CBO MEMORANDUM

CAUSES AND CONSEQUENCES
OF THE TRADE DEFICIT:
AN OVERVIEW

March 2000

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

In recent years, the U.S. trade deficit has grown very large by historical standards, prompting concerns that it is damaging or may pose a threat to the economy. The Senate Committee on Finance asked the Congressional Budget Office (CBO) to carry out a study of the trade deficit, its causes, and its effects on the economy. The committee also asked CBO to examine the effects of various federal policies on the trade deficit—especially those that might be considered to reduce or eliminate it. This memorandum summarizes the results of that effort.

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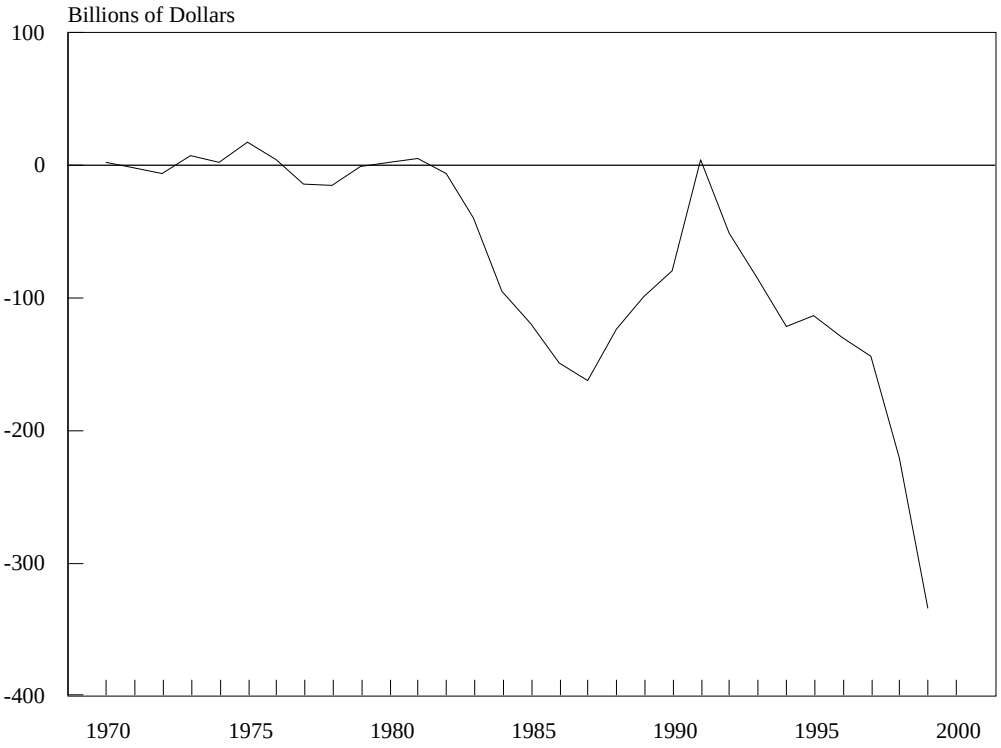
INTRODUCTION AND SUMMARY

Since World War II, the United States has supported agreements among nations to eliminate barriers to international trade and investment. Despite occasional resistance, that support has generally reflected a public consensus about the benefits to be gained from free trade. Since long before the war, the United States had run an almost unbroken string of trade surpluses—that is, an excess of exports over imports—and the war damaged or destroyed much of the most significant international competition for U.S. industry. Consequently, before 1970, U.S. industry seemed to have little to fear and much to gain from free trade.

After 1970, however, the almost unbroken string of trade surpluses turned into one of trade deficits, and in the 1980s and 1990s, those deficits grew quite large (see Figure 1). Opponents of freer U.S. trade point to the deficits as evidence of mistaken U.S. and unfair foreign trade policies. Many are concerned that the deficits cause a number of economic ills, such as unemployment and slower economic growth, and they therefore support import restrictions and other trade policies intended to reduce or eliminate the deficits.

