

**Globalization and the US Trade Deficit:  
Domestic Sources, Foreign Sources, and Policy Challenges**

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Dr. Catherine L. Mann\*  
Senior Fellow, Institute for International Economics

The US trade deficit is composed of cross-border flows of goods and services, which are determined by US and foreign income growth, along with relative prices. Over the last 30 years, the US trade deficit has narrowed and widened influenced largely by the degree to which the US and foreign economic cycles are in or out of sync, and as augmented or dampened by movements in the dollar.

Since 1991, however, global imbalances, measured on the one hand by the US trade deficit or current account and on the other by the current account surpluses of our trading partners, have widened nearly without pause. The US trade deficit reached \$670 billion in 2004—an unprecedented excess of domestic spending over production for any large industrial country. On the counterpart side, all our trading partners are running trade surpluses with the US—growth in the rest of the world has come to be dependent on US demand patterns.

Regardless of the exact point when economic forces push back hard, few suggest that the trajectory for the US imbalance is sustainable. By construction, neither is the collective path for the rest-of-the-world. Moreover, that no other individual country faces as significant a quantitative change to their trade balance as the United States should not imply ease of adjustment. In fact, just the opposite could be the case: Each country (including the United States) facing the policy choices and structural challenges to reorienting demand and production could argue that someone else should ‘go first’.

The co-dependency of global imbalance has taken many years to develop, and cannot be unwound in short-order. Nor should interdependence be seen as negative; rather that sustained global growth must be better balanced. Policymakers here and abroad have important structural issues to address. However, there are some near-term challenges where the timing of policy decisions is more urgent. Finally, coordinated policy action may be needed to put the global economy on a less vulnerable footing.

***Domestic Sources of the US Trade Deficit***

US trade evidences the empirical regularity that US imports grow relatively faster when US GDP grows as compared to how much US exports grow when foreign GDP grows. This empirical

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\* Many thanks to Katharina Plück for preparing the charts.

finding has several potential foundations ranging from relatively richer and sophisticated US consumers and business who demand variety and can fragment production, to trade protection abroad particularly in services. As the US has grown robustly in terms of domestic demand since the 1990s, the result is a US trade deficit of unprecedented magnitude, both in dollar terms and as a share of GDP.

This macroeconomic story of the US trade deficit masks important features of the disaggregated data. In particular, a very large structural imbalance in the consumer categories of trade is likely a reflection of domestic imbalances in the United States, which point to key domestic sources of the U.S. trade deficit, both structural and amenable to short-term policy attention.

What does the disaggregated picture of US trade show? (**Chart 1**) The largest category on both sides of the US trade equation is capital goods and industrial supplies and materials excluding energy, which accounted for 45 percent of exports and 32 percent of imports (2004). Up until 1997, net trade cycled through larger and smaller surpluses depending in large part on the US and global business cycles. Since about that time, however, the trade balance in this category has not recovered even as global growth has revived. From a surplus of about \$50 billion in 1997, this balance is now in deficit some \$50 billion. This change likely reflects a number of factors: the partial and slow pass-through of the recent dollar depreciation into trade prices; relatively slow growth of investment in US exporters' markets abroad; a shift in the international supply chain for production of capital goods to center on China; and persistent effects of the Asian financial crises on policies there.

On the other hand, US 'other private services' such as education, finance, and business and professional services continue to reveal international competitiveness of US firms. The balance on trade in this category of trade (which now accounts for 6 percent of total imports and 13 percent of total exports) is positive and has continued to rise despite slow growth and relatively closed markets abroad. This is particularly impressive given that empirical analysis of the income elasticity of trade in services indicates that sluggish growth abroad disproportionately tends to hold down exports of these services.

What is most notable about the US trade deficit, however, is that the biggest component of the non-oil/non-agriculture trade deficit is in consumer goods, which accounts for 21 percent of imports and 8 percent of exports. When added to the net deficit in autos, nearly three-quarters of the increase in the non-oil/non-agriculture trade deficit since 1997 can be accounted for by these two categories of personal consumption expenditures. Only outright recession (in 1991 and 2001) stemmed the widening in these components of net trade.

