The U.S. Trade Deficit and Trade Policy

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International Commerce and the World Economy

Professor Sheldon
sheldon.1@osu.edu

National Income Accounting and Trade

- National income accounting needed to understand U.S. trade deficit
- Accounting identity is:

$$\underset{\text{Supply}}{Y} = C + \underbrace{I + G}_{\text{Demand}} + (\underbrace{X - M}_{\text{Current Account}})$$

Y = gross domestic product (GDP)

C = household purchases

I = investment purchases

G = government purchases

X = exports and M = imports

National Income Accounting and Trade

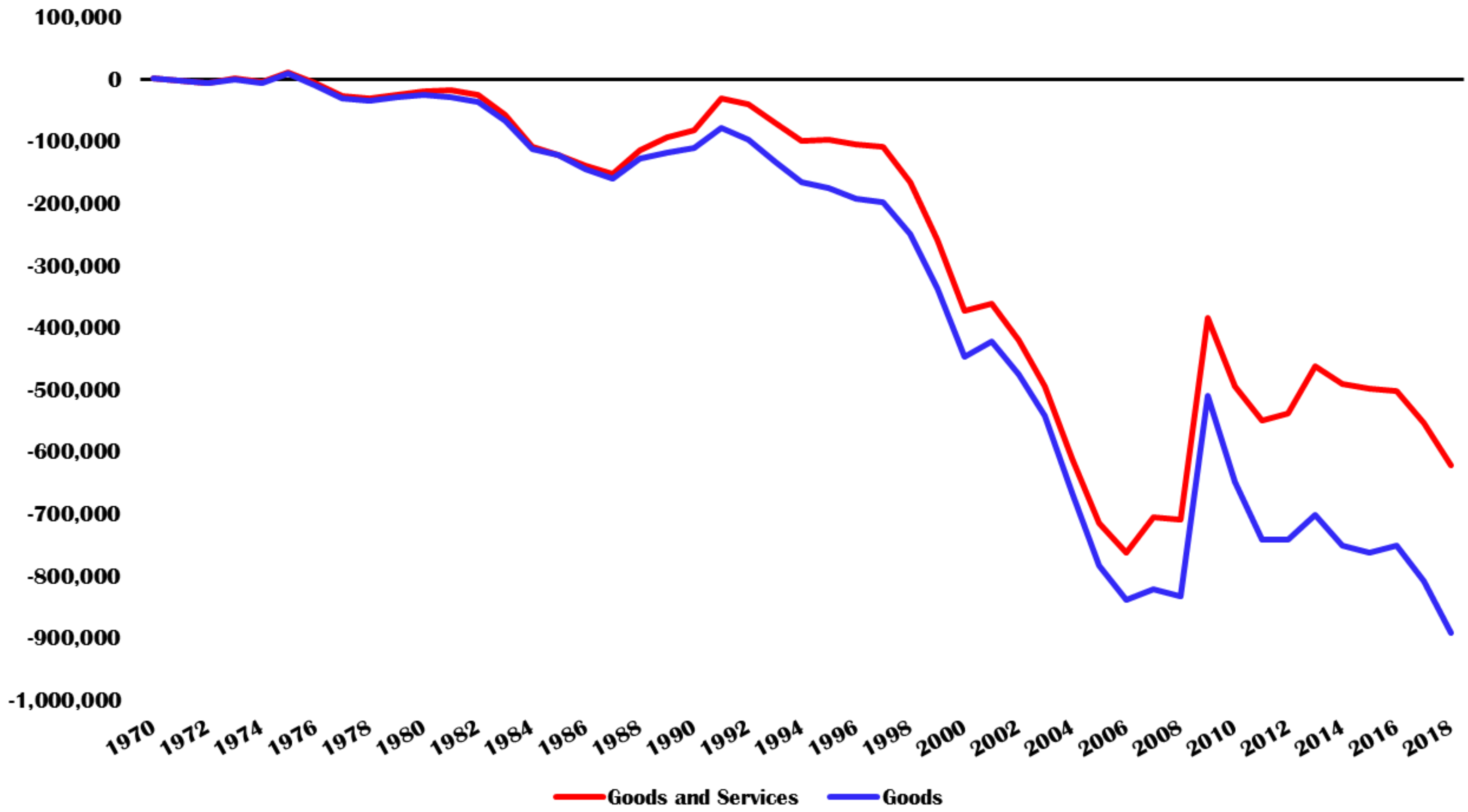
- Current account can be rearranged:

$$(X\text{-}M) = Y\text{-}(C+I+G)$$

- 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

U.S. Current Account: 1970-2018 (millions of $)



