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### The Trade Deficit

One day recently I had a meeting in New York. Before leaving, I set my Sharp VCR to record a television program I would miss while away. Then I drove my Volvo to the airport, boarded an Airbus A310, and while in transit finished some notes for the meeting on my Toshiba laptop computer. My suit was made in Hong Kong, my coffee cup in Portugal. It is quite possible that my breakfast cereal was the only American-made product I encountered all morning.

This was not a surprising experience in the 1990s, but it would have been very unusual just 20 years ago. It is sometimes hard to remember that as recently as 1981, the United States exported as large a value of manufactured goods as it imported, and it remained the world's clear leader in high technology. Until the late 1970s, U.S. aircraft and computer manufacturers had no major rivals abroad; imports of foreign automobiles and consumer goods were largely restricted to the low end of the market.

The massive trade deficits that now seem a permanent feature of the U.S. scene emerged quite quickly between 1981 and 1984. In 1981 the U.S. trade picture still looked healthy. Exports of manufactured goods more than paid for manufactured imports, while exports of agricultural goods and earnings from overseas assets more than covered the cost of oil imports. The broadest measure

of U.S. trade, the so-called current account of the balance of payments, was in modest surplus, as it had been for most of the century. By mid-1984, however, the current account was in deficit at an annual rate of more than \$100 billion, and despite some improvements in the late 1980s, there is little prospect that it will move into balance for years to come. (In fact, it is more likely to increase.)

Many critics of American economic policy point to the trade deficit as evidence that our prosperity is built on sand. The general public, while sanguine about the economy generally, is worried about the trade deficit; rising public concern led to the passage of the 1988 Trade Act, a law that, while not overtly protectionist, certainly carried a tougher tone than its predecessors. Yet there are also respectable voices claiming that the deficit presents no problem, or even that it is a sign of American strength. Before we even ask why the United States has begun to run a trade deficit, we need to ask why the trade deficit matters.

#### Why worry about the trade deficit?

Ask the man in the street why a trade deficit is a bad thing, and he will probably answer that it costs America jobs. The point seems obvious enough: If we spend more on imports than foreigners spend on our exports, the result is reduced demand for American labor. The immediate job costs of international competition are easy to understand: plants closed because of competition from imports, workers laid off because of the drying up of export markets. At first glance the numbers can seem very impressive. Consider, for example, the situation in 1990. In that year the United States ran a current account deficit of \$98 billion, about 1.8 percent of national income. If we could somehow have kept those dollars at home, the extra demand would have been enough to employ about two million more workers. It is natural to

imagine that those two million "lost jobs" are the crux of the problem.

Yet focusing on the employment effects of the trade deficit is not only misleading—it is slightly more than 100 percent wrong. America's trade deficit problem has nothing to do with jobs. As we have seen, the 1980s were actually a time of quite satisfactory job creation. New jobs created in sectors that are insulated from international competition, such as services, far outpaced any job losses in export or import-competing sectors. Not only did the United States do very well at creating jobs in the 1980s despite the ballooning trade deficit, it would have done little if any better—indeed, probably a bit worse—had the trade deficit somehow been prevented.

The reason is that the amount of employment offered in the U.S. economy is normally limited by supply, not demand. It's not very hard to increase demand: The problem is that increasing demand too much leads to inflationary pressures. Driving the unemployment rate below 5 to 6 percent will lead to accelerating inflation. In 1990, U.S. unemployment was, if anything, at the low

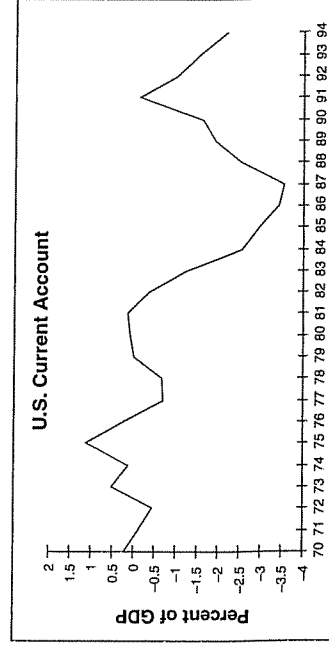


Figure 11

The U.S. economy generally ran small surpluses on its current account, the broadest measure of its international trade, until 1981. In the 1980s, however, the nation plunged into a deep trade deficit. This deficit peaked in 1987 and has declined since then, especially when measured as a share of national income.

end of the safe range, so we could not have had fuller employment without higher inflation.