How might the trade deficit in consumer goods be related to domestic structural trends and policies? **Chart 2** shows the savings-investment decomposition of the national income and product accounts (NIPA). Net investment is always in excess of net national savings. Fiscal balance, a part of national savings, is negative for most of the period, albeit briefly in surplus at the end of the 1990s. The most notable feature of the savings-investment balance is the trend decline in the household savings rate. A low savings rate implies strong consumption spending

out of wage and salary income, which has been bolstered by periods of high stock market valuation, enjoyed during the period of fiscal discipline, and now home equity wealth, coming from the current mix of fiscal and monetary policies.

Decomposing the fiscal deficit reveals an important link between fiscal policy choices and the trade deficit. According to the Congressional Research Service Report for Congress (March 2, 2005) 45 percent of the decline in the federal budget balance between FY2000 and FY2004 (from a surplus of 2.4 percent of GDP to a deficit of 3.6 percent of GDP) was on account of tax cuts. The tax cuts in 2001 added about \$30 billion in the second half of that year and the tax cuts of 2003 added another \$101 billion to disposable personal income (Macroeconomic Advisors September 17, 2002 and September 19, 2003). The March 2005 projections for the fiscal deficit from the Congressional Budget Office indicates what might be in store for consumption spending based on legislation to extend the expiring tax provisions—some additional \$700 billion in potential consumption spending. All these tax cuts translate into a lot of actual and potential consumption, which is clearly falling, at least in part, on imports.

Are there consequences of persistent spending in excess of earnings? The US received a \$1.8 trillion inflow of capital in 2004 from the rest of the world, well in excess of what was ‘needed’ to finance the trade and current account deficit. Even so, the decades long and accelerating excess of spending over production yields a build-up of net financial obligations to the rest of the world. The net international investment position (NIIP) turned negative in 1986, and has since swelled from \$0.8 trillion (about 7 percent of US GDP) in 1997 to \$2.4 trillion (about 23 percent of GDP) in 2003 (latest data). Perhaps more important, there is a rising share of interest-bearing financial instruments in the foreign purchases of US assets, in particular, of official and private purchases of US treasury securities, which is the manner in which the fiscal deficit is financed.

In sum, domestic sources of the US trade deficit center on extraordinarily robust domestic consumption underpinned by the structural trend decline in household savings in the United States, and further supported at various times by stock-market and housing equity wealth, and through deficit spending on the government account, particularly and disproportionately in recent years caused by the policy choice of personal income tax cuts. While foreign capital inflows remain robust to finance this spending, the rising share of interest-bearing instruments in these flows translates into a potentially more vulnerable financial position, both domestically and in international markets, should interest rates rise.

### ***Foreign sources of the US trade Deficit***

The counterpart to the widening US trade deficit of the 1990s is the geographically widespread and in most cases increasing trade surpluses vis-à-vis the US. (Chart 3). The widening US trade imbalance is not just due to imports from China or Japan or Mexico, but is broad-based across all trading partners. Indeed, the worsening of the bilateral US trade balance vis-a-vis Western Europe in recent years is about the same dollar magnitude as with China.

Just because a country has a bilateral trade surplus with the US does not necessarily imply domestic savings-investment imbalance within the country—a country can have a bilateral trade

surplus with the US and a bilateral trade deficit with another country leaving the country in balance overall between domestic demand and production. A country's global current account position is one way to measure this domestic balance. During the 1990s, almost all countries moved toward current account surplus, in some cases dramatically so. (Table 1) Persistent global current account surpluses reflect a systematic dependence on exports for GDP growth. In conjunction with bilateral trade surpluses vis-à-vis the United States it reveals a particular dependence on the exports to the US market.

