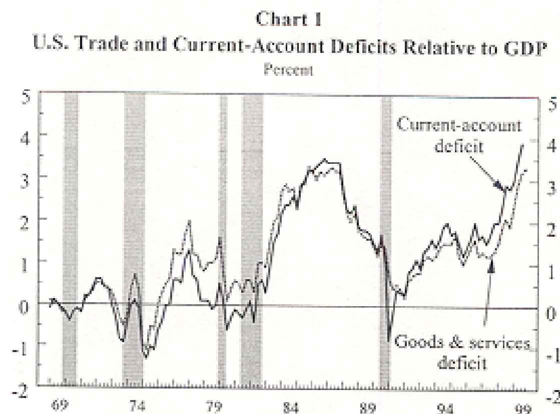
Statement by Lee Price
Chief Economist, Department of Commerce
before the
Trade Deficit Review Commission
February 24, 2000

Chairman Weidenbaum, Vice Chairman Papadimitriou, members of the Trade Deficit Review Commission, thank you for your invitation to appear before you on the subject of the trade deficit.

After holding steady for several years, the U.S. trade deficit has been rising sharply since 1997 (Chart 1) and deserves close scrutiny by this commission. Your report later this year on the deficit's causes, consequences, statistics, and other related issues should help guide the thinking of our nation's policy makers on this complex and controversial topic.



In the realm of economic policy, which is concerned with raising the standard of living of everyone, some economic indicators deserve more attention than others. Progress in raising everyone's standard of living tends to be reflected best by variables like the real growth rate, unemployment rates, the distribution of income, and investment in people, systems, equipment, and structures. The trade deficit is not a variable like one of those. In fact, like interest rates, the ups and downs of the trade deficit may reflect positive or negative trends. The trade deficit tends to fall when the national economy weakens and to rise when it strengthens. Indeed, the nation's last trade surplus occurred in the recession of 1973-75 and the last current account surplus occurred in the recession of 1990-91.

Important Economic Relationships

At first glance it may seem that, since the trade balance represents exports minus imports, understanding the trade deficit simply means explaining the trend in exports and the trend in imports. The construction of our national economic accounts, however, allows us to take a more complex view of the forces underlying the trade deficit. Fortunately, the legislative charge to your commission recognizes these relationships.

Trade flows make up the largest and most volatile portion of current account flows, with net investment income flows and net unilateral transfers (e.g., foreign aid, pension payments to Americans abroad) accounting for much smaller portions of the current account. As shown in Chart 1, movements in the current account closely track the trade deficit. By the procedures used in constructing our national economic accounts, the current account deficit equals two other interesting measures: (1) our net capital inflow, or the difference between the amount of capital foreigners invest in the U.S. minus the amount of capital Americans invest abroad; and (2) the amount that investment in the U.S. exceeds domestic saving (including business and government saving as well as household saving). (When these independent measures do not come out equal in practice, the statistical framework identifies what is known as a "statistical discrepancy.")

Ex post, we can "explain" the changes in the trade deficit by examining changes in the components of these three net balance: exports and imports; capital inflows and capital outflows; and domestic saving and investment. All of these aggregates are typically rising over time, so explaining changes in the trade deficit generally means explaining differences in their growth rates in a generally expanding world economy.

The trade deficit will tend to be driven up when:	Because that means:
1) Americans find imports more attractive	Import growth rises
2) Foreigners find our exports less attractive	Export growth slows
3) Foreigners find investing here more attractive	Capital inflow rises
4) Americans find investing abroad less attractive	Capital outflow slows
5) Americans spend a rising share of their income	US saving slows
6) Americans find investing at home more attractive	US investment rises

Likewise, the trade deficit will tend to decline when the opposite of these six trends occur (e.g., Americans find imports less attractive causing import growth to slow). Often some of these six trends will have opposing effects on the direction of the deficit. In addition, the interrelated nature of these trends make the trade deficit difficult to address. For example, rising imports, paid for in U.S. dollars, can lead to larger capital inflows as foreigners look for places to invest their dollars. These capital inflows can then lead to rising levels of investment.

Important Underlying Forces

The substantial recent increases in the trade deficit over a short run period has been driven largely by two forces: differential growth rates in the U.S. relative to our trading partners and the exchange rate.