Source: U.S. Census Bureau

National Saving

$S = Y - C - G$

$S = Y - C - G - T + T$

$$S = Y \underbrace{- T - C}_{\text{Private Saving: } S^p = Y - T - C} \underbrace{+ T - G}_{\text{Public Saving: } S^g = T - G}$$

Government's net tax revenues are T

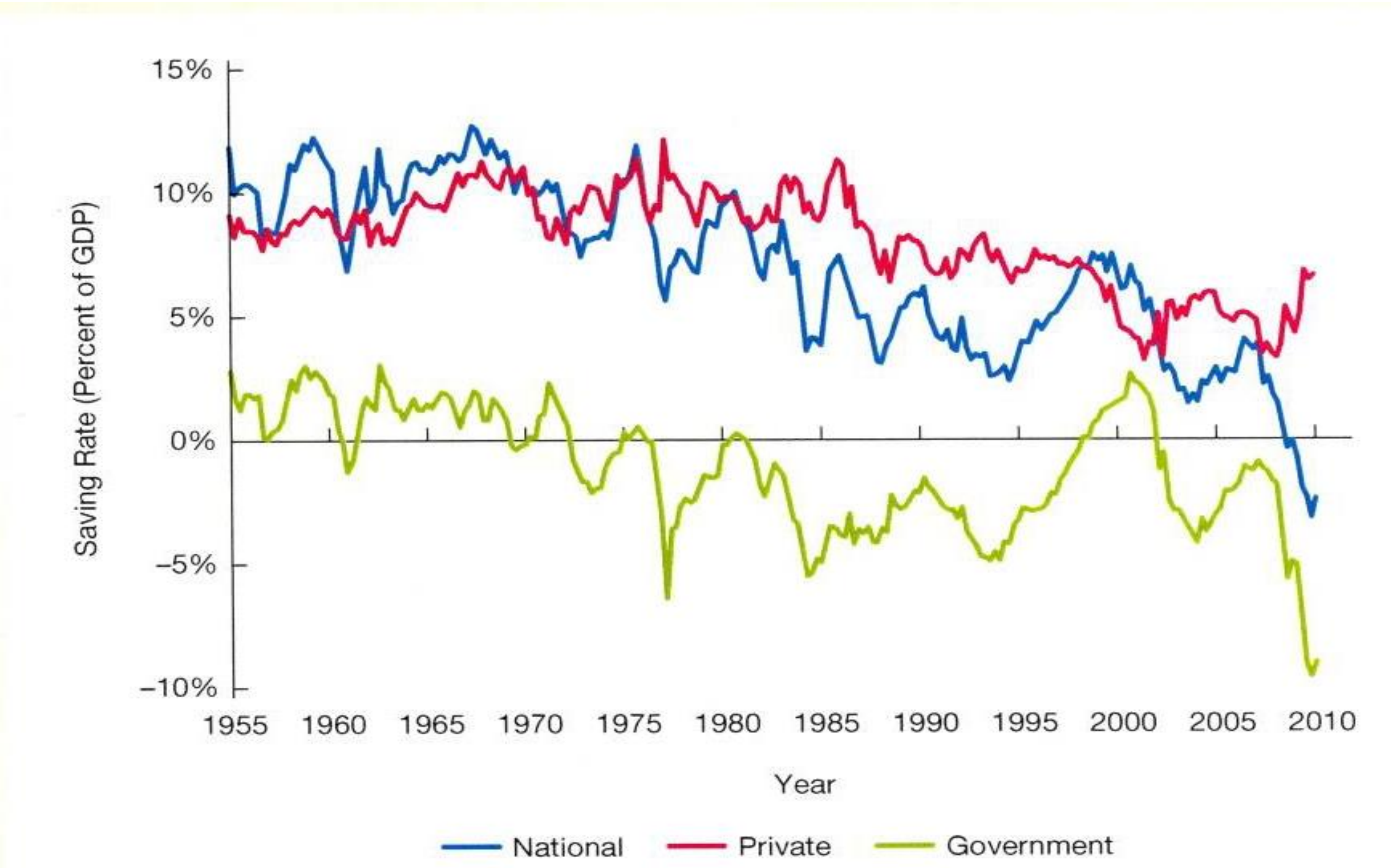