An alternative presentation of trade data puts China at the center of global trade. (Chart 4) China's rapidly rising bilateral trade surplus with the industrial countries of the US and, to a lesser extent, Western Europe is in stark contrast to its bilateral trade deficits distributed around the Asian region, including Japan. These patterns of trade for China, in conjunction with the pattern of US bilateral trade with other Asian economies including Japan (Chart 3), are consistent with China being a value-added production-platform for goods ultimately destined for the United States and to a lesser extent Western Europe. So, the explosion in intra-regional trade in Asia is not so much from 'home grown' demand, and the region's growth success remains dependent on the exporting outside the region, particularly to the United States. This dependence the US has willingly abetted, what with its more rapid domestic demand.

The domestic growth strategy focused on exports and regional development, now centered on China, is consistent with the observed systematic evolution of real effective exchange-rates in the region. (Chart 5) From the time of initial economic reforms, which commenced at different times for different countries in the Asian region, there has been a drifting lower of real effective exchange rates in the Asian region. This exchange-rate strategy has yielded high growth and rapid development, which would tend to put revaluation pressure on the currencies. However, following the financial crises of 1997, the currencies depreciated and the associated accumulation of international reserves could be viewed as an insurance policy should private finance once again roil markets. However, the policy choice to systematically limit currency appreciation dampens the economic signals that promote a balanced domestic-demand oriented growth strategy, which also yields higher domestic standards of living. Moreover, excessive accumulation of international reserves carries risks, for example, of capital loss when currencies do move. So, the export approach to growth and the associated exchange-rate and international-reserves strategy have downsides, which should be appropriately weighted in the policy calculus.

Exchange rate stability in the region over the years has been associated with periods of systematic purchases of US treasury securities. Important foreign official purchases appeared in 1986-1989 and again in the mid 1990s, times when the dollar was experiencing depreciation pressures. However, official purchases accelerated during 2003 and 2004, and are unprecedented in terms of dollar value and as a share of total financial inflow. These foreign official purchases are concentrated by holder, with the estimated share of Japanese official holdings in total estimated official holdings rising from 28 to 37 percent between 2000 and 2004 and the estimated share of holdings by China and Hong Kong, SAR rising from 16 to 20 percent of total estimated official holdings.

The real effective exchange rate of the renminbi stands out. Based on real effective exchange rates, it would appear that the Chinese exchange rate regime has maintained its currency valuation well beyond the time when at least some appreciation is consistent with continued economic reforms. Such reforms would yield more balanced GDP growth, raise standards of living, and limit real and potential negative consequences of excessive accumulation of international reserves (see Nicholas Lardy and Morris Goldstein for more details).

To the extent that China is now at the center of regional production, its exchange rate regime influences policy choices in the region. Other economies in the region may wish to maintain exchange rate stability as part of the regional production relationships and thus arrest their currency appreciation by buying US Treasury securities. As a consequence, they may be accumulating a financial vulnerability as well as delaying needed structural changes in the sources of growth.

### ***Policy Challenges***

With the US current account beyond all historical precedent and with the build-up of US assets in the portfolios of private and official actors, the dollar should be under significant depreciation pressure and indeed it has depreciated from its trade-weighted 2002 peak. However, dollar adjustment alone is unlikely to close the US side of the global imbalance due to the size of the initial imbalance, the lop-sided role of US consumption, and slackness in demand abroad.

Policy choices are important. In the context of rising fiscal deficits, the US is vulnerable to a negative feedback loop between the fiscal deficit and the current account deficit. As the share of US treasury securities held abroad increases (that share already has more than doubled in the last ten years to over 50 percent), the interest paid on US government debt increasingly will be paid to foreign holders of that debt. Interest payments will worsen the fiscal deficit and augment the current account directly as well. Our long-term policy challenge is to address the structural deterioration in household savings. Of more urgent policy consideration is the additional impetus for future consumption spending and the associated decline in national savings generated by a permanent cut in personal taxes.