<u>Relative Growth</u>

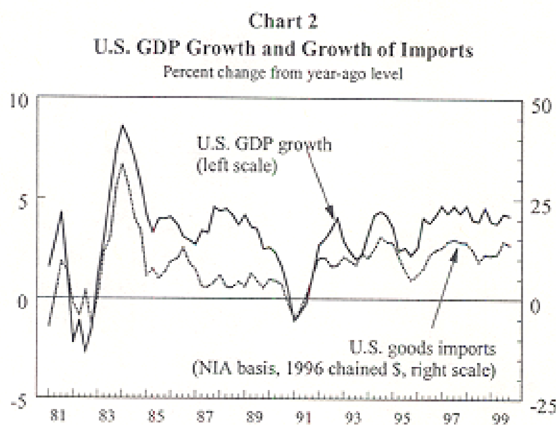
Stronger growth in the U.S. typically means:

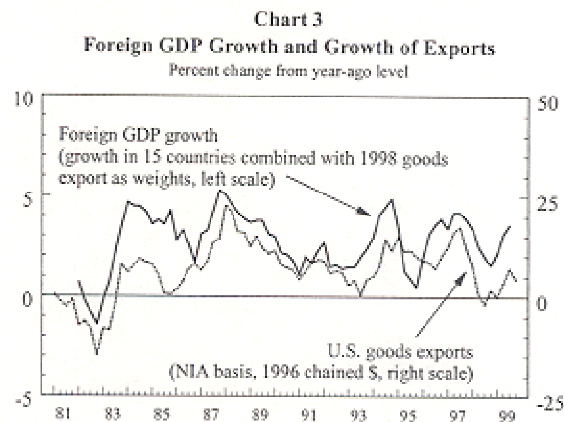
- American incomes to spend on imports grows more rapidly.
- American profitability and structure of interest rates rise
  - discouraging capital outflow,
  - encouraging capital inflow, and
  - raising U.S. equity values, the "wealth effect" raising spending faster than income.
- More investment occurs in the U.S.

Slower growth abroad typically means:

- Foreign incomes to spend on our exports grows more slowly.
- Profitability and the structure of interest rates abroad decline, discouraging capital outflow and encouraging capital inflow.

The relationship between domestic growth and a country's imports is indicated by Charts 2 and 3. Note that not only does growth in our imports move in tandem with our economy's growth rate but foreign countries' imports from us move in response to their own growth.



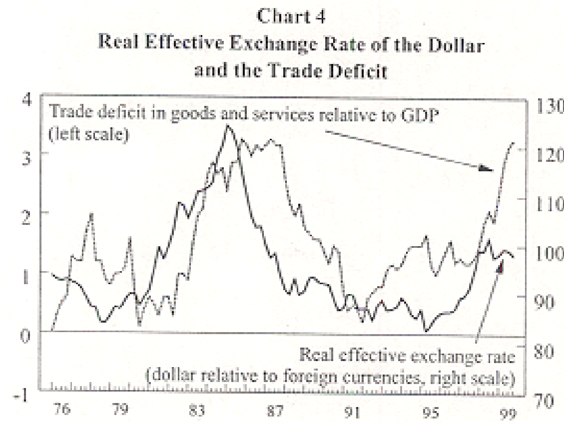


Exchange Rates

As the *Economic Report of the President* noted recently,

> "Exchange rate movements, reflecting in part the desirability of U.S. assets, have also contributed to the rising trade deficit by affecting the relative price of imports and exports. Chart [4] shows that, over the past several decades, the trade deficit has tended to rise when the dollar has strengthened. Between 1995 and 1998 the dollar appreciated, although by less than in the 1980s."

Chart 4
Real Effective Exchange Rate of the Dollar and the Trade Deficit



Developments in the 1990's

Since 1997, all six trends listed on page 2 above have played a role, to a greater or lesser extent.

- Strong domestic demand and falling import prices have caused imports to accelerate.
- Weak foreign demand depressed our exports.
- Higher profitability here than abroad encouraged capital inflow and discouraged capital outflow.
- Strong domestic demand and profitability also spurred robust investment here.
- National saving has also moved up (but less than investment) because the decline in household saving has been largely matched by the rise in government saving.

It is sometimes said that domestic saving and investment move autonomously and determine a country's trade balance. If every country's trade and current account balances were essentially determined by their own internal and autonomous savings and investment decisions, there would be no mechanism for equilibration of the world's trade and capital flows. Only by recognizing that these trade and international capital flows are jointly determined with domestic savings and investment decisions can we properly understand the forces at work behind our trade balance.