In fact, however, the deficits are not caused by either U.S. or foreign trade policies. Rather, they are determined by the balances between saving and investment in the United States and in other countries and the effects of those balances on international flows of capital. The major changes in the U.S. trade deficit since 1970

FIGURE 1. THE U.S. BALANCE OF TRADE, 1970-1999



SOURCE: Congressional Budget Office using data from the balance-of-payments accounts published by the Department of Commerce.

NOTE: The measure plotted is the current-account balance. The value for 1999 is a CBO estimate based on published numbers for the entire year for trade in goods and services and for the first three quarters of the year for other components.

can be traced to three primary sources: a long decline in saving as a share of gross domestic product (GDP) that began in the mid-1950s and accelerated in the 1980s, fluctuations in the business cycle, and relatively attractive investment opportunities in the United States in the 1990s.[1]

1. Gross domestic product is the total output of goods and services produced by factors of production (capital, labor, land, and so on) located in the United States, regardless of whether those factors are U.S. or foreign owned.

In the early 1980s, the percentage of GDP accounted for by gross saving fell rapidly and was reflected in a widening gap between the supply of saving and the demand for domestic investment.[2] The declining share of saving had broad consequences: the economy accumulated less capital and therefore grew more slowly and paid workers lower average wages than it would have if the share had remained higher. Inflows of capital from abroad partially filled the gap and permitted domestic investment to exceed saving. Those inflows also created a trade deficit, allowing domestic consumption and investment to exceed domestic production.

The trade deficit has also fluctuated with the business cycle, increasing during economic expansions and declining during recessions. For example, the trade deficit shrank as the economy slowed in the early 1990s but has increased since the current expansion began in 1992. Some evidence suggests that demand for private investment in the 1990s has grown beyond what would be expected to occur simply as a result of a normal upswing in the business cycle. Regardless of whether that is true, substantial growth of private investment over the past decade has combined with the longer-standing low saving rate to produce today's large current-account deficits.

2. Gross saving is the portion of GDP not consumed by U.S. residents and therefore available for investment either domestically or abroad. Gross domestic investment is the total investment in the domestic economy by either U.S. residents or foreigners.

But inflows of foreign capital carry a price tag: interest must be paid on debt owed to foreigners, and a share of profits and dividends must be paid to foreigners who invest in U.S. equities. The ease with which debt can be repaid will depend primarily on the future performance of the U.S. economy. There are no fixed required payments on equity investments; equity investors are paid only if the investment is profitable, though equity investors are generally compensated for accepting that risk with higher average expected returns. Nevertheless, the cost of paying for foreign capital invested in the United States is generally less than the benefit the United States receives from that capital.

Policies promoting free trade benefit the U.S. and world economies. Although fluctuations in the trade deficit can, at times, cause painful dislocations for particular industries and their employees and the underlying cause of the deficit can hurt the economy, deficits themselves do not cause significant long-term economic ills for the economy as a whole. The nation is generally better off allowing the inflow of capital from abroad and running a trade deficit than being forced to reduce investment to match the shortfall in savings.

Trade policy normally has little if any effect on the trade deficit because it does not affect saving and investment. Policymakers could, of course, design broad and severe trade restrictions to close the deficit by choking off imports. But such polices would ultimately cause exports to decline by almost as much as imports. Hence, they

would reduce or eliminate both the beneficial effects of capital inflows from abroad and substantial gains from trade. They would also significantly disrupt the economy by forcing it to adjust to the lower levels of trade. Finally, trade restrictions would not reverse the long-term decline in saving as a share of GDP that brought on the deficits 20 years ago and continues to contribute to their magnitude. Rather, they would be likely to reduce investment.

WHAT IS THE CURRENT-ACCOUNT BALANCE?