On the other side, long-term structural reforms in Europe oriented toward more domestic growth will aid in balanced GDP growth there. The European economies are already absorbing price signals through the exchange rate to motivate further structural reforms. Prompt consideration of monetary policy would further assist in the reorienting of demand toward domestic consumption and investment.

In Asia, to the extent that policymakers have inhibited an appreciation of their currencies against the dollar, they are delaying, and likely making even more difficult, their own structural reforms to reorient demand in their own economies. In addition, for the countries that have not absorbed any depreciation vis-à-vis the dollar, future dollar depreciation will reduce the value of their stock of US assets; hence a further build-up makes it increasingly difficult to alter the exchange-rate regime. Finally, if the US succeeds in its domestic reforms, countries may experience slowed export growth. These risks to exports and to value of invested capital could be most acute

in Asia where there has been the tendency to limit both currency change and structural reorienting of demand. Realigning exchange rates would address both the structural policy challenge to reorient demand and the more urgent objective of minimizing future capital losses on the existing portfolio of dollar assets.

Achieving more balanced growth paths and realistic exchange rates are difficult to orchestrate both domestically and internationally. It is in every policymaker's interest to pursue actively their own structural reforms, as well as engage collaboratively in the process of strengthening and sustaining global growth. Rising global imbalances and downward pressure on the dollar suggest that policy makers face some pressing short-term decisions: On the US side, addressing the near-term impetus to consumption spending; and on the Asian side addressing the regional exchange rate relationships. A failure of the policy process—both short-term and structural—increases the vulnerability of both home and global economic activity.

*Reference material by Nicholas Lardy and Morris Goldstein*

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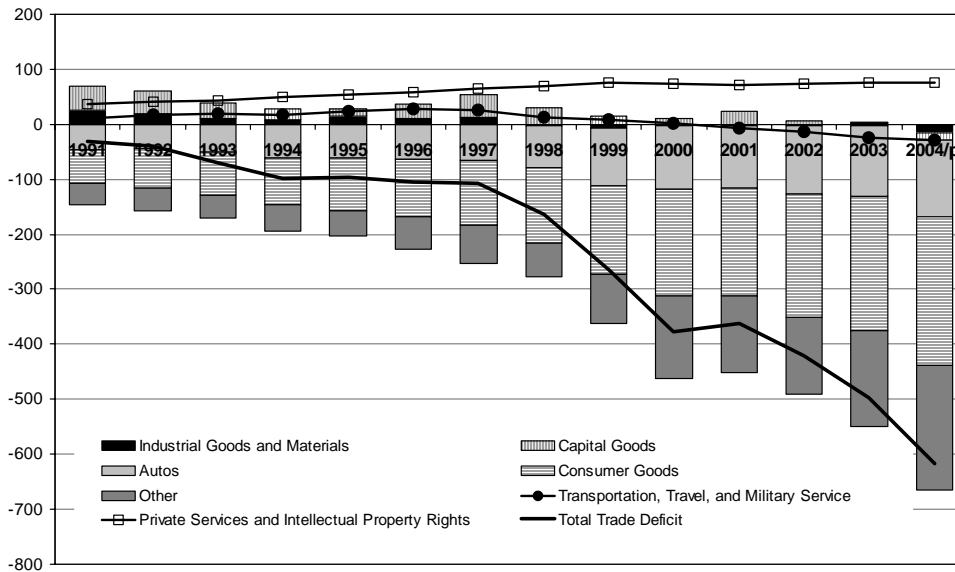
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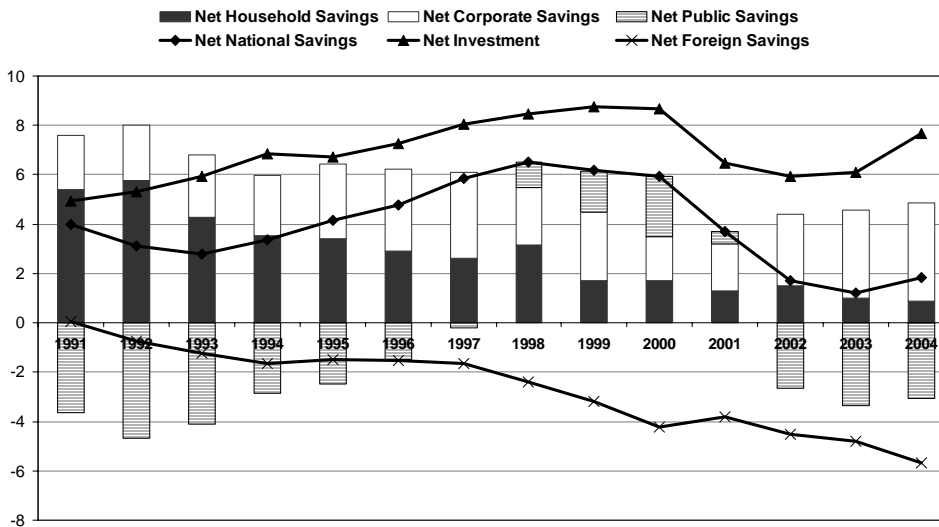
# Chart 1 : Disaggregated Trade, 1980-2004 (\$billions)