Recent experience provides an excellent case study of how the trade deficit, the net capital inflow, and the saving-investment gap are jointly determined. Since mid-1997, economic crises in Asia, Russia, and very sluggish growth in other areas encouraged a net capital inflow into the U.S., which contributed to lower interest rates here and a stronger dollar, thereby encouraging more U.S. business investment and more U.S. household spending on housing and consumer durables, which kept U.S. saving in check despite a large increase in government saving. *Ex post*, the three identities are maintained, but no one can deny that developments abroad have had a direct and substantial effect on both the size of the U.S. trade deficit and our savings-investment gap.

Comparison with Developments in the 1980's

Some of the concern about the trade deficit probably derives from the experience of the 1980s when the trade deficit was associated with notions of weakness in U.S. manufacturing and the creation of the "Rust Belt." In fact, the legislation creating your commission charged you with looking at many of the variables that were troubling during the period of large deficits in the 1980s. Although the magnitude of the recent rise in the trade deficit resembles the rise in the mid 1980s (see Chart 1), the patterns of the domestic economy accompanying those two increases in the trade deficit are very different. Since the largest swings in the trade balance occur in manufactured goods, we should look at indicators from the manufacturing sector alone as well as for the economy overall.

- U.S. business investment weakened during the course of the 1980s but was strengthening in the 1990s (Chart 5);
- Manufacturing capacity in particular has been expanding rapidly in the recent period and, even with the slowdown to a more sustainable rate, remains faster than at any point in the 1980s (Chart 6);

Chart 5
Net Investment in Structures, Equipment and Software of Nonfinancial Corporations

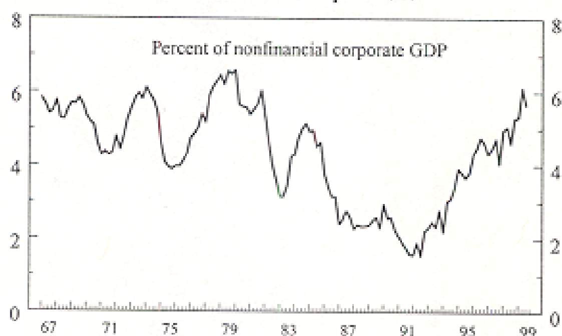
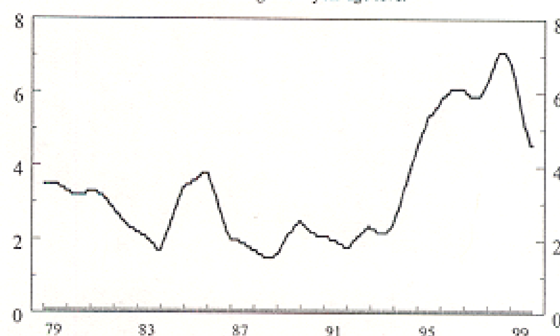
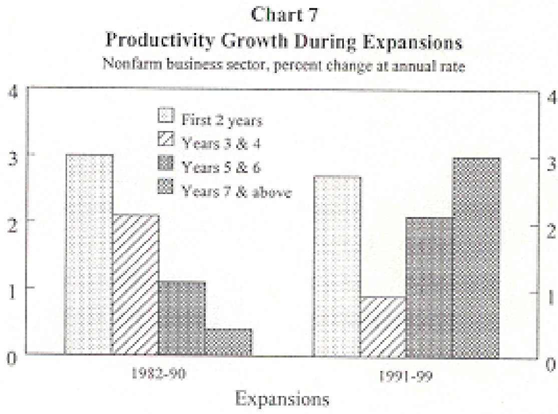
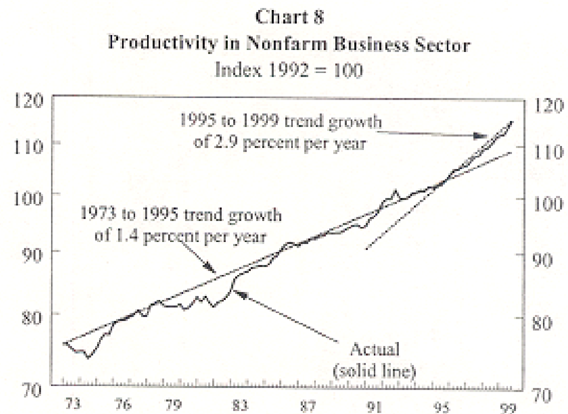


