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Before the U.S.-China Economic and Security Review Commission,
hearing on China and the Future of Globalization.

May 19, 2005

The Trade Deficit and the Over-Valued Dollar

In my statement, I will make one simple but important point: the United States has a large and unsustainable trade deficit *because* of the over-valuation of the dollar. There can be differences over the factors that have led the dollar to be over-valued, but the debate over the cause of the over-valuation does not change the fact that the mechanism that has driven the rapid run-up in the trade deficit is the over-valuation of the dollar. This over-valuation has made U.S. goods and services uncompetitive in international markets and has allowed imported goods and services to undermine domestically produced items in the U.S. market. I lay out this argument in more detail below.

The large and growing trade deficit is widely recognized as a serious problem. In the first quarter of 2005, the Commerce Department estimated the trade deficit as $717.6 billion, just under 6.0 percent of GDP. This deficit is far larger than any trade deficit the United States ever ran in the past. The run-up in the dollar in the early eighties led to a rising trade deficit that eventually peaked at just over 3.0 percent of GDP, slightly more than half the share reached in the first quarter of 2005.

While a country as big as the United States can run a deficit of this size for two or three years, it cannot sustain a deficit of this magnitude for long. If the trade deficit were to remain at 6 percent of GDP (it is still increasing according to the most recent data) then the net indebtedness of the United States would be more than 90 percent of the value of the stock market by the end of 2015. (These calculations assume that the nominal interest rate on foreign owned assets in the United States averages 5.0 percent. They also assume that nominal GDP grows at a 5.0 percent annual rate, approximately the rate projected by the Congressional Budget Office.)

This means that the total amount of U.S. assets held by foreigners would exceed the value of foreign assets held by people living in the United States by an amount equal to 90 percent of the size of the stock market. Net indebtedness would be more than 1.5 times the value of the stock market by the end of 2025. In other words, the only way that the United States can finance this trade deficit is by selling off the country's capital stock, and before too long it will run out of capital stock to sell. This is why virtually all economists would agree that a trade deficit of the current magnitude is unsustainable.

In spite of the agreement on the unsustainability of the trade deficit, there is some confusion on the cause of the deficit. While many economists argue that the trade deficit is attributable to an over-valued currency, there are some analysts who claim that the real problem is a lack of domestic savings. By definition, the trade deficit is equal to the gap between domestic savings and domestic investment. Many have inferred from this relationship that the key to getting the trade deficit down to a manageable level is

therefore to increase domestic savings. However, this view is not an alternative to the argument that the dollar is over-valued. In fact, it is the same argument.

To see this point, it is important to understand the mechanism through which a lack of savings can lead to a larger trade deficit. In the conventional story, a lack of national savings (in this case due to large government budget deficits, coupled with low private sector savings), leads to upward pressure on interest rates. Higher interest rates in the United States make it a more attractive location for foreign investors, since they will be able to get a higher return on funds invested in bank deposits, government bonds, or private bonds. This means that high interest rates in the United States will increase foreign demand for U.S. bank deposits, bonds, and other interest paying financial assets. In order to buy these U.S. financial assets, foreign investors must first acquire dollars. The effect of foreign investors buying more dollars is to raise the value of the dollar in international financial markets. In this way, less savings in the United States can lead to a rise in the value of the dollar.

The higher dollar has the effect of raising the price of U.S. exports to consumers in other countries. U.S. goods and services are priced in dollars. This means that if the value of the dollars rises, so that it takes more yen, euros, or pounds to buy a dollar, then the price of U.S. made goods and services will be more expensive to people seeking to buy them with foreign currencies. (This discussion assumes that the price of goods and services produced in the United States do not fall in response to a reduced demand for exports. It also assumes that prices of goods and services imported into the United States do not rise [measured in the currency of the exporting country] as demand for imports increases. While this is not strictly true, it is a reasonable first approximation. The basic analysis does not change in any substantive way if the changes in prices are allowed.)