Imagine that in 1990 America could somehow have eliminated its trade deficit at a single stroke—say, by imposing quotas on imports. This would have added to the current demand for labor the demand for another two million workers to fill the jobs currently “lost” because of the deficit. But would employment really have risen by two million? Of course not. First of all, the United States does not have two million suitable workers available (or the plant capacity to employ them). America in 1990 was not like America in 1938, with a huge reserve army of easily employable workers ready to go to work given sufficient demand. Most of the five million or so unemployed were either unskilled or part of the inevitable “frictional” unemployment that occurs as workers change jobs or outmoded plants close. The main effect of an increase in demand would have been not to increase employment but to bid up wages. To put it another way, adding two million jobs, if we could have done it, would have driven the U.S. unemployment rate down to around 3 percent. But that isn’t possible, or at any rate not for very long: At that low an unemployment rate, inflation would begin to accelerate rapidly.

In reality, of course, that wouldn’t happen. The Federal Reserve Board would raise interest rates to choke off demand and cool down the economy. Since the economy already had more or less as many workers employed as it could manage without inflationary pressure, this offset would destroy roughly as many jobs as eliminating the trade deficit would create. They wouldn’t be the same jobs: Construction and service workers would be laid off while manufacturing workers were called back. But overall employment would not rise.

Attempts to reduce the trade deficit might even have led indirectly to a *fall* in employment, at least for a while, as the government either drove down the exchange value of the dollar or

restricted imports, both of which are inflationary in their own right. To keep inflation under control would therefore have taken a little extra tightening on the domestic side. So we would probably have had slightly fewer jobs without the trade deficit than we do with it.

Alert readers will have noticed that this argument was carefully applied to 1990—a year in which the U.S. economy was at or below the NAIKU. But what about when the economy is in a recession, as it was in 1992? Didn’t the trade deficit cost jobs then?

The answer here is a little more complicated. Other things equal, the United States would have had lower unemployment in 1992 if it had had a smaller trade deficit. This was because the U.S. economy as a whole was suffering a shortfall in demand, and reducing the trade deficit is one way to increase demand. But there are lots of other ways to increase demand, such as cutting

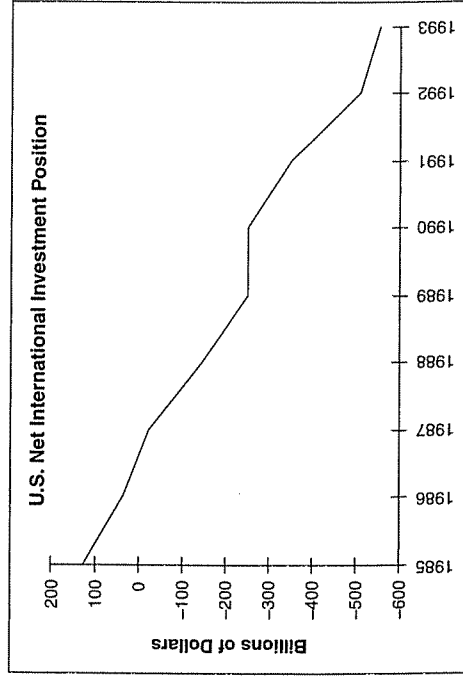


Figure 12

The trade deficits of the 1980s changed the United States from the world’s largest creditor to its largest debtor, reversing the results of 60 years of investment abroad in only four years.

interest rates, reducing taxes, or increasing public spending; all of these are pleasant things to do in their own right. The constraint on doing enjoyable things to increase demand is the risk that we will overdo it and create inflation problems—and a smaller trade deficit would increase that risk.

The point is that although the U.S. economy does sometimes stumble into recessions, our ability to keep unemployment down is ultimately limited by supply, not demand. A lower trade deficit might seem to mean more jobs in a particular year, but over the long run the trade deficit and the average rate of unemployment are pretty much unrelated.