Chart 6
Manufacturing Capacity
Percent change from year-ago level

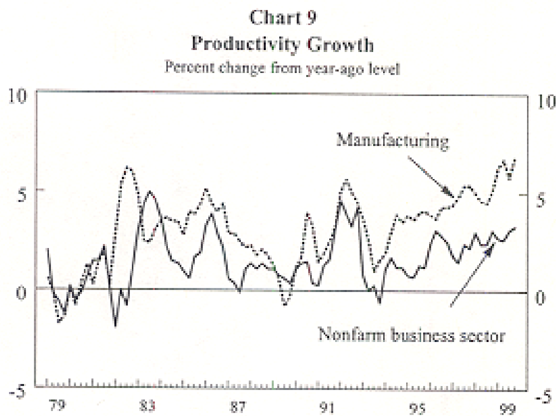


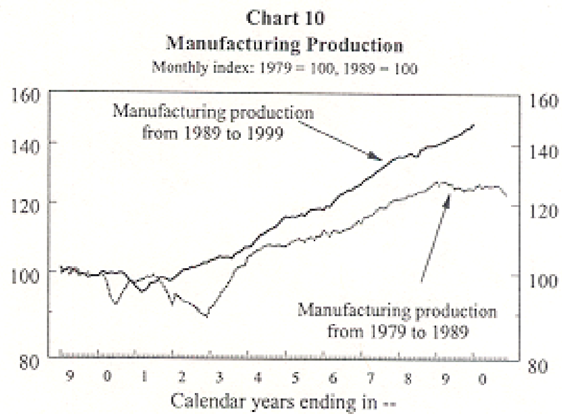
- growth in productivity was falling in the 1980s but rising in the late 1990s (Charts 7 and 8).



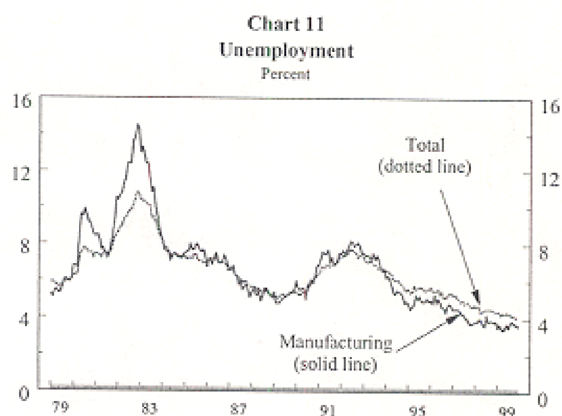


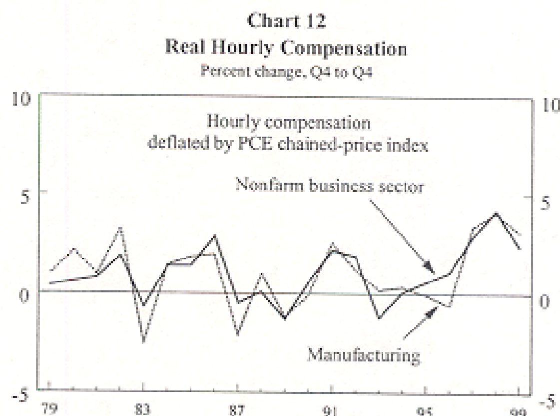
- growth in manufacturing productivity has been particularly strong of late (Chart 9);
- manufacturing output was sluggish with the trade deficit's rise in the 1980s, but has continued buoyant in the late 1990s (Chart 10);





- national unemployment was much higher in the mid-1980s – 7.2 percent in 1985 versus 4.2 percent in 1999 (Chart 11); such low unemployment has increased employer's investment in training their workers;
- unemployment among manufacturing workers was higher than the national average in the mid-1980s (e.g., 7.7 percent in 1985) but lower than the national average last year (3.6 percent) (Chart 11);
- robust investment in training, equipment, and new systems has raised productivity and generated much stronger noninflationary real wage growth over the last three years than during the 1980s period of large trade deficits (Chart 12).