Source: Bureau of Economic Analysis, International Transactions Accounts Tables.

# Chart 2: The NIPA in Disaggregate

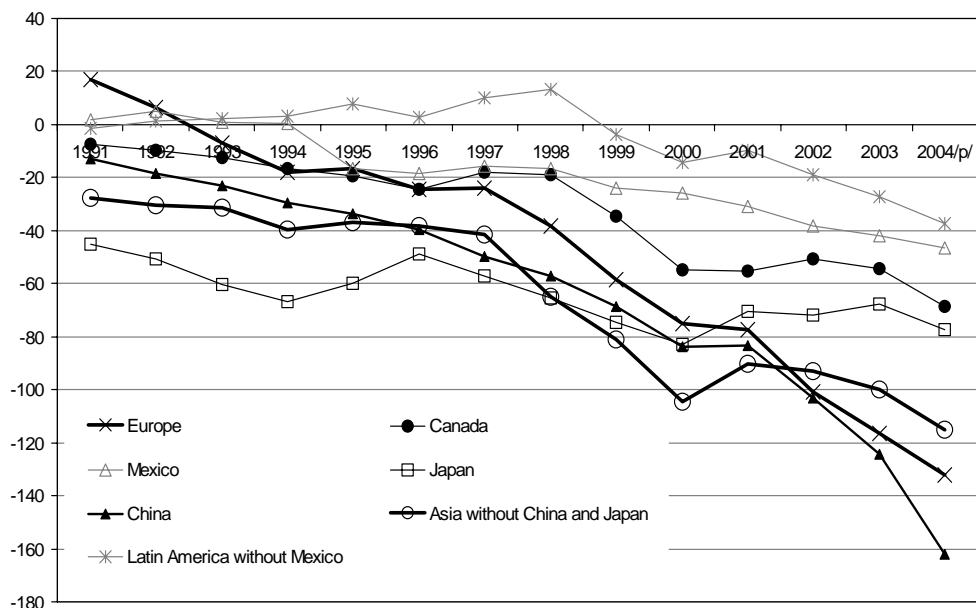
## US Savings and Investment as Percent of GDP, 1980-2004



Source: Bureau of Economic Analysis, National Income and Product Accounts; International Transactions Accounts; Catherine Mann.



