The U.S. Trade Deficit and Trade Policy

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International Commerce
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National Income Accounting and Trade

- National income accounting needed to understand U.S. trade deficit

Accounting identity is:

\[ Y = C + I + G + (X - M) \]

- Supply
- Demand
- Current Account

\[ Y = \text{gross domestic product (GDP)} \]
\[ C = \text{household purchases} \]
\[ I = \text{investment purchases} \]
\[ G = \text{government purchases} \]
\[ X = \text{exports and } M = \text{imports} \]
Current account can be rearranged:

\[(X-M) = Y-(C+I+G)\]

Determined by difference between aggregate supply (Y) and demand (C+I+G), i.e., if Y is less than (C+I+G), country runs trade deficit.

With a trade deficit, imports make up difference between what U.S. residents supply and demand.

What is root cause of U.S. trade deficit?

Need to see connection between flows of goods and services (C, I, G, X and M) and financial flows.
U.S. Trade Deficit


Source: U.S. Census Bureau
National Saving

\[ S = Y - C - G \]

\[ S = Y - C - G - T + T \]

\[ S = Y - T - C + T - G \]

Government’s net tax revenues are \( T \)

\( T = \text{tax revenues} - \text{transfer payments} \)

\( Y - T \) is total after-tax income or disposable income

Private Saving:
\[ S^p = Y - T - C \]

Public Saving:
\[ S^g = T - G \]

National Saving = Private Saving + Public Saving
\[ S = S^p + S^g \]
National Saving

Source: Bureau of Economic Analysis
Savings and the Trade Deficit

- Savings: \[ S = (Y - T - C) + (T - G) \rightarrow S = Y - C - G \]
  \[ (X - M) = Y - (C + I + G) \rightarrow (S - I) \]
  i.e., current account is difference between national savings S and investment I

- Since 1980s, as percentage of GDP, U.S. investment has exceeded savings, and at same time U.S. has consistently run a trade deficit

- Difference made up by capital inflows as foreigners accumulate U.S. financial assets

- U.S. capital account surplus offsets its current account deficit, i.e., the U.S. balance of payments “balances”
National Savings and Trade Balance

Source: Bureau of Economic Analysis
What is Cause of U.S. Trade Deficit?

- Most economists agree U.S. trade deficit driven by decline in national savings rate – both private and public.
- U.S. households have high marginal propensity to consume and U.S. government has propensity to run fiscal deficits.
- Trade deficit will continue unless savings increase and/or investment falls.
- Any increase in fiscal deficit will feed into trade deficit – exacerbated by fact that U.S. economy is running at full employment.
Should we be concerned?

- To facilitate trade deficit, U.S. runs negative net international investment position (NNIP)
- NNIP is U.S. financial claims on other countries minus foreign financial claims on U.S.
- 2016 NNIP = -$8.4 trillion, i.e., -45% of GDP and expected to increase to -53% by 2021
- Many economists believe this is not sustainable in long run, requiring significant depreciation of US $ with major adjustment costs
- The longer U.S. trade deficit continues, the more extreme relative price adjustment will be
NNIP and U.S. Trade Deficit

Source: Bureau of Economic Analysis and Department of Commerce
Trade Policy Won’t Fix U.S. Trade Deficit

- Economists agree: bilateral trade policy will not solve U.S. trade deficit – diverts trade to other countries/products
- Tariffs reduce imports, but also reduce exports, i.e., lower imports reduces demand for foreign currency, $ strengthens, exports decline
- Essentially U.S. trade deficit is a macroeconomic phenomenon that can only be resolved through macroeconomic policy
- Policy choices: (i) Tax consumption/reduce fiscal deficit; (ii) Depreciate exchange rate; (iii) tax capital inflows