America's Trade Deficit: The Latest False Alarm

A Commentary by W. Michael Cox and Richard Alm

ONCE AGAIN, AMERICA is worried about its trade deficit. A quick look at the numbers shows why. Through June, the red ink in goods and services totaled $119 billion, up from $66 billion for the first six months of 1998. The gap between imports and exports is certain to eclipse last year's $164.3 billion, itself a record. In the growing trade deficit, pessimists say they've found the Achilles' heel of this decade's low-inflation, high-growth, low-unemployment economy. They wonder how the economy can be strong when the United States keeps falling further behind in international competition. Anguish about the situation wouldn't be complete without disaster scenarios in which bloated trade deficits lead to a weaker dollar, higher interest rates and eventually a severe recession.

In recent years, the Federal Reserve Bank of Dallas has argued against those who persist in finding failure amid America's economic success. We've put into perspective concerns about layoffs, eroding living standards and declining real wages. When it comes to the trade deficit, the pessimists are once again wringing their hands and once again wrong—not just in their predictions but in their economic logic.

Trade deficits aren't a sword of Damocles hanging over America's economy. For two decades now, the country has prospered with merchandise trade deficits—some in the 1980s larger than this year's as a percentage of GDP. Yet our success is not a matter of luck, which someday might run out. The U.S. economy has grown stronger with big trade deficits because they reflect one of our economy's greatest strengths—its attractiveness to the world's investors.

The antidote to alarm about trade deficits lies in understanding how nations track their business dealings with each other. In international financial accounts, the balance of payments always balances. The dollar value of what goes out equals what comes in, except for minor statistical discrepancies. This is true for a big, powerful country like the United States, just as it is for small, developing nations.

The statistics that show the United States heading toward a record trade deficit this year tell only half the story. They show only the nation's international transactions in goods and services. What's missing are capital flows, grown larger in recent years as nations dismantled barriers to commerce and investors discovered the global economy.

The goods and services account shows the United States had a deficit of $164.3 billion last year. The U.S. capital account, however, doesn't show a nation awash in red ink. Quite the contrary. In 1998, foreigners invested $502.6 billion in the United States and Americans sent $292.8 billion overseas—leaving this country with a healthy surplus of $209.8 billion (*Table 1*).

While comprehensive international accounts will always sum to zero, transaction categories typically show surpluses or deficits. For the United States, surpluses in cross-border capital flows offset deficits in goods and services plus net income paid to foreigners. By the time this year's numbers are final, they doubtlessly will show the same pattern.

The headline we've seen so often—"America's Trade Deficit on Record Pace"—could just as easily read: "Foreign Investment in America Jumps."

Pessimists use the trade deficit to portray the United States as weak, a nation losing sales and jobs to other nations. But the surplus in the U.S. capital account leads to a quite different conclusion, one that ought to be welcomed by most Americans.

Table 1
U.S. Balance of Payments, 1998
(Billions of dollars)

Merchandise exports	670.2	
Merchandise imports	–917.2	
Merchandise balance	–247.0	
Services exports	263.7	
Services imports	–181.0	
Services balance	82.7	
Overall goods and services		**–164.3**
Income from abroad	258.3	
Income paid out to foreigners	–270.5	
Net investment income		**–12.2**
Foreign investment in the U.S.	502.6	
U.S. foreign investment	–292.8	
Net inflow of capital		**209.8**
Unilateral transfers		**–44.1**
Statistical discrepancy		**10.8**
Net balance on account		**0**

Savvy investors put money into economies with the best prospects for profit. The calculus depends on any number of factors, but there's no doubt that the most important are fast growth, stable financial markets and cutting-edge technology. In the past two decades, no country has done a better job than the United States of offering all three.

Over time, the net inflow of investment capital provides a mirror image of the trade deficit (*Chart 1*). During the first three decades after World War II, an era of minimal trade and cross-border investment, the two accounts hovered close to balance.