### Chart 3: US Goods Balance with Selected Trading Partners (\$billions)



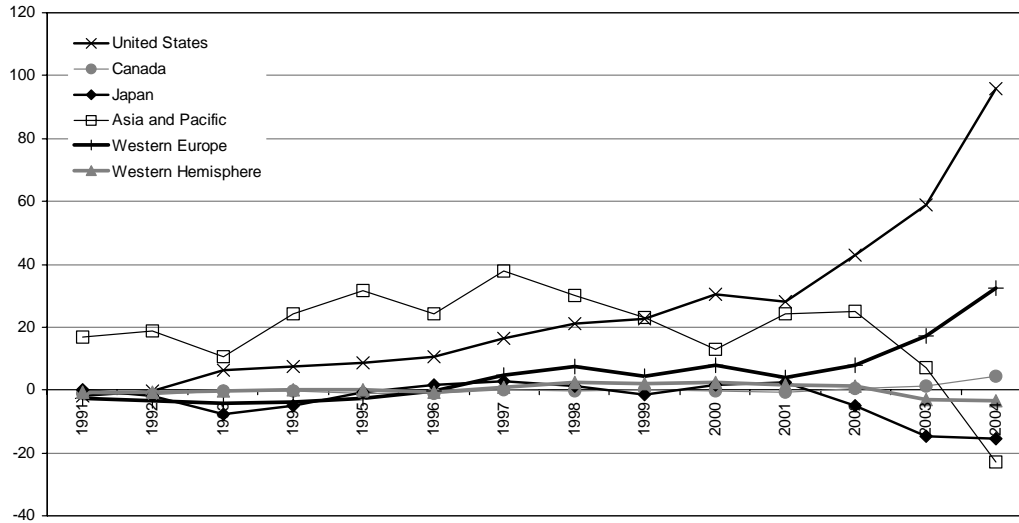
Source: BEA, International Transactions.

### Table 1: Current Account Balances as Percent of GDP

	1990	1995	1998	2003	2004	2005p
China	3.1	0.2	3.3	3.2	4.2	4.1
Japan	1.4	2.1	3.0	3.2	3.7	3.3
Asia/Pacific	-0.6	-1.8	4.5	4.9	4.5	3.6
Latin America/ Caribbean	-0.1	-2.2	-4.5	0.4	0.8	0.2
Western Europe	-0.3	0.8	1.0	0.9	0.8	0.8

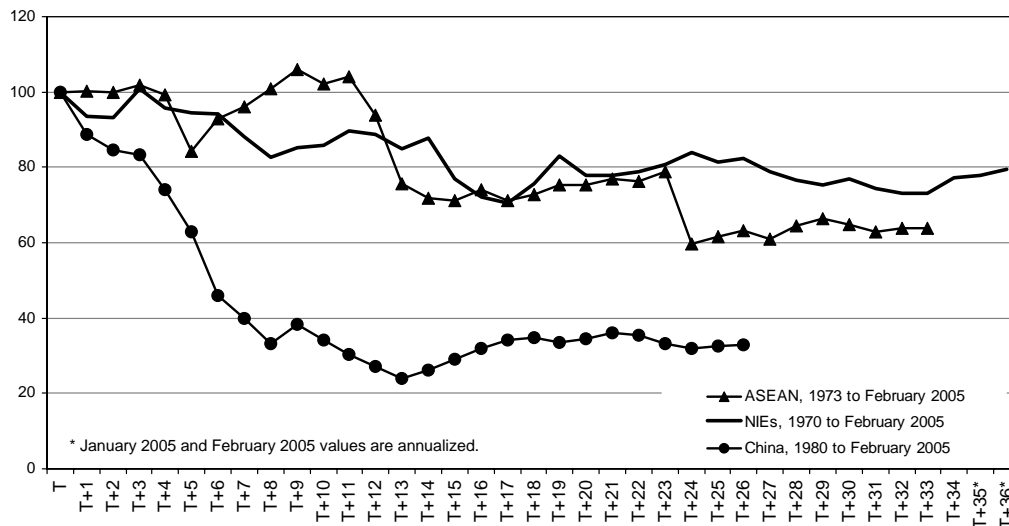
Source: IMF WEO, April 2005.

## Chart 4: China's Goods Balance with Selected Trading Partners (billions USD)



Source: UN COMTRADE Database.

## Chart 5: Real Effective Exchange Rates, Time T (beginning year of economic integration) = 100



Source: JP Morgan Real Effective Exchange Rate Indices;  
Time T from IMF WEO April 2004, chapter 2, p. 85.