T = tax revenues – transfer payments

Y – T is total after-tax income or disposable income

National Saving = Private Saving + Public Saving

$$S = S^p + S^g$$

National Saving



Source: Bureau of Economic Analysis

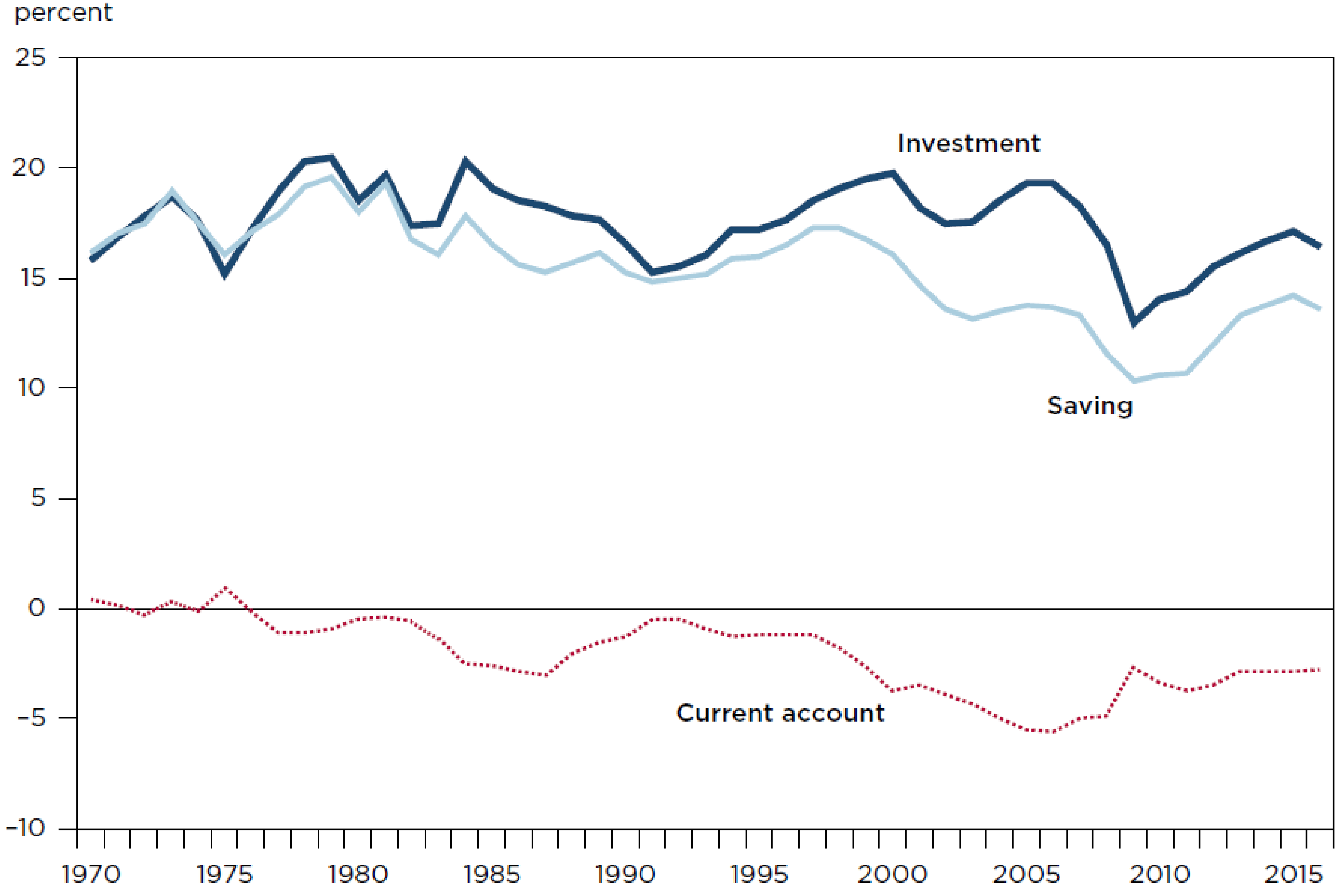
Savings and the Trade Deficit