To assess the significance of the trade balance for the economy as a whole, economists generally employ a broad measure known as the current-account balance—the sum of the balances on the trade of goods and services, income flows from foreign investments, and unilateral current transfers.[3] The current-account balance is the subject of two accounting identities that are important stepping-stones to understanding the causes and effects of trade deficits.[4]

- The current-account balance is equal to the negative of the financial-account balance, which is the balance on foreign investment flows. Thus, if a country runs a current-account deficit, it also runs a financial-account

3. Unilateral current transfers include such items as government grants, taxes paid by U.S. residents to foreign governments, and taxes paid by foreign residents to the U.S. government.

4. An accounting identity is an equality that follows straight from the definitions of the terms employed and the rules of double-entry bookkeeping. It involves no empirical observations or economic theory.

surplus of equal magnitude, which means that the net inflow of foreign investment equals the current-account deficit.[5]

- The current-account balance is equal to the difference between gross saving and gross domestic investment. Thus, if a country runs a current-account deficit, its gross domestic investment is greater than its gross saving by an amount equal to the current-account deficit.

WHAT CAUSES THE CURRENT-ACCOUNT DEFICIT?

According to the second accounting identity, changing the current-account balance requires changing saving, investment, or both. Events in the trade sector of the magnitude normally encountered have no significant, sustained effects on aggregate saving or investment. Such events include reduced demand for U.S. exports as a result of recessions in foreign markets, the trade policies of U.S. trading partners (even large partners such as Japan, Canada, Mexico, China, or the European Union), or any U.S. trade policy other than severe restrictions on all or almost all imports.

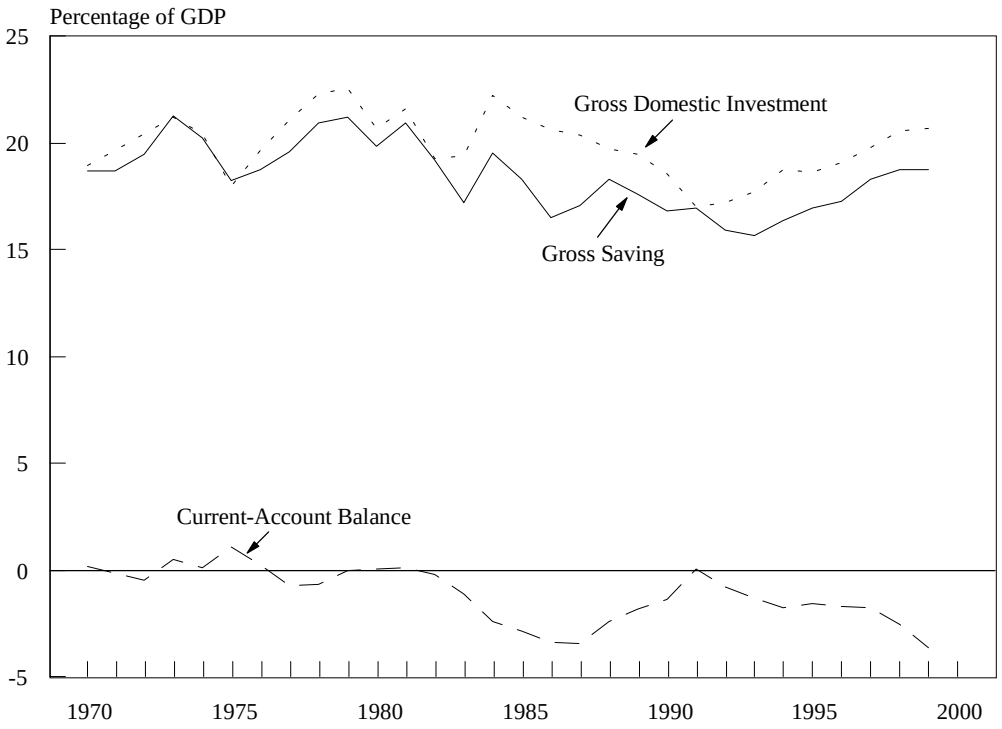
5. Strictly speaking, the current-account deficit is equal to the negative of the sum of the capital- and financial-account balances. The capital-account balance of the United States is usually very small, however, and can be ignored.

