JOINT ECONOMIC COMMITTEE
SENATE REPUBLICANS

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TRADE DEFICITS, CURRENT ACCOUNT DEFICITS, AND THE DOLLAR

Recent movements in the overall trade balance of the Nation have been encouraging. American exports are booming (they set a new record dollar-valued high in April), export growth has outstripped import growth for eight consecutive months, and the trade deficit in goods and services has declined (it fell by 3.1% in the 1st quarter of 2007). While it is too early to tell if the trade and related current account deficits are on a longer-term trend of improvement, lagged effects of declines in the value of the U.S. dollar along with resurging growth in economies of our trading partners may be taking hold to help erase what have, since the early 1990s, been persistent and increasingly large deficits. This article provides some basic definitions for the trade and current account deficits and discusses recent movements in the trade and current account deficits and in the value of the U.S. dollar in historical perspective.

Some Simple Definitions.

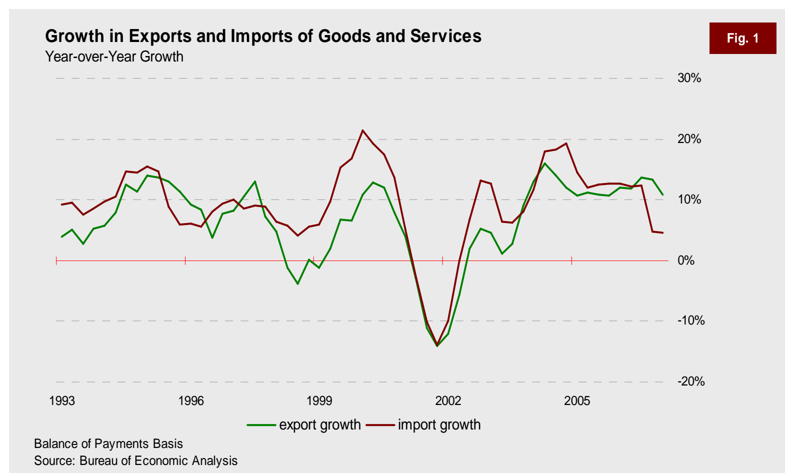
The **trade balance** measures exports minus imports of merchandise. The presence of a trade deficit is not always bad, *per se*, as it merely means that the U.S. imports more goods than it exports. Indeed, growing economies tend to run trade deficits, as they demand more goods than can be produced domestically.

The **current account balance,** another accounting balance reflecting international trade, is a broader measure than the trade deficit of wealth flows into and out of the U.S. The current account balance encompasses the merchandise trade balance, but also includes other categories of trade such as services, gifts, and aid. The trade balance accounts for the vast majority of the current account balance.

A current account deficit can be financed only through foreign investment. A net inflow of goods must be paid for somehow and this requires exporting some kind of financial asset (cash, bonds, stocks, foreign direct investment, etc.) to foreigners. A current account deficit is roughly what a particular country must borrow from abroad in a period to finance the shortfall of domestic savings relative to investment.

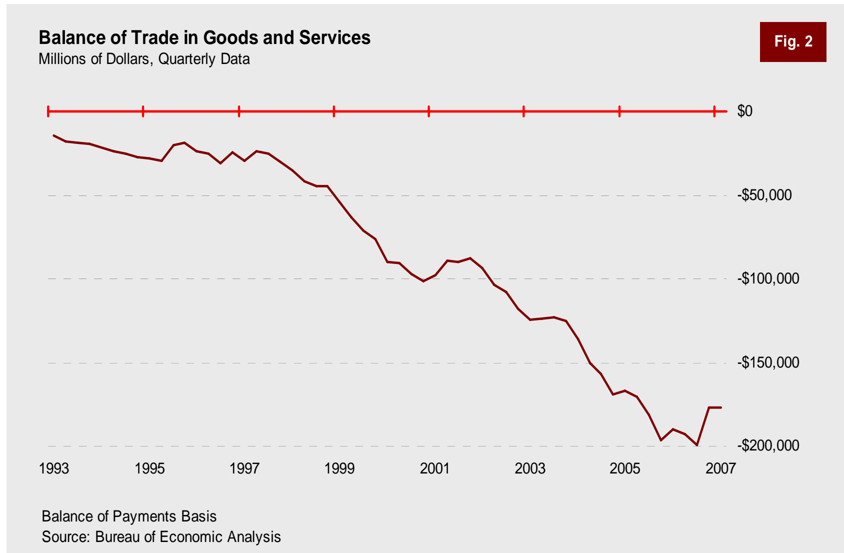
The Recent Record.