Need to Improve Statistics on the International Accounts

I am pleased that your commission is also charged with making recommendations about improving our trade and current account statistics. The Bureau of Economic Analysis and the Economic Directorate of the Bureau of the Census produce those statistics and have been considering ways to improve them. Outlines of their ideas are attached.

Note that the Administration's budget includes a $1.4 million initiative to improve the goods export statistics from the Bureau of the Census. In recent years, the Administration has requested $1.1 million for BEA to improve the international services trade and finance statistics in the balance of payments accounts, but Congress has failed to appropriate the funds. In addition, the Customs Service has a current initiative to upgrade their antiquated computer system. I urge this commission to take a close look at those initiatives and other ideas for improving the data gathering and estimation for our international accounts.

Conclusion

As Federal Reserve Chairman Greenspan noted in his Humphrey-Hawkins testimony last week, "growing net imports and a widening current account deficit require ever larger portfolio and direct foreign investments in the United States, an outcome that cannot continue without limit." Although we cannot predict with any confidence how the recent slide in the trade balance will inevitably end, we should consider some alternative ways it might end.

Faster growth abroad offers the most benign mechanism for lowering the trade deficit. That would improve the market for our exports and gradually tilt capital inflows abroad. There are increasingly hopeful signs that a number of economies important for our exports are strengthening. Unfortunately, this mechanism for reversing the slide in the trade deficit is also the one least under our control.

Mechanisms more under our control could reduce the trade deficit in theory, but they would cause more harm than good by suppressing consumption and/or investment, directly or indirectly, and disrupting the domestic economy. Concern over the trade deficit should not lead to measures that undermine our fundamental economic success. We should keep in mind that the remarkably strong growth of our economy in recent years is improving the condition we most care about. Real wages and incomes are growing strongly across the income spectrum for several years. Unemployment has fallen to the lowest level in a generation. Investment for future prosperity is booming. Indeed, our traded goods sector itself is largely flourishing, not languishing.

On the other hand, we ignore the trade deficit at some risk. Just as we should avoid measures to reduce the trade deficit at the expense of economic growth, we should also avoid measures (such as a major shift in fiscal policy) that would exacerbate the trade deficit. Although the intention may be to stimulate the economy, international capital markets would likely react so unkindly to such a policy that it would have the reverse effect.

Thank you for this opportunity to discuss the issues raised by the recent increase in our trade deficit. I am happy to answer any questions you may have.

Attachment

Challenges Confronting U.S. Trade and Finance Statistics

Increased integration in world markets for goods, services, and capital, in combination with major advances in computer and communications technology, have resulted in gaps in the Nation's coverage of international transactions. These gaps pose difficulties for the analysis of trade, monetary, and regulatory policy.

In the area of international trade in goods, there appears to be a serious understatement of exports. Census Bureau estimates indicate that U.S. exports of goods may be understated by between 3 and 7 percent, but the understatement could be as high as 10 percent. This understatement not only results in an overstatement in the U.S. trade deficit, but also appears to be contributing to an understatement in real GDP and productivity growth, with serious consequences for budget and monetary policy. The causes for this understatement in exports include underestimation of low valued transactions (a problem that is increasing with the growth in E-commerce and the use of international courier services), failure of exporters to file the required documentation, missing or incomplete information on the documents that are filed, and undervaluation of export shipments in response to foreign quotas or tariffs.

In the area of services, most of the largest gaps in coverage have been closed in recent years through the development of new surveys and the extension of existing surveys. However, insufficient detail for several of the major services categories hampers analysis, and lack of quarterly reports makes estimates in the accounts imprecise and subject to large revisions. The need for more detailed and accurate information on U.S. services trade has become more acute in recent years with the inclusion of services in multilateral trade agreements to which the Nation is a signatory–namely, the General Agreement on Trade in Services and the North American Free Trade Agreement.

In the capital accounts, Bureau of Economic Analysis (BEA) has made good progress in improving coverage through data exchanges with other countries and improvements in surveys in cooperation with the Treasury Department and the Federal Reserve. Also in cooperation with the Federal Reserve, BEA has begun to report on international flows of U.S. currency. However, large gaps remain in the coverage of U.S. portfolio investments abroad and foreign portfolio investments in the United States. In addition to these existing gaps, new gaps are emerging through growth in new financial instruments that are not separately identified or fully covered by the existing data collection system.