If the trade deficit doesn't cost jobs, why worry about it? One answer is that we shouldn't. Herbert Stein, Chairman of the President's Council of Economic Advisers under Richard Nixon, has flatly declared the trade deficit to be a "nonproblem." A significant minority of economists agrees with him. Some even believe that it represents a sign of America's strength. But even these optimists would concede that the trade deficit does have a cost: a gradual mortgaging of future U.S. income to foreigners.

After all, the United States does not get its imports for free. When we buy more goods and services from foreigners than we sell to them, we must give the foreigners something else to cover the difference. What we give them is assets: The U.S. trade deficit in the 1980s was financed by a steady sale of American assets—stocks, bonds, real estate, and, increasingly, whole corporations to foreigners.

The U.S. Department of Commerce regularly reports an estimate of what it calls the U.S. net international investment position: the difference between the value of American assets abroad and foreign assets in the United States. That position has been in the black since World War I, when Britain liquidated many of its holdings here and borrowed heavily from U.S. banks to finance its war effort. The U.S. net investment position grew substantially in

the 1950s and 1960s as U.S. corporations went multinational. Even during the 1970s the United States continued to invest more abroad than foreigners did here.

But that investment position quickly evaporated. At the end of 1983 our claims on foreigners were still worth \$268 billion more than foreign claims on the United States by the end of 1991 the situation was more than reversed, with foreign assets here exceeding our assets abroad by \$382 billion.

What's wrong with being a net debtor? There is one definite cost. There are also some vaguer risks.

The definite cost is, by definition, that you owe people money. From now on, the United States will be obliged to deliver a stream of interest payments to foreign bondholders, rents to foreign landowners, and dividends to foreign stockholders. The numbers are fairly staggering. In 1981 U.S. net investment income from abroad was \$34 billion; in 1989 it was negative; and the number will continue to worsen as foreigners expand their U.S. holdings. Our payments to foreigners are a direct drain on our resources, and the longer the trade deficits continue, the larger this drain will become.

But America is a huge country; it can shrug off burdens that would crush smaller nations. The spectacular decline in our net investment income since 1981, measured as a share of GNP, amounts to about a 1.5 percent drain on our economy—not a trivial number, but hardly ruinous. If the United States were to continue to sell assets at current rates, the burden of paying foreign investors could rise by an additional 2 to 3 percent of GNP by the end of the century. Again, this is serious, but no cause for panic. The United States could continue to run trade deficits as big as that of 1989 for a long time before the payment burden becomes unupportable.

But what about the risks? The big economic risk is that as the United States becomes a massive net debtor it will be exposed to

financial crises whenever the confidence of foreign investors is shaken. This is what happened to most of Latin America at the beginning of the 1980s. Banks lent the Latin nations large sums for a decade, then abruptly cut off the flow when their confidence began to waver, precipitating an economic crisis. The vision of the United States as a giant Argentina may be unlikely, but no one should dismiss it out of hand.

The other risks are political. First, there is at least some case to be made that growing foreign ownership of U.S. assets compromises our national sovereignty. We tended to dismiss this argument as patently silly when we were the foreign investors who wanted to invest in other countries. Now that the shoe is on the other foot, it seems more compelling. Second, both the trade deficit and the growing foreign stake here tend to feed crude forms of economic nationalism at home, increasing the risks of a trade war. In fact, it was primarily concern over growing protectionist pressure that led the Reagan administration to start talking down the dollar in 1985.

The measurable costs of the trade deficit, then, are serious but not devastating. The risks are uncertain but worrisome. There isn't any reason to panic about the trade deficit, but getting it down would make everyone breathe a little easier.

But before we start talking about bringing the trade deficit down, we need to ask why we have a deficit in the first place.

#### **Why the trade deficit?**

In 1982 Martin Feldstein, the Harvard professor newly appointed Chairman of the President's Council of Economic Advisers, found a new reason to condemn the emerging budget deficit. At a time when most critics of that deficit worried that it would lead to inflation, or perhaps to high interest rates, Feldstein argued that it would lead to something quite different: unprecedented *trade*

deficits. Initially his audiences were bemused. Over time, however, as the budget and trade deficits mounted together, the idea of "twin deficits" became a cliché—as well as a target for bitter attack.