Emerging from a mild recession at the end of 2001, the U.S. trade balance has reflected continuing vitality in both U.S. consumption and production. U.S. exports of goods and services have steadily grown since August 2002 to reach record dollar-value highs recently. Yet import growth has generally been strong enough to outstrip export growth (see Fig. 1).

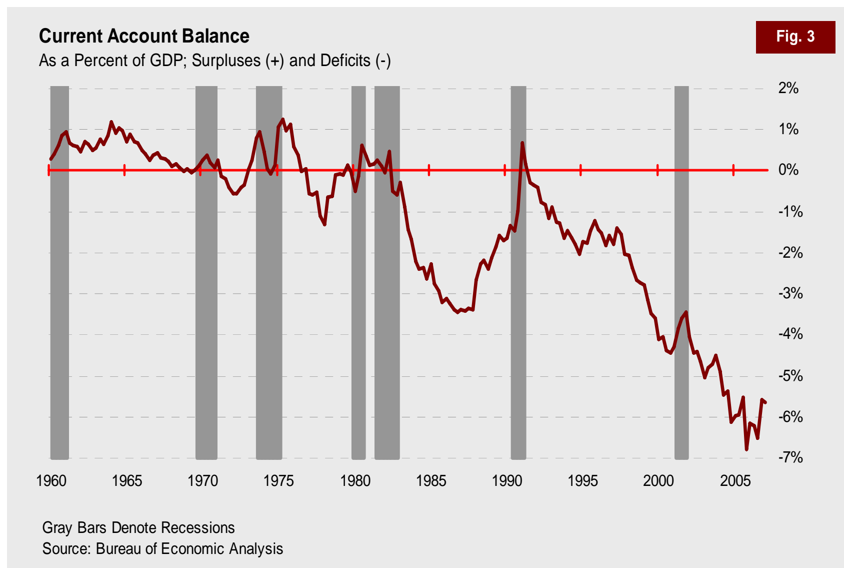


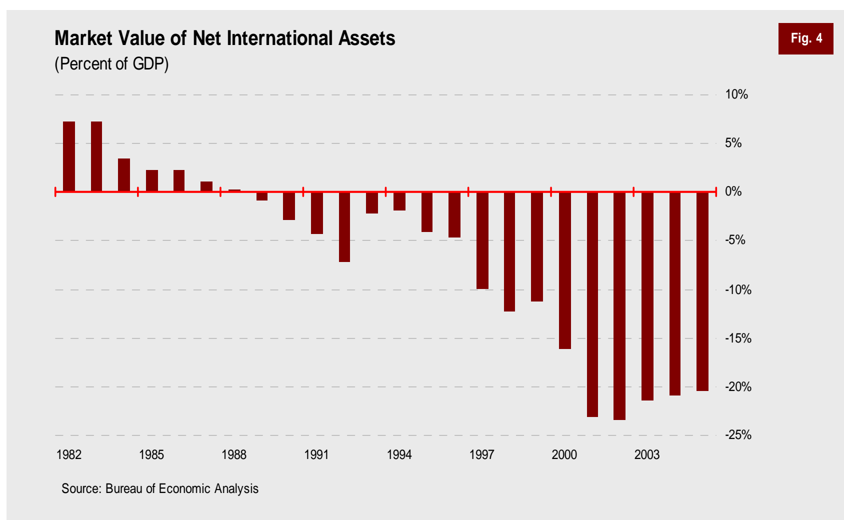
Balance of Payments Basis
Source: Bureau of Economic Analysis

As import growth outstripped growth in exports, the dollar value of the U.S. trade deficit hit a record high in August 2006, and the U.S. current account deficit reached an unprecedented 6.5 percent of the gross domestic product (GDP) in the 3rd quarter of 2006.[1] While export growth has outstripped import growth for eight consecutive months through April of this year, the reverse has been true on average since the early 1990s. This led to persistent and generally growing trade and current account deficits since the early 1990s (see Figs. 2 and 3).