- Savings: $S = (Y - T - C) + (T - G) \longrightarrow S = Y - C - G$

  $$(X - M) = Y - (C + I + G) \longrightarrow (S - I)$$

  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

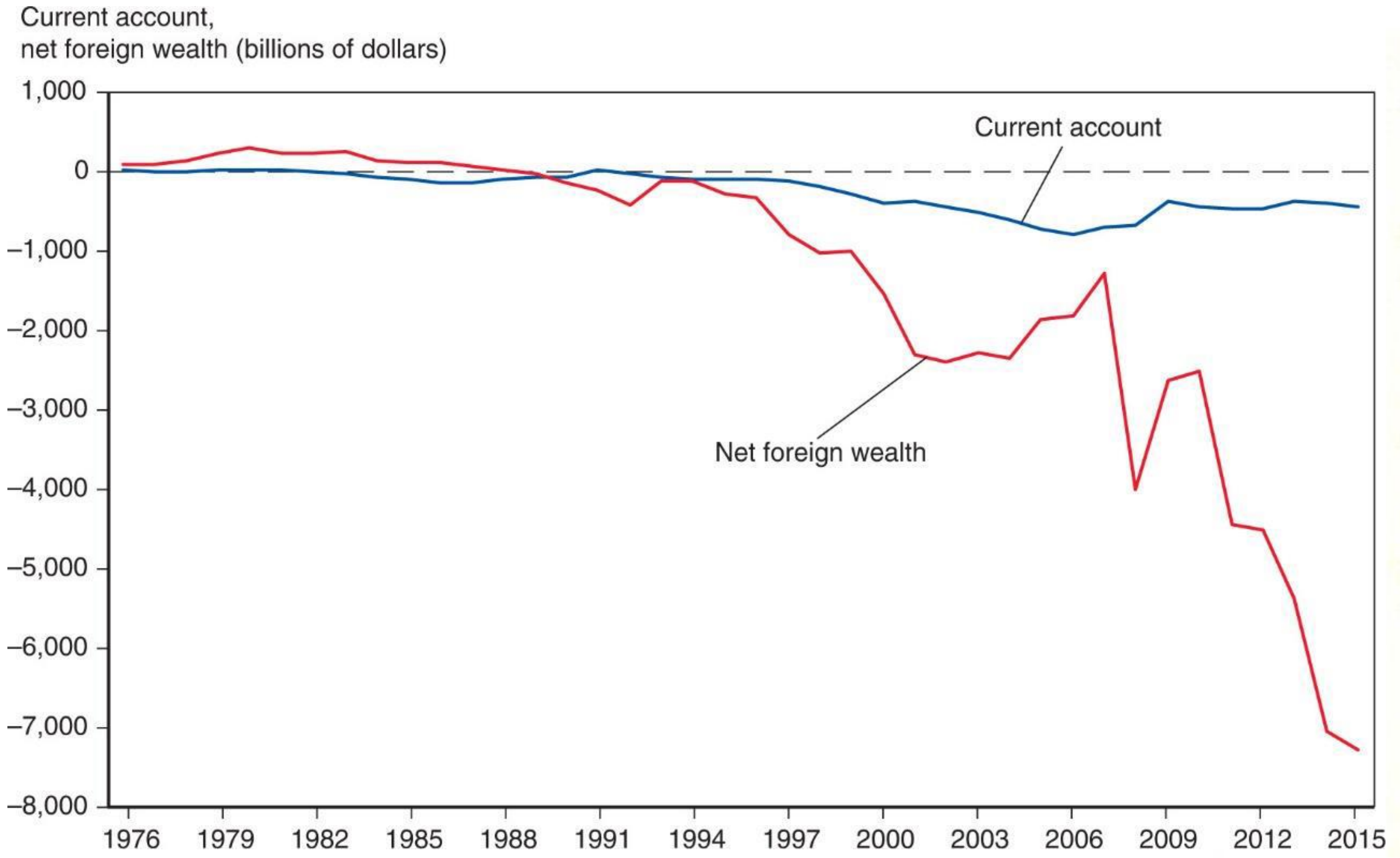
What is Cause of U.S. Trade Deficit?

- 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**