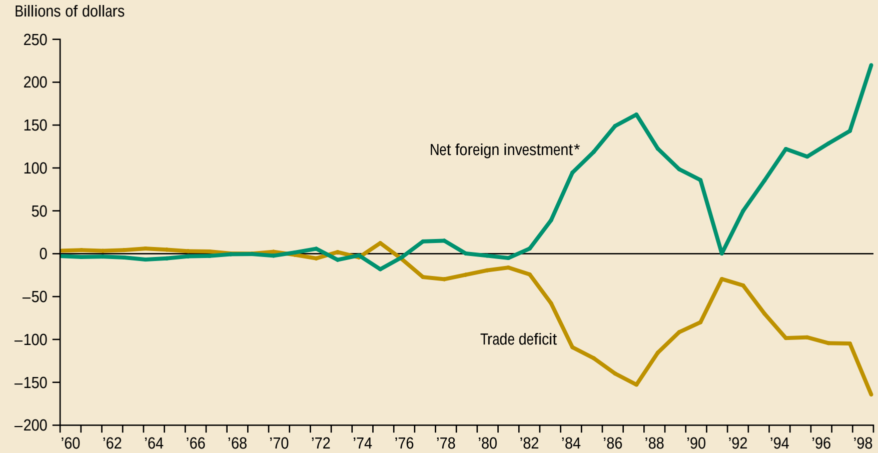
In the early 1980s, that changed. Foreign money rushed into the United States, creating a capital-account surplus and a trade deficit. The timing wasn't accidental. The 1970s brought a revolution in technology, led by the invention of the microprocessor. Investors figured—correctly, as it turned out—that the United States had the entrepreneurial fire and economic system to take advantage of the new technology.

Both the capital surplus and the trade deficit shrank from 1988 to 1992—a time when Europe revived with the fall of the Berlin Wall and the United States lapsed into a brief recession. What was happening? Investors shifted their funds to Europe, Russia and the Third World. The United States received less investment, so the hydraulics of the balance of payments brought our trade deficits down.

As the United States recovered and prospects dimmed for developing nations, U.S. trade deficits and capital surpluses once again ballooned. It's no secret why. Investors are buying into the world's most dynamic economy. America in the 1990s has offered strong growth, low inflation and exciting new technologies.

Ultimately, what gets brokered on world markets is the attractiveness of a nation's business climate—its willingness to embrace new technologies and undergo the economic churn that is capitalism's path to progress. Countries that endure the constant economic makeover—in Joseph Schumpeter's words, "creative destruction"—will prosper. Those that don't, won't. Admittedly, it can be an unpleasant process, full of the hardships of downsizing, layoffs, corporate mergers, restructurings and bankruptcies. Even so, the United States has accepted the short-term pain to reap the long-term benefits of a system based on competition, incentives, opportunity, and free and open markets.

Chart 1
U.S. Trade Deficit and Capital Flows, 1960–98



* Includes statistical discrepancy.

SOURCE: Bureau of Economic Analysis, *Survey of Current Business*.

The equality in international accounts punctures the pessimists' biggest worry. They argue that trade deficits destroy U.S. jobs by moving production overseas. After all, if Americans spent an additional $200 billion on U.S. goods, more Americans would be working, right? Wrong. What's left out of their argument, once again, is the capital account and the restructuring of the U.S. economy that it helps finance. When foreigners invest in the United States, they help spur growth by endorsing new and stronger U.S. industries—with more and better jobs for American workers. If it weren't that way, the nation's unemployment rate wouldn't have fallen from nearly 10 percent in the early 1980s to just over 4 percent today. If it weren't that way, real income per capita in America wouldn't have grown by over a third since the early 1980s.

Americans hear too much about the trade deficit and too little about the nation's surplus in international capital flows. Too bad. Our ability to attract investment reflects the strength of the U.S. economy and explains why trade deficits persist at a time when nearly all barometers of the nation's economy are positive.

The real problem with focusing on the trade deficit lies in the misconception that other countries are taking advantage of us, that Americans aren't getting a fair shake in the international marketplace. This belief can lead to foolhardy policy. It's tempting for a nation fixated on red ink in trade to lash out at imports. Protectionism, though, will only sap America's economic vitality.

The United States could generate a trade surplus if it chose to. What's required is a smaller surplus in international capital flows. Making America less attractive to investors would do the trick. How about a severe recession? Perhaps excessive taxation? Either way, neither Americans nor foreigners would be eager to invest here. As a result, capital would flow out instead of in, and Americans would end up shipping out more goods and services than they import.

Would anyone celebrate? We hope not.

Cox is senior vice president and chief economist in the Research Department at the Federal Reserve Bank of Dallas. Alm is a business reporter for the Dallas Morning News.