The U.S. trade and current account deficits have generally been rising in tandem since the early 1990s, which is not surprising given that the trade balance is a dominant component of the current account balance. Financing the increasingly large current account deficits, which reflect excesses of U.S. investment over saving, has required foreign investment. Thus, since the early 1990s, foreign investors have been steadily adding to their holdings of U.S. assets (see Fig. 4, which shows the generally negative net asset position of the U.S. as a percent of GDP for the periods shown).



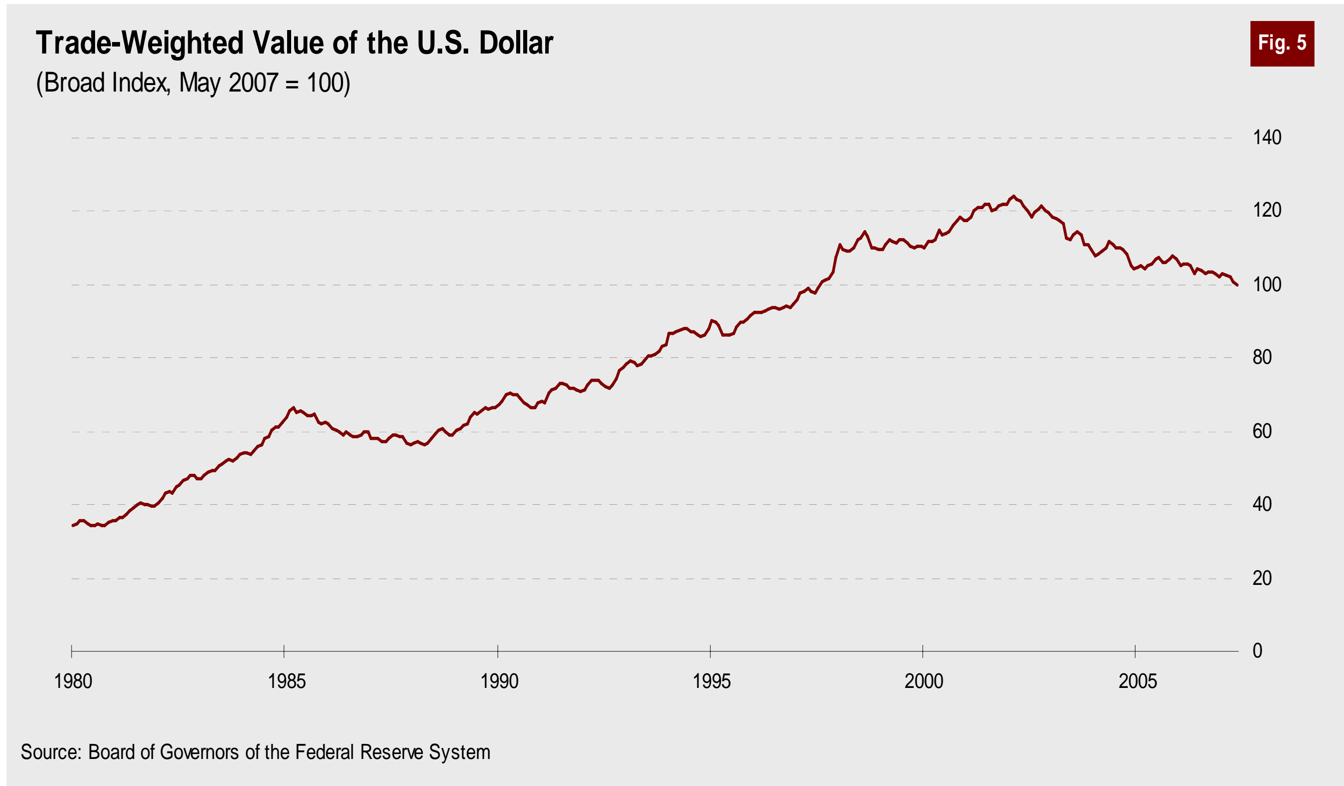


Growth in holdings of dollar denominated assets abroad has caused some to fear the possibility of a precipitous decline in demand from other countries for assets denominated in dollars. That possibility could lead to sudden