The higher price of U.S. exports in turn leads to reduced demand, and therefore a fall in U.S. exports, at least compared to a situation in which the dollar did not rise. (Exports may still rise even if a higher dollar is making them less competitive, they just would be increasing more slowly than would otherwise be the case. It is also important to recognize that exports and imports are often directly linked. For example, if car parts are shipped from the United States, to be assembled in Mexico, and the finished car is eventually sold in the United States, an increase in the number of cars that the U.S. imports from Mexico would be associated with an increase in the export of car parts to Mexico.)

The rise in the value of the dollar leads to the opposite outcome in the case of imports. If the price of producing goods or services in Japan, Germany, or England is held fixed, and the dollar rises relative to the price of the currencies of these countries, then the price of these goods and services will become cheaper for people in the United States. For example, if it costs 20,000 euros to build a car in Germany, this car would cost $20,000 in the United States (ignoring shipping costs), if the value of the euro and the value of the dollar were equal, so that one dollar traded for one euro. However, if the dollar rises in value so that a dollar is equal to the value of two euros, then the same car would sell for just $10,000 in the United States. In this way, a rise in the value of the dollar makes

imports cheaper for people living in the United States, leading the United States to purchase more imported goods.

The two effects of the higher dollar both lead to a rise in the trade deficit. On the one hand, the higher dollar makes U.S. exports to other countries more expensive, causing them buy fewer goods and services from the United States. At the same time it makes foreign goods and services cheaper for consumers in the United States, thereby causing imports to rise. Fewer exports and more imports means that the country will have a larger trade deficit.

In this story, even though inadequate national savings is the ultimate cause of the trade deficit, the immediate cause of the deficit is the over-valued dollar. It is essential to recognize this fact. People in the United States make the decision to buy more imported goods and services because the higher dollar has reduced the price of imported goods and services relative to domestically produced goods and services, not because of inadequate savings in the United States.

This point can be easily demonstrated by describing the counter-factual. Imagine that savings increased by a large amount in the United States, but the value of the dollar remained unchanged. In this situation, there is no reason to believe that people who opted for foreign made cars, computers, clothes, etc. will now choose to buy the same products from U.S. producers. In fact, it is almost inconceivable that any U.S. consumer thinks about the domestic savings rate or the budget deficit, when he or she makes a decision on whether to buy a foreign or domestic produced shirt or pair of shoes. Consumers base their purchasing decision on a variety of factors, which may include concerns about domestic workers or national prosperity, in addition to considerations of price and quality, but they almost certainly do not base their buying decision on their assessment of the size of the national savings rate.

In short, inadequate savings in the United States can lead to a large trade deficit precisely because it leads to an over-valued dollar, it is not an alternative explanation. Those who believe that higher savings and/or lower budget deficits are essential to reducing the size of the U.S. trade deficit, must also believe that it is necessary to reduce the value of the dollar.

There is one alternative way in which higher savings can lead to a reduced trade deficit, without a decline in the value of the dollar, although presumably not one advocated by proponents of increased national savings. In addition to being affected by the price of the dollar relative to foreign currencies, imports also fluctuate in step with the U.S. economy. Other things equal, imports in the United States increase as GDP increases. The basic reason is very simple: as the economy grows, we buy more of everything, including more cars, clothes, etc. that are produced abroad. In addition to the high value of the dollar, one of the factors that has helped to increase the trade deficit in the years since the recession has been the relatively good growth performance of the United States.

Of course, this process works in reverses as well. If the United States economy grows more slowly, or even contracts, then import growth will slow, or in the extreme case, imports could even fall. A sudden rise in savings could bring about this result. For example, if consumption spending were to fall sharply as a result of a collapse of the housing market, then this would correspond to a large increase in savings in the national income accounts. At least in the short-term, this fall in consumption would almost certainly be associated with a large downturn in the economy, since there would be no obvious source of new demand that could quickly offset a plunge in consumption.