Such events can cause temporary, unintended changes. For example, an exporter whose sales to a foreign market unexpectedly decline when that market goes into recession may be left with an unintended excess of inventory (a form of investment). But once all economic actors bring their saving and investment back in line with their intentions, total saving and investment return to their previous levels (other things being equal). Consequently, such events normally cause no more than temporary deviations of the current-account balance (perhaps a few months to a couple of years) from its long-term level. That level is determined primarily in international capital markets by the relative demands for and supplies of investment capital among countries.

A Long Decline in Domestic Saving

The U.S. current-account deficits of the past two decades were brought on primarily by a long downward trend in domestic saving as a percentage of GDP that began in the mid-1950s and accelerated in the early 1980s (see Figure 2). The decline led to a shortage of funds for domestic investment, which in turn caused real (inflation-adjusted) interest rates to rise higher than they would otherwise have been. The higher interest rates attracted inflows of financial capital from abroad. The need to convert those inflows from foreign currencies into dollars increased the demand for

FIGURE 2. SAVING, INVESTMENT, AND THE CURRENT-ACCOUNT BALANCE



SOURCE: Congressional Budget Office using data from the national income and product accounts and the balance-of-payments accounts published by the Department of Commerce.

NOTE: The value plotted for the current-account balance for 1999 is a CBO estimate based on published numbers for the entire year for trade in goods and services and for the first three quarters of the year for other components.

dollars in foreign exchange markets and thereby put upward pressure on the value of the dollar relative to other currencies.

As saving declined as a percentage of GDP, consumption consequently increased. The rise in consumption was larger than the decline in gross domestic investment that was induced by the higher interest rates. As a result, total domestic

demand for goods and services—consumption plus investment—increased, putting upward pressure on the prices of U.S. output.

The upward pressure on the dollar and the prices of U.S. output made U.S. imports less expensive for domestic purchasers and U.S. exports more expensive for foreigners. As a result, imports rose and exports fell relative to what they would otherwise have been, causing a chronic current-account deficit that equaled the net inflow of foreign investment. The larger supply of goods and services in the U.S. market partially alleviated the upward pressure on prices. Nevertheless, U.S. imports remained less expensive for domestic purchasers and U.S. exports remained more expensive for foreigners than before the drop in saving, and the deficit consequently continued.

Declines in federal saving and personal saving accounted for most of the fall in gross saving over the post-World War II period. Saving by state and local governments and corporations (in the form of undistributed corporate profits) changed comparatively little. Federal saving, as measured in the national income and product accounts, peaked in 1947 at 6.2 percent of GDP, as the federal government began paying off the debt incurred during the Great Depression and the war. It then declined for several decades, reaching negative levels in 1971 and bottoming out at -3.7 percent of GDP in 1983. Since 1992, federal saving has reversed about three-

fifths of that decline, reaching 2.3 percent of GDP in 1999—a reflection of the sizable federal budget surpluses.

While federal saving followed a downward trend over most of the postwar period, personal saving rose from a low of 2.7 percent of GDP in 1947, peaked at 8.0 percent of GDP in the first half of the 1980s, and then began dropping precipitously. It recovered partially from 1987 through 1992 but then resumed its decline, reaching 1.7 percent of GDP in 1999—its lowest level since the Great Depression.

Although gross saving has increased significantly relative to GDP for most of the past decade, it nevertheless remains low by historical standards and continues to contribute to the large current-account deficits. The increase in saving stems largely from the improvement in the federal budget balance. A substantial portion of that improvement is cyclical, a function of the increased tax revenues and moderated spending for welfare and unemployment programs that have accompanied the record economic expansion. Some of the decline in personal saving may be cyclical as well. But even with the increase in federal saving, total gross saving was at a lower level relative to GDP in 1999 than it was throughout most of the 1950s, 1960s, and 1970s.