Feldstein was, of course, deliberately oversimplifying. His emphasis on the linkage between the two deficits had two purposes: first, to persuade his "what-me-worry" political masters that they should do something about the budget deficit; and second, to answer protectionists who blamed the U.S. trade deficit on unfair foreign trade practices. Today, few economists believe in a simple one-to-one linkage between the budget and trade deficits. Yet a revised version of the "twin deficit" story is still the best explanation for the emergence of unprecedented trade deficits in the 1980s.

The basic story runs as follows: Beginning in 1981, U.S. national saving began to fall sharply. Only part of that fall was a result of the budget deficit—hence the need to qualify the "twin deficit" view a bit—while part of it represented a change in the behavior of households. In any case, what happened was that U.S. national saving began falling well short of U.S. investment demand, which remained strong. If the U.S. economy had not had access to world capital markets, this saving shortfall would have produced a crunch that pushed interest rates sky-high. Instead, the United States was able to turn to foreigners to fill the gap. Much of U.S. investment was financed, not out of our own savings, but through the sale of assets to foreigners.

As a matter of straightforward accounting, the United States always buys exactly as much as it sells from the rest of the world. If it sells foreigners more assets than it buys, it must correspondingly buy more goods than it sells. So the emergent U.S. dependence on foreign capital to finance its investment had as an inevitable counterpart the emergence of a trade deficit. The ultimate cause of the trade deficit therefore lies in a decline in U.S. saving—partly, but not entirely, due to the budget deficit.

Although this mainstream story is now widely accepted, many readers may feel that it is missing something. Where are all the real things that affect international trade? What happened to the dollar? What happened to U.S. competitiveness? Don't these have something to do with the trade deficit, too?

The answer is that they do, and then again at a deeper level they don't. That is, at any point in time, when we discuss the U.S. trade deficit, the level of the dollar and the international competitiveness of U.S. industry clearly matter. The ups and downs of the dollar, in particular, have been spectacular since 1980. When the dollar rose against the currencies of our major competitors in the first half of the 1980s, it sharply raised the prices of U.S. goods relative to foreign, playing a key role in encouraging imports and discouraging exports. Some of this effect was reversed when the dollar fell again after 1985. Yet even though exchange rates play a crucial role in international trade, at a deeper level capital flows are the real story.

The relationships among capital flows, exchange rates, and the U.S. trade balance have become the subject of a peculiarly nasty debate in recent years—peculiar, because the subject is relatively technical and straightforward. Yet hardly a week goes by without an angry debate between mainstream economists, who assign great importance to the exchange rate, and their critics.

One line of criticism comes from the right. Many conservatives believe that the world should return to a gold standard—that the value of each currency should be fixed in terms of gold. Since this would also fix the values of currencies in terms of each other, these conservatives are uncomfortable with the idea that changes in exchange rates may sometimes play a useful role. So they welcome the arguments of academics like Stanford's Ronald McKinnon, who declares that exchange rates are irrelevant to trade.

### Why devaluation is sometimes a good idea

At a basic level, the United States has a trade deficit because it spends more than it earns, and Japan has a trade surplus because it earns more than it spends. That's why any attempt to solve trade imbalances simply by shifting demand from foreign to U.S. goods will fail. But if this is the case, why bother with expenditure-switching policies at all? Why is devaluing the dollar sometimes a good idea?

The reason is that trying to solve the U.S. trade deficit just by cutting U.S. spending and raising demand abroad will not lead to the right kind of demand. Despite the rapid increase in international trade over the past 40 years, the world economy is still far from being perfectly integrated. Most of the income of U.S. residents is spent on goods and services produced here; the same is true of Europe and Japan. As a result, most of a reduction in U.S. expenditure will be reflected, other things equal, in a fall in demand for U.S. goods and services; only a small fraction of an increase in expenditure in Europe or Japan will be spent on U.S. products.