This economic downturn would lead to reduced imports, since the United States would be buying less of everything, including imported goods and services. However, if the downturn in the United States had no major effect on the rest of the world (a clearly implausible assumption), then demand for U.S. exports would not be affected. If U.S. imports fell, but U.S. exports remained on the same growth path, then the U.S. trade deficit would shrink. If the U.S. economy sank far enough, then imports could decline enough to bring the trade deficit into balance, or at least down to a sustainable level. In this way a rise in savings could lead to a reduction in the U.S. trade deficit, without any necessary change in the value of the dollar.

While it is possible to describe a path that gets from higher savings to a lower trade deficit without a decline in the value of the dollar, it seems unlikely that anyone in a policy position would really advocate this course of action. Effectively, it amounts to correcting the U.S. trade deficit by throwing the economy into a severe recession or even depression. Presumably, those who argue that increased national savings are necessary to reduce the trade deficit are not really advocating a recession/depression.

If we rule out correcting the trade deficit through recession, then the only real path available for reducing the trade deficit is by lowering the value of the dollar. A higher savings rate may help in this process, but a higher savings rate does not act as an alternative to reducing the value of the dollar, it is one possible mechanism for bringing about this result.

Furthermore, in the current international financial situation, it is questionable how much impact higher savings in the United States will have on the value of the dollar. This is due both to the fact that it is not clear how much impact savings will have on interest rates, and how much impact interest rates will have on the value of the dollar.

The first question arises because interest rates in the United States are already extremely low, in spite of the low domestic savings rate. The real interest rate on 10-year government bonds is currently around 1.0 percent, compared to an average of more than 3.0 percent over the last three decades. (This is based on a nominal interest rate of 4.2 percent and an inflation rate (measured by the CPI) over the last year of 3.2 percent [March 2004-March 2005]). It is difficult to believe that the interest rate in the United States would decline to any significant degree, if the budget deficit were cut substantially or private savings rose.

The workings of the second link in this chain seem even more questionable. Foreign investors are not currently buying up large amounts of U.S. financial assets in order to take advantage of high domestic interest rates. Rather, a large percentage of the foreign purchases of U.S. financial assets are currently made by foreign central banks, primarily the central banks of the East Asian countries. These banks are buying up U.S. assets in a conscious effort to maintain the high value of the dollar relative to their currencies, they don't care much about the interest rates they earn on their dollar holdings. Therefore, they would not cut back their purchases of U.S. government bonds just because the interest rate fell by 0.5 percentage points, or even a larger amount.

In other words, the extent to which higher savings in the United States could lead to a lower dollar is being severely limited by the intervention of foreign central banks who are consciously trying to prevent the dollar from declining in value relative to their currencies. As long as this situation persists, the trade deficit will not be substantially reduced even if there were a large reduction in the budget deficit or increase in private savings.

(Other U.S. trading partners, most notably Canada and the European countries, have allowed their currency to float more freely against the dollar. While it may be possible to bring about a further decline in the dollar relative to the currencies of these countries, even if the dollar value of the East Asian currencies remains relatively fixed, it is unlikely that their central banks will allow too much dollar depreciation against their currencies. It is important to remember, that if the dollar declines against the euro and other currencies, and the East Asian currencies remain fixed relative to the dollar, then the East Asian currencies have also declined relative to these currencies. This will have the effect of not only making U.S. exports more competitive in these markets, but also the exports of the East Asian countries. For this reason, other central banks are likely to limit the extent to which they will let their currencies rise relative to the dollar, unless the currencies of the East Asian countries also rise relative to the dollar.)

In sum, there really is only way in which to reduce the U.S. trade deficit: reducing the value of the dollar. A lower budget deficit and higher private savings rate are desirable and may help to contribute to a reduction in the value of the dollar, but they are not substitutes for a lower dollar. Furthermore, in the current international financial environment, where many countries are fixing their currencies against the dollar, it is not clear that even sharp reductions in the budget deficit and increases in the private savings rate will have much impact on the value of the dollar.