Economists have devoted considerable research to explaining the decline in personal saving over the past two decades, but no single theory examined so far can completely account for it. Several factors have probably contributed to the decline,

and it is not clear that all factors have been identified. One likely contributing factor is the large capital gains on investments in land and corporate stocks over the period, which have made people wealthier and more inclined to spend money on consumption. Another likely factor is increases in outlays in the Medicare and Social Security programs. Those programs transfer resources to the elderly, who tend to save less than other age groups do. Still another possible factor is the development and spread of new credit vehicles, such as credit cards and home-equity loans, that have eased previous constraints on consumption, but their significance is not entirely clear.

Other factors appear not to have contributed to the decline in personal saving or to have been much less significant than capital gains and spending increases in Medicare and Social Security. Those other factors include changes in interest rates, changes in the growth rate of the economy (apart from any effects that expected future changes in growth rates might have on capital gains in the stock market), and changes in the demographic composition of the population (that is, changes in the proportion of the population in age groups that typically save a smaller portion of income).

The Business Cycle

The chronic current-account deficit has also fluctuated with the business cycle. When a country experiences an economic boom, its investment typically rises faster than its saving, so its current-account surplus declines (or its deficit increases). During a recession, investment typically falls faster than saving, so the current-account surplus increases (or the deficit declines). Similarly, aggregate demand (including that for imports) increases during an economic expansion and falls during a recession. In line with that typical course of events, the U.S. current-account deficit peaked in the mid-1980s when the U.S. economy was in an economic boom, declined to near zero in the early 1990s (actually becoming a slight surplus in 1991) when the country was in recession, and has increased substantially since then in line with the current prolonged economic expansion.[6]

Growth of Investment in the 1990s

Other factors besides the business cycle may have contributed to the rapid growth of the current-account deficit in the 1990s. Although the nominal share of gross domestic investment (government plus private) in GDP in 1999 was not particularly

6. The 1991 surplus did not result solely from cyclical fluctuation. In 1991, the federal government received substantial sums from other countries to help defray the cost of fighting the Persian Gulf War. Those payments were included in the current-account balance.

high by historical standards, the real share of private investment was. Two factors explain why total nominal investment was not high relative to GDP in 1999: the substantial drop in federal investment in defense in the 1990s and a decline in the average price of investment goods relative to the average price of other goods and services in the economy. The real share of gross private domestic investment in GDP has trended upward since the late 1950s, and its growth since 1991 has been especially pronounced. In 1999, it reached its highest level in at least 70 years.

Several factors may have boosted private investment in the 1990s beyond what one would expect in a typical economic expansion. Some analysts argue, for example, that deregulation, reduction of trade barriers, and the declining cost of capital goods (especially computers) have increased productivity in the United States and made it a uniquely profitable place in which to invest. Whatever the merits of that argument, economic problems in Japan, several other East Asian countries, and parts of Europe have made them less attractive places for investment, further increasing the relative attractiveness of the booming U.S. economy to international investors.

DO INFLOWS OF FOREIGN CAPITAL HARM THE ECONOMY?

Some observers are concerned that current-account deficits might have significant detrimental effects on the economy. In fact, the decline in saving that brought on the continuing deficits has a number of negative economic effects, but in general, the deficits themselves do not further harm the economy as a whole. Rather, the inflows of capital from abroad benefit it by offsetting some of the negative effects of the decline in saving.

Effects on GDP, GNP, and Wages

The inflows of foreign investment accompanying the current-account deficit have had small positive effects on GDP and wages. Both are higher than they would have been if government policy had been used to prevent the deficit from arising in response to the decline in saving. The effect of the current-account deficit on gross national product (GNP) is even smaller, but whether the effect is positive or negative is unclear.[7]

GDP increases because most of the net inflow of foreign investment over time eventually translates into higher gross domestic investment in the United States (even

7. GNP is the total output of goods and services produced by U.S.-owned factors of production (capital, labor, land, and so on) regardless of whether those factors are located in the United States or abroad.

if the initial investment is in federal debt or an already existing asset). As a result, there is more productive physical capital in the U.S. economy. The additional capital makes labor more productive, and that in turn boosts GDP and wages.