To see the problem this causes, consider the example illustrated in the accompanying table. Imagine that the United States reduces its spending by \$100 billion, while the rest of the world (ROW) simultaneously increases its demand by the same amount. Does this translate smoothly into a \$100 billion reduction in the trade deficit? Unfortunately, it does not. At least \$80 billion of the reduction in U.S. spending is likely to represent a fall in demand for goods and services produced here, with only \$20 billion representing a fall in demand for imports. Meanwhile, no more than \$10 billion of the rise in spending of the rest of the world is likely to be spent on U.S. goods, with \$90 billion spent on ROW products. The result is therefore a net reduction in demand for U.S. products of \$70 billion, and an equal increase in demand for ROW products. Instead of a smooth reduction in the U.S. trade deficit, we would get a combination of recession in the United States and inflation abroad. To make the adjustment work, some way has to be found to switch \$70 billion in spending from ROW to U.S. products. The easiest way to do this is to lower the foreign exchange value of the dollar, which makes U.S. goods cheaper to ROW residents and ROW goods more expensive to U.S. residents.

The lesson of this example is that while devaluing the dollar cannot by itself solve a trade deficit, it can be crucial as part of a deficit-reduction strategy.

	Total demand	Demand for U.S. products	Demand for ROW products
United States	-100	-80	-20
ROW	+100	+10	+90
Total	0	-70	+70

It was not inevitable that this trade deficit would emerge via a strong dollar. The Federal Reserve could have expanded the supply of dollars to keep the exchange rate low. But this would have led to an inflationary boom that sucked in imports (an experience that Britain had in the 1980s). As it turned out, however, the Federal Reserve kept inflation down by raising interest rates, which made dollar-denominated assets attractive to foreigners and so led to a rise of the dollar against other currencies. This rise in the dollar, by making U.S. goods expensive compared with foreign, then led to the emergence of the unprecedented trade deficits that were the counterpart of the capital inflows. The point is that while the rise of the dollar was a central part of the story as it actually played out, it is still correct to say that the U.S. trade deficit was essentially caused by the fall of national saving, which led to massive imports of capital.

What about competitiveness? It is obvious to everyone that the once-vaunted U.S. superiority over other nations in technology and quality has eroded over the past generation. Doesn't this loss of superiority help explain the rise in our trade deficit? The answer is no. If U.S. national saving had remained high, the loss of competitive advantage would not have led to a trade deficit. It would instead have led to a fall in the dollar, which would have compensated for the loss of technology and quality by making U.S. goods relatively cheaper. This is what happened in the 1970s. The United States had about the same trade balance at the end of the 1970s as it did at the beginning, but with a much lower dollar. This isn't to say that a dollar that declines every year is without costs. Competitiveness does matter—but not for the trade deficit.

We'll come back to exchange rates and competitiveness when we look at dollar policy in chapter 9. For now, the important thing to recognize is that the root cause of the emergence of trade deficits in the 1980s was America's low national saving rate,

Other critics come from the left—people who want an active government role in promoting exports and limiting imports, and who dislike the idea that a market mechanism like the exchange rate can do the job. They therefore like the arguments of pundits such as the *American Prospect's* Robert Kuttner, who wants us to use a tough trade policy to bring our trade deficit down, and who accuses the advocates of a low dollar of wanting to balance trade by cutting American wages.

As usual, the intellectual debate has been warped by the political imperatives of the moment—a distortion that takes place all the more readily because it takes a little sophistication to understand what the exchange rate does and does not do.

The important thing to grasp is that the exchange rate is a crucial part of the *mechanism* that determines the trade balance, without being an independent *cause* of the trade balance. If this sounds unduly metaphysical, consider the following analogy. Think of the U.S. trade balance as an automobile. The exchange rate is not that car's engine—it is more like the drive shaft, with desired capital flows providing the motive power. In other words, changes in the exchange rate play a crucial role in translating changes in desired capital flows into changes in the trade balance, but the root cause of the trade imbalance lies elsewhere.

