important question is WHEN this adjustment will happen. And *how fast* it will happen. So, will this occur in months? Years? Decades? Centuries? And if so, how quickly will it occur?

A "hard landing" (fast adjustment) would result in a massive slowdown in US GDP growth, and therefore world growth (and related rising unemployment).

A "soft landing" would occur gradually over time, and government policy (in all countries) could respond appropriately and no major economic disruption will occur.

Setser and Roubini, fear a "hard landing". Levey and Brown have confidence that there will be a "soft landing" or smooth adjustment.

<u>The Fear (of Setser and Roubini and others)</u>

To re-state the fear more clearly:

Because the US has a huge current account deficit, this eventually (in the long, long run) must correct itself (over an infinite time span, a country's exports must, on average, equal its imports).

One typical way a current account can adjust is through an exchange rate movement. In this case, the dollar needs to depreciate (thereby making US exports cheaper, and imports more expensive).

Also, central banks, such as in China, know that someday the dollar will fall, and when it does they will suffer a loss on their huge holdings of US-denominated bonds.

So, the fear is that these central banks (and other private holders of US bonds) will eventually sell them, and that this will happen quite quickly.

When they sell those US bonds (or stop buying them), the dollar will fall.

When the dollar falls, and investors sell their dollar bonds and dollars and buy Eurobonds, or Japanese securities, or even Chinese yuan, there will be a capital OUTFLOW from the US. (This reversal of the Capital/Financial Account, will in turn cause a decrease in the Current Account; remember, they are the opposite of each other.)

This outflow of capital flows from the US, and the fall of the dollar will cause US interest rates to rise quickly. (Why?)

This sudden increase in the US interest rates will reduce US private investment (I will fall) and also reduce consumer spending (C will fall), and put the US in a severe recession.

Because the US is the largest economy in the world, the US recession will cause a world-wide recession. (**Mainly through the reduction in imports from Japan, China, etc. by the US. Remember, a strong GDP for our trading partners is good for our exports. So, conversely, a weak US will hurt exporters like China and Japan a lot.**)

The fear is that all of this will happen very suddenly, and of course, with the concomitant rise in unemployment around the world.

To re-cap: Setser and Roubini think this will happen unless something is done soon. Levey and Brown think this is a myth, and that we will experience a smooth adjustment.

<u>Levey and Brown "Don't worry."</u>

Levey and Brown say that we don't have to worry about a hard landing for three reasons:

1) They believe Central Banks (such as China and Japan) will continue to finance US deficits
2) Even if Central Banks do start divesting in US bonds, and "pull-out" from the US, Levey and Brown feel private investors will come in a "fill in the gap"
3) They believe that if there was a crash, it wouldn't hurt the US as much as it would hurt Europe and Japan. (Will China be hurt too? Most likely.)

Levey and Brown believe, essentially, that many foreigners are investing in America private because America is the most dynamic (and best) place to invest (reason #3 of #1-#4 on page 2) So, S is less that I, but that is because I opportunities are so many in the US. Also, they feel that Central banks don't mind buying US bonds because the US dollar is still the reserve currency of the world, and will be for a long time.)

Setser and Roubini feel that #1, #2, and #3 points (immediately above) are all incorrect. That is, they feel that central banks WILL stop financing US debt; and when they do, private investment will NOT fill in a large part of that gap; and the US will be hurt quite a bit, when it does happen, so the US should worry a lot too.

Is America different?

The US deficit is extremely large, especially for the largest country in the world. Many small, developing countries have had large current account deficits, and suffered huge, sudden depreciations in their currencies, and were very damaging to their economies. (Recent examples: Argentina (2001-2002), Thailand (1997), Mexico (1994-1995).)

Is America’s deficit different? Well, yes, in one important way. US debt is, of course, in US dollars! The US dollar is the world’s “reserve” currency, and will be so for a long time. (Although, the Euro is becoming more prominent.) Also, if the dollar does fall in value this is not as big a problem as it was for Thailand, for example.

In 1997 Thailand owned a lot of foreign debt, but those loans were in dollars. So, when the baht fell (in part because they had a current account deficit) to adjust, this also made their foreign debt skyrocket. But if this happens for the US, the dollar amount of the debt will not change. In fact, this will be good for Americans who hold foreign assets abroad.

For example, if an American holds a Japanese bond, and the dollar falls dramatically against the Japanese yen and other Asian currencies, this means the holder of the yen-bonds will experience of capital gain! This effect (which Levey and Brown emphasize) will mitigate any crash of the dollar, if it occurs.