The effect on GNP is smaller. Unlike GDP, GNP captures the effect of paying the cost of capital inflows from abroad—the interest and dividends paid to foreign investors. Those inflows might reduce GNP slightly if some of them ultimately translate into consumption rather than investment. Foreign investment is still generally beneficial, even in that case: people would not choose current consumption over the future income from investment unless they felt the consumption was of greater benefit. If all of the foreign capital inflows financed gross investment that added to the capital stock, the resulting additional output would probably be more than enough to make payments to foreigners, and the current-account deficit would have a small, positive effect on GNP.

Effects on Different Sectors of the Economy

The inflow of foreign capital associated with the trade deficit has changed the distribution of output and employment among various sectors of the economy. Free trade, which may sometimes imply a trade deficit, can hurt certain workers and businesses in industries that face particularly stiff foreign competition. Recognizing

that workers in industries negatively affected by trade often cannot move swiftly to new, growing industries, the Congress has enacted laws creating a system of trade adjustment assistance to try to compensate those workers, although making the system work poses some difficult challenges. However, the inflow of capital that accompanies a trade deficit will help other industries, particularly those in interest-sensitive sectors such as the ones that produce investment goods. On balance, allowing inflows of foreign capital strengthens the nation's productive capacity, boosting production and income.

Concerns About Foreign Finance and Economic Stability

The continuation of large current-account deficits caused the U.S. net international investment position (NIIP) to become negative in the late 1980s for the first time since 1915. The NIIP is the total of U.S.-owned assets in other countries minus the total of foreign-owned assets in the United States. The NIIP has become increasingly negative since the late 1980s and will continue that trend as long as deficits persist. The size and growth of the negative NIIP have prompted concerns about whether foreigners continue to finance the trade deficit and how a negative investment position affects the stability of the economy.

Will Foreigners Continue to Finance the Deficits? Most investors prefer to keep a large portion of their investments in their own country, or at least in investments denominated in their own currency. They do that to avoid various risks of international investing, not the least of which is the risk of adverse movements in exchange rates. Consequently, encouraging foreigners to devote an increasingly large share of their investment portfolios to a particular country (such as the United States) often requires an increasingly large premium in the return paid on assets in that country. Indeed, real interest rates rose in the United States around 1980, when the large current-account deficits and corresponding financial-account surpluses began.

Although real interest rates have not followed a rising trend since then, some observers worry that a continuation of the large current-account deficits will eventually boost interest rates further as foreigners become sated with U.S. assets and stop increasing the share of their portfolios invested here. Should that happen, the rise in interest rates would cause gross domestic investment in the United States to decline, thereby reducing or eliminating the current-account deficit. But such an eventuality would not drive interest rates higher than they would be if the current-account deficit was eliminated by trade policy.

Effects on the Stability of the Economy. Although the United States may have the largest negative NIIP in the world, it also has the largest economy against which that investment position must be compared when analyzing the NIIP's effect on economic

stability. Furthermore, as of 1998, about half of investment included in the NIIP was equity, not debt. Although a substantial buildup of debt decreases the stability of GNP in the same way that leveraging a corporation decreases the stability of its profits, a buildup of equity has the opposite effect. As a result of foreign equity investment in the United States, part of the increase in profits during economic booms and part of the decrease in profits during recessions fall on foreigners rather than Americans, and that tends to moderate swings in the business cycle.

Some people worry about a more extreme version of instability in which investors suddenly attempt to pull their funds out. That happened recently in a number of East Asian countries and earlier in several Latin American countries. The risk of such capital flight for the United States is very low, for at least two reasons. First, the U.S. capital market is much larger relative to the world market than are the markets of countries that have experienced such capital flight. Consequently, the scale of capital flight required to cause the same level of disruption to the U.S. economy would be much larger relative to the world capital market and less likely to occur. Second, capital flight usually results from investors' fears of losing their money. Those fears usually arise either because the country is highly leveraged and having difficulty paying its debt as a result of slower-than-expected growth or because the country is trying to maintain an overvalued exchange rate for its currency that investors fear cannot be sustained. Neither condition applies to the United States.