America's experience in the first half of the 1980s provides a good example. National saving fell—that is, consumption spending increased as a share of national income. But investment spending remained high, because an inflow of foreign capital took the place of the reduced flow of domestic saving. So overall spending in the U.S. economy rose faster than national income. The only way for an economy to spend more than it earns, however, is to import more than it exports—to run a trade deficit. So it was inevitable that the United States would develop a large trade deficit.

which led it to import large quantities of capital. The next question is: What can be done about it?

#### Can the trade deficit be eliminated?

Can the United States eliminate its trade deficit? Of course it can. When it really wants to (or really has to), virtually any country can run a trade surplus. Most Latin American countries quickly shifted from large trade deficits to large trade surpluses when the debt crisis struck in the early 1980s. The United States may not want to emulate that experience, but it shows that trade deficits are not immutable facts. If America continues to run a trade deficit, it is because it chooses not to take the steps that would eliminate it.

The solution to a trade deficit has two parts. Expenditure must be both *switched* and *reduced*. Somehow people must be persuaded to switch their demand from foreign to U.S. goods—either by reducing the value of the dollar or by imposing tariffs and import quotas. But this isn't enough. There must also be a policy to reduce the level of domestic demand, so that the expenditure-switching policies don't just feed inflation.

That, of course, is the problem. We can all agree that it would be nice if Americans could sell more to foreigners and buy less, although we may argue about how best to arrange that happy event. Reducing domestic demand is another matter. Expenditure reduction hurts, and there is only one reliable way to do it: balance the federal budget, or even move it into surplus. Unless we do that, there is nothing much we can—or should—do about the trade deficit.

It's important to understand why both switching and reducing are needed to eliminate the trade deficit. Let's therefore imagine the consequences of two alternative strategies for reducing the trade deficit *without* a cut in domestic demand: an aggressive

effort to drive the dollar down, making U.S. goods cheaper on world markets; and a protectionist policy that imposes new restrictions on U.S. imports.

There is no question that the government—or more accurately the Federal Reserve—could drive the dollar down if it wanted to. All it has to do is increase the supply of dollars. The resulting fall in the foreign exchange value of the dollar would certainly help U.S. exporters and make it easier for American firms to compete with imports at home.

Unfortunately, there is a side consequence of printing dollars: inflation. Any policy that tries to drive the dollar down other than by reducing our need for foreign capital will necessarily feed inflation. This is an unwanted consequence in and of itself, and it also undermines the initial objective of the policy, because inflation reduces the competitiveness of U.S. producers at any given exchange rate. The eventual result of an effort to drive the dollar down will be to raise U.S. prices by roughly the same proportion as the dollar falls, so that U.S. competitiveness is unaffected. The result, then, would be inflation with no gain on the trade front.

A protectionist policy could certainly reduce U.S. imports. But if U.S. savings have not been increased, lower imports will mean a lower supply of dollars to the foreign exchange market and thus a stronger dollar; the rise in the dollar will cut into exports and encourage increases in whichever imports are not restricted. The dollar will probably rise enough to just about eliminate the favorable impact of the import restrictions on the trade balance. The Federal Reserve could, of course, prevent the dollar from rising by printing more dollars—but this merely brings back the inflation problem.

The moral of both of these scenarios is fairly simple. There isn't much that the United States can do about its trade deficit simply by trying to encourage exports or discourage imports. The only way to cut the trade deficit successfully is to accompany



export-promoting and import-cutting measures with domestic policies that reduce domestic demand—in effect making room for a trade improvement.

But how can we reduce domestic demand? For practical purposes, only one course of action is open: cutting the budget deficit. Even if you don't believe the simple "budget deficit equals trade deficit" formula that Feldstein made so popular, there are no plausible ways for the federal government to make room for balanced trade except by balancing its budget. This might not work: Even balancing the budget might fail to eliminate the trade deficit (we'll spend more time on this in chapter 7). But it is the only plausible policy.

So the solution to the trade deficit is both clear and unacceptable. Eliminate the budget deficit and drive the dollar down (or impose new restrictions on imports), and probably (though not certainly) the trade deficit will shrink rapidly. But since we are in no hurry to eliminate the budget deficit, the solution isn't available. Implicitly, the United States has decided to live with its trade deficit for quite a while.