[1] The gross domestic product is a broad measure of the total market value of all newly produced final goods and services within the country's borders in a period.

declines in U.S. asset values (e.g., sudden declines in stock and bond prices and depreciations of the U.S. dollar relative to foreign currencies), leading to sharply higher interest rates and a risk of a significant slowdown in the U.S. economy and, perhaps, recession.

The value of the dollar has declined relative to currencies of most of our major trading partners since the beginning of 2002 (see Fig. 5). Yet, over that same period, until recently, U.S. trade and current account deficits generally continued to grow (see Figs. 2 and 3).[2] The lack of a more significant response of the trade and current account deficits to the dollar depreciation could have arisen for many reasons, including lags in responses of trade and production patterns internationally to changes in exchange rates.



A Path Previously Traveled?

While the magnitudes of the record-setting trade and current account deficits recorded last year are unprecedented, the U.S. faced a similar situation in the 1980's and emerged unscathed through an orderly drop in the value of the dollar. Many analysts see it as likely that such an experience will recur as overseas markets continue to recover and the U.S. becomes less central to world economic growth. Since the global recession that began at the start of this decade and until recently, continued weakness in economies abroad led to an imbalance between goods demanded by Americans and goods demanded by the rest of the world. More recently, as growth has picked up in economies of many of our trading partners and the dollar continues to depreciate, the U.S. current account and trade deficits have declined relative to their record highs.

[2] For a basic introductory discussion of exchange rates, see the JEC report entitled ***A Primer on Exchange Rates***, available at http://jec.senate.gov/republicans.

A risk to the U.S. economy of a resurgence of the growth in the current account and trade deficits that had been occurring generally since the early 1990s would be a possible loss of confidence in the U.S. on the part of foreign lenders. Any loss of confidence in the dollar's value that would lead to a *rapid* drop in its value as U.S. asset holders abruptly flee dollar-denominated assets would drag down stock and bond prices and send interest rates soaring. Such an eventuality would choke off U.S. growth and threaten a return to global recession.

In the early 1980s the U.S. also borrowed heavily from abroad to finance imports and the current account deficit swelled to reach almost 3.5% of GDP. But by the late 1980s, the current account improved without causing a recession due to a large, but orderly, drop in the value of the dollar vis-à-vis currencies of our major trading partners. For example, the dollar fell by 55% vs. the Deutch-mark and by 56% vs. the yen over the 1980s as the German and Japanese economies boomed and attracted their own investment. The decline in the dollar also coincided with U.S. GDP growth rates in the 3-4% range.

In recent years, the trade-weighted value of the dollar has declined by almost 20% relative to its peak in early 2002 in nominal terms (i.e., not adjusting for relative inflation rates across countries in prices of goods and services). During that period, the dollar has also declined by around 55% against the euro, close to 10% against the Japanese yen, and 7.24% against the Chinese yuan. Orderly dollar depreciation should eventually help contain our trade and current account deficits as U.S. exports become relatively more attractive to consumers in growing foreign economies.

Investors in other countries will likely continue to hold U.S. securities – so long as the U.S. remains a hospitable and profitable destination for capital. Economies in Europe and Japan have only recently climbed out of stagnation. For many years, there had been few other destinations for capital outside of the U.S., as the American economy remained the prime engine of world growth and a fertile investment destination. In the existing competitive global markets for capital, it is imperative to maintain and enhance U.S. capital markets as hospitable and profitable destination for global flows of financial capital.