Restricting trade to reduce the current-account deficit (with the intention of preserving economic stability) might itself decrease the stability of the economy. As a result of the free-trade policies that allow the deficits to develop, part of the increase in demand for goods and services during economic booms and part of the reduction in demand during recessions falls on the foreign suppliers of U.S. imports and their employees rather than on their U.S. counterparts. Other effects can go in the opposite direction; for example, part of the drop in income during recessions in other countries will fall on U.S. exporters to the countries in question. Nonetheless, the net effect of free trade on average is likely to be more stable GDP, GNP, and employment. The reason is that the total sales of a firm to several countries tend to be more stable than the sales to any one country—a benefit of diversification.

SHOULD ANYTHING BE DONE ABOUT THE CURRENT-ACCOUNT DEFICIT?

Since the effects of the deficit are small and—in important ways—positive, there is no economic reason to use trade policy to attempt to reduce or eliminate it. In fact, such use would more likely hurt the economy. It would have little effect on saving and would close the imbalance between saving and investment primarily by reducing investment. The case against such use of trade policy is much stronger than that, however. Most such uses would be ineffective, and those that would actually work

would have substantially damaging effects of their own on the economy beyond the negative effects of the deficit reduction itself.

Some tools of trade policy, such as subsidizing exports and encouraging other countries to eliminate their barriers to imports from the United States, would have no significant effect on the current-account balance (see Table 1). Although using such tools might increase U.S. exports, the resulting increased demand for the dollar in foreign exchange markets (since foreigners would need more dollars to purchase the additional U.S. exports) would cause the dollar to rise relative to other currencies. That would make U.S. imports cheaper, so imports would increase by roughly the same amount as exports. As a result, the current-account deficit would not be significantly affected.

The current-account balance is also not very sensitive to import restrictions, such as tariffs (taxes on imports) or quotas (limits on the physical amount or value of a good or service that is imported). Although restrictions would reduce imports, the resulting decline in the supply of dollars to the foreign exchange market would cause the dollar to rise in value relative to other currencies. That, in turn, would make U.S. exports more expensive, causing them to fall by almost as much as imports. Thus, although tariffs would help producers that competed with imports in the industries to which the tariffs were applied, they would hurt exporters and import-competing industries that were unprotected. Sufficiently severe trade restrictions

TABLE 1. EFFECTS OF VARIOUS TRADE-RELATED POLICIES ON THE CURRENT-ACCOUNT DEFICIT

Policy	Effect on the Current-Account Deficit
Trade Policy	
Export subsidies	Increase exports and imports by roughly equal amounts because of policy-related movements in exchange rates; have little if any effect on the current-account deficit.
	Reduce federal saving and raise the current-account deficit if subsidies are not offset by decreases in other spending or increases in receipts.
Eliminating foreign trade barriers	Increase exports and imports by roughly equal amounts because of policy-related movements in exchange rates; have little if any effect on the current-account deficit.
Standard tariffs and quotas	Reduce exports and imports by roughly equal amounts because of policy-related movements in exchange rates; have little effect on the current-account deficit unless tariffs and quotas are sufficient to eliminate almost all trade.
	Higher tariff revenues, if they occur and are not spent for other purposes, increase federal saving and decrease the current-account deficit.
Combined import tariffs and export subsidies (of equal rate)	Policy-related movements in exchange rates offset tariffs and subsidies; have little if any effect on imports, exports, or the current-account deficit.
Exchange Rate Policy	Has little if any effect on the current-account deficit.
Benign Neglect—No Policy Action	The current-account deficit is likely to decline on its own as a share of gross domestic product over the next decade.

SOURCE: Congressional Budget Office.

could eliminate the deficit since they could completely shut off all imports; with no imports, there can be no trade deficit. The decline in imports and exports, however, would severely disrupt the economy.

Even if not taken to that extreme, using trade barriers to reduce the deficit would be highly damaging to the economy. Fairly simple calculations indicate that imports and exports would each decline by a much larger amount than the current-account deficit—possibly several times the amount. Those reductions would greatly diminish the gains from trade that arise from comparative advantage, specialization, and economies of scale. They would also increase unemployment temporarily as exporting industries contracted, forcing workers to find new employment in other industries. Such frictional unemployment could be severe if the trade barrier was high and broad enough.

