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Trade Deficits Come Due Someday

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In a recent interview on the EconTalk podcast, Massachusetts Institute of Technology economist David Autor said that a trade deficit represents a loan that has to be paid back. This is an important issue, since the U.S. has run a large trade deficit for several decades now:

I was happy to hear someone talk about this fact, which is rarely acknowledged. But not everyone was pleased. When I repeated Autor's statement, Dan Ikenson, director of the Herbert A. Steifel Center for Trade Policy Studies at the Cato Institute, said that I don't understand how trade works, and that a trade deficit isn't a loan. Ikenson is wrong, and this provides an important opportunity to explain how trade deficits work.

Free Trade Feud

Suppose there are two countries, Germany and the U.S. And suppose that one fine day, Germany gives the U.S. a car. But Germany isn't running a charity; it doesn’t just go around handing out cars -- the U.S. has to give something in return. If the U.S. gets the car from Germany for free, it’s called aid, not trade.

So what does the U.S. give Germany in exchange? It could send over a real, usable good or service -- some bushels of corn, perhaps, or some copies of Windows 10. If the U.S. gives corn and software equal to the value of the car, that's called balanced trade.

Alternatively, if the U.S. doesn’t feel like growing any corn or writing any software today, it could write Germany an IOU. The U.S. could pay for the car not with corn or software, but with dollar bills. The Germans might then use the dollar bills to buy some long-term American financial asset, such as a U.S. Treasury bond or some shares of Apple stock. In this case, we say that the U.S. ran a trade deficit with Germany, because it got something of real value from Germany (a car), while all Germany got in return was a slip of paper.

But at some point, Germany is going to want to exchange its slip of paper for something of real value -- something some German person can use and enjoy. Whoever in Germany is holding onto the American financial asset can’t use it within his or her own country -- Germany uses euros, not dollars! He or she could sell the dollar-valued asset to another German for a euro-valued asset, but that just delays the issue -- at some point, someone is going to decide to use the dollar-valued asset to get something of real, usable value. And where do you spend dollars? In the U.S.

At that point, the German will sell his or her dollar-valued asset for dollars, and use those dollars to purchase some real good or service from the U.S. At that point, the U.S. will run a trade surplus, and Germany will run a trade deficit. The scales will balance out. The U.S. will get a slip of paper, and Germany will receive some item of real value in return.

This example illustrates why a trade deficit is a loan *of real goods and services*. The country running a trade surplus is giving up value -- doing real work, using up real time and resources -- in exchange only for paper promises. At some point in the future, the country now getting those paper promises is going to want something of real value in return, and at that time it will be able to get those things without any effort or expenditure of resources.

Now, there are several ways in which one of the trading partners can end up walking away with more value than the other.

The first way is a default. The financial asset that is being held by someone in Germany could become worthless before it can be exchanged for something real. The U.S. government could choose to default on its sovereign debt, leading to a plunge in the value of Treasury bonds. Or

Apple could go bust, sending the value of its shares to zero. If this happens, no one in Germany will ever be able to recoup the full value of the car that was given to the U.S. The U.S. will have gotten something for little or nothing (although a default would probably end up hurting the U.S. economy).

The second way is inflation, which represents a partial default. U.S. inflation could rise, meaning that a dollar purchases less in real value than it used to. In this case, the German holding on to the U.S. financial asset, waiting to make a purchase, is out of luck.

The third way is via a manipulated exchange rate. Through complicated techniques such as capital controls and sterilization, it is possible for a country to swap goods and services in exchange for goods and services of lesser value. Suppose that private German citizens, for some reason, would demand U.S. financial assets worth 5,000 bushels of corn in exchange for one Volkswagen Jetta. But the German government -- which wants to nurture its automobile industry by encouraging higher production volumes -- decides to make them trade the Jetta for financial assets worth only 3,000 bushels of corn. In this case, Germany will be getting less than fair value for its car. This is similar to what many people believe China was doing with the U.S. in the 2000s.

So a trade deficit does represent a loan, but that loan doesn’t always have to be paid back in full, and the terms of the loan can sometimes be unfairly favorable to the borrower.

Nevertheless, most of what we get from our trade deficits will have to be paid back someday. The U.S. will almost certainly not default on its sovereign debt. Inflation may rise, but that will only partially erode the amount owed. People in other countries have a lot of U.S. financial assets, and if they decide to redeem them, then at that moment the country will have to give them goods and services that cost Americans' time, sweat, effort and resources.

Today, Americans may think they’re getting stuff for free by running a trade deficit. But it isn't free. Someday, we -- or, more accurately, our children -- will have to give stuff away in return.