Understatement of exports: The unprecedented expansion in the size of goods exports and imports over the past decade has increasingly strained the ability of compilers to process the shipping records and statistical documents that are the basis for the goods estimates. Despite efforts at automation of data processing for both exports and imports, processing problems remain. In addition, the nature of trade has changed significantly. The Census Bureau needs to conduct new statistical surveys to estimate "low-value" transactions. More ambitiously, it needs to develop means to measure accurately the value of parts and subassemblies that are transferred among trading partners in the production process.

Collaborative work between the Bureau of the Census and the Customs Service has demonstrated yet another avenue for remedying the understatement of exports. Intensive on-site compliance audits at ports or border crossings, conducted by teams from Census and Customs, have brought to light instances where U.S. companies have been lax in reporting exports. The laxity has run all the way from failures to report to simple but pervasive errors in reporting. The audits have lead to more conscientious reporting by U.S. exporters, accompanied in some instances by large gains in reported exports. Compliance auditing is somewhat costly but it appears to result in significantly more complete trade statistics.

Shortcomings in the reporting systems: The shortcomings in the systems over which companies file the trade documentation required by the U.S. Government differ depending on whether exports or imports are involved. Consider exports first. Jointly, since 1995 the Bureau of the Census and the Customs Service have developed and deployed a modern electronic system for the filing of export records. Indeed, in recent months the Census Bureau has even introduced a system by which U.S. exporters can file their Shippers Export Declarations over the Internet. Notwithstanding all this progress, something like a third of Shippers Export Declarations are still filed in paper form. Both Census and Customs are working closely with the trade community to assist private companies in making the transition to electronic filing. If at all possible, these outreach efforts should be strengthened. The payoff from switching all exporters to electronic filing is large. Tests have shown that the electronic filing of trade information by the private sector leads to considerably more accurate trade statistics.

Turning to imports, we find that Customs already has in place an electronic filing system for imports and that something like 98 percent of all import records are now filed electronically. But the Customs import system is antiquated–almost two decades old–and urgently in need of modernization. Lacking modernization, the reliability of import statistics will almost certainly deteriorate. The Administration is well aware of this need and has advanced a funding proposal. Commission support for the modernization of the Customs system should help focus public attention on this important issue.

Volatile and rapidly growing services: As the size of trade in services has grown, so has the complexity of measuring it. Although BEA has dramatically expanded coverage of international services in recent years, the absence of sufficient detail for some major services categories hampers the analytical usefulness of the data, and the lack of timely quarterly indicators will make the services data increasingly inadequate and ultimately subject to large revisions. Addressing these problems would require BEA to develop a quarterly survey for the most important services covered by its existing annual survey of selected services. It would also require an expansion of BEA's surveys of foreign direct investments to provide information on the growing international trade in services by multinational corporations and their affiliates by type of service.

New and growing financial instruments: The globalization of international financial markets has been accompanied by enormous growth, much of it in direct securities transactions–that is, transactions that are not channeled through U.S. brokers, banks, and other financial intermediaries–and in new financial instruments such as derivatives. With only partial funding for improvements, BEA has been forced to rely on data exchanges with foreign central banks and to take interim steps in improving the measures of investment income and capital flows. These actions have helped, but the need for a comprehensive revamping of the collection system has taken on new urgency with the passage of time. The major problem areas and needed actions include:

- Intermediated portfolio investments: BEA, Treasury, and the Federal Reserve System need to improve the capture of information on foreign stocks, bonds, and other portfolio investments made through U.S. brokers, banks, and other financial institutions. To do this would require strengthening the existing system of collecting data on portfolio investment by expanding coverage, improving compliance, and eliminating gaps and overlaps in coverage between foreign direct and portfolio investment.

- Directly channeled portfolio investments: BEA, Treasury, and the Federal Reserve need to work to implement a coordinated international system of data collection to better capture information on portfolio investments made directly with unaffiliated foreign residents. BEA and Treasury–in cooperation with the International Monetary Fund and many other nations–have completed work on common definitions as the basis for collecting consistent data and are in the process of conducting surveys. Following analysis of the results, data exchanges among organizations and countries will take place in an effort to fill existing gaps in coverage.

- Derivatives: Further work is needed to develop measures of new financial instruments, such as derivatives, that cut across both the direct and portfolio modes of investment. As we learned from the Long-Term Capital derivatives collapse there are significant risks associated with these instruments, yet there are no consistent statistical measures of these instruments and the cross-border risks that they present.