Intervening in foreign exchange markets to drive down the dollar relative to other currencies and thereby relieve pressure on U.S. exporters and importers would not reduce the deficit because it would also cause an offsetting increase in the U.S. price level. Even if accompanied by monetary policy designed to prevent the offsetting price increase, such intervention could be effective for only a short period. Furthermore, to whatever extent it actually succeeded in lowering the deficit (which would be small, at best), it would do so by lowering investment, not by increasing saving.

Because of the ineffectiveness of trade and exchange rate policies in reducing the current-account deficit, the harm that can come from their use, and the benefits of being able to borrow on world capital markets, a better response from an economic standpoint is simply to wait for the trade deficit to subside on its own. The trade deficit is likely to decline significantly as a percentage of GNP over the next 10 years. Any slowing of the rapid pace of U.S. economic expansion will tend to moderate the ongoing surge of the deficit, as will the recovery of Japan and other foreign countries from their economic problems. In addition, some of the leading factors that help explain the decline in personal saving that has contributed to the deficits of the past two decades may also moderate.

The current-account deficit might be further reduced by policy reforms that have been proposed in other areas for reasons unrelated to their effects on trade. Any reform that either increases saving or reduces investment will lower the current-account deficit. Proposed reforms with the potential to significantly affect saving include changes in the tax system and reforms that would improve the federal fiscal position.

Various proposals have been made to revise the structure of the federal income tax to increase incentives to save, but most of them would do little to reduce the current-account deficit. Some proposals for comprehensive tax reform, which would effectively convert the income tax to a consumption tax and integrate the corporate

tax with the personal tax, would increase both saving and investment, at least in the very long term. But to reduce the deficit, saving would have to increase more than investment, and it is not clear that would happen. Other proposals—for example, expanding tax-preferred savings accounts (such as individual retirement accounts)—would slightly increase private saving. However, if the resulting drop in revenues was not offset by other tax increases or spending reductions, federal saving would almost certainly decline by even more.

Increases in the federal budget surplus affect the trade deficit. Other things being equal, each dollar increase in the budget surplus would boost total saving in the economy by roughly 50 cents to 80 cents. However, the economic expansion that is contributing to current and projected budget surpluses is also accompanied by large increases in demand for domestic investment. Greater demand offsets (and will probably continue to do so) some of the reduction in the current-account balance that would otherwise result from the increases in the budget surplus.

CONCLUSION

Since the trade deficit is an excess of imports over exports and obviously hurts some people, it would seem on the surface to be a problem of international trade that might be fixed or alleviated by the tools of trade policy. In fact, however, it is not. Its

cause lies not in international trade but in factors affecting international capital flows. In the case of the recent U.S. trade deficits, those factors are largely of domestic origin—a long decline in saving, a prolonged upswing in the business cycle, and perhaps a number of changes in the U.S. economy that have made it a particularly productive place for international investors to put their funds. Although some people are harmed by the deficits, others are helped. On balance, the continuing deficits have small, beneficial consequences for the United States.

Given the benefits of the trade deficit, there is little if any reason to try to reduce or eliminate it, particularly since it is likely to subside on its own even without any policy response. Further, if one nevertheless wanted to reduce the deficit, trade policy would not be a good way to accomplish that goal. Short of broad restrictions on imports of a magnitude much larger than is normally discussed in policy debates today, the standard tools of trade policy will not have much effect on the deficit. Under restrictions that were severe enough to substantially reduce the deficit, both imports and exports would ultimately decline much more than the deficit, disrupting the economy and causing unemployment in the export sector and possibly elsewhere. In general, the government policies that are most likely to have a large impact on the deficit are not trade policies but budget policy and any other policies that substantially influence saving and investment in the economy. Other effects of those policies, however, are generally more important than their effects on the current-account deficit.