The U.S. Trade Deficit Is Not A Debt To Repay

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It’s a presidential election year so the quadrennially-maligned U.S. trade deficit is taking its lumps. Donald Trump says the trade deficit means the United States is losing at trade, and it’s losing because U.S. trade negotiators aren’t smart enough. Bernie Sanders believes the trade deficit deprives the economy of production and good jobs. Meanwhile, some of the economics commentariat argue that trade deficits are bad because they represent a burden on future generations – a debt that must be repaid.

Trump and Sanders are both wrong, but the focus of this analysis is on the last point. Economists, apparently, disagree about whether or not the trade deficit constitutes a debt to be repaid. It’s worth noting that those who take the affirmative position tend also to be economists who are more skeptical of the benefits of trade and who hail, preponderantly, from the philosophical left. One gets the impression that the debt argument is being used to wrap trade skepticism in a moral sheen it doesn’t deserve.

Last week, Bloomberg View columnist (and assistant finance professor at Stony Brook University) Noah Smith and I had a littleback-and-forth about this issue on Twitter, which we agreed to suspend with Smith promising to “write a post in simple and clear terms” explaining how the deficit is a loan. Today, Bloomberg postedhis column, which is interesting and includes some reasonable illustrations about trade. But it is not convincing in the least that the trade deficit is a debt to repay.

Smith’s central point is that trade has to be in balance because, in his example, the Germans aren’t willing to exchange the cars they produce for pieces of paper (dollars) indefinitely. Eventually, Americans will have to accept the return of those dollars for real output and that, ultimately, running a trade deficit is just an intertemporal shifting of the burden of production and the reward of consumption. A small portion of the accumulated debt, Smith suggests, can be reduced through three channels: inflation, default, and currency manipulation. But, eventually, we are on the hook to come up with the real goods and services to cover most of the debt. In his explanation, Smith conflates debt and equity (one doesn’t default on equity, Noah!) but otherwise makes no mention of the capital account or the fact that foreigners are willing to exchange their accumulated dollars for U.S. assets. He concludes:

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.

Let me assure you that Americans, who part with hard-earned dollars for every transaction, don't think they're getting stuff for free. But here's why Smith is wrong on the broader question. There's a clearer, more instructive way to conceptualize the issue. The United States runs a trade deficit with the rest of the world because Americans spend more dollars on foreign-produced goods and services than foreigners spend on U.S.-produced goods and services. The dollar value of U.S. imports exceeds the dollar value of U.S. exports, so our trade account is negative. It's in deficit. That's straightforward.

A slightly broader measure of international transactions than the trade account is the current account. The current account includes the trade account plus net proceeds on investment (income earned on U.S. assets abroad minus income earned on foreign-held assets in the United States) plus net transfers (remittances and aid, primarily, flowing into the United States minus remittances and aid, primarily, flowing out of the United States). Those two components (net proceeds and net transfers) are much smaller than the value of exports and imports, so the U.S. current account typically isn't much larger or much smaller than the trade account. In 2015, the trade deficit amounted to $540 billion and the current account deficit was $484 billion.

So, how is it even possible to run a trade deficit in the first place? How can Americans send $540 billion more abroad for goods and services than foreigners send to the United States for goods and services? In Noah Smith's telling, that $540 billion is a loan to Americans that we have to pay back – unless there's an all-out default or the value of that debt is diminished through inflation or currency manipulation. Those are the three channels – unsavory, all of them – through which Americans can abrogate some of their obligation to pay back the $540 billion. But Smith is missing a huge part of the picture – the part that clarifies that the trade deficit is not a debt.

Americans are able to purchase more goods and services from foreigners than they sell to them because foreigners buy more assets from Americans than Americans buy from foreigners. There is a positive inflow of dollars on the capital account. Foreigners don't only buy goods and services from Americans. They buy U.S. assets (equities, property, factories, service centers, shopping malls, machines, other physical assets, corporate debt, and government debt) from Americans. Likewise, Americans don't only buy goods and services from foreigners. We buy foreign assets (equities, property, factories, services centers, shopping malls, machines, other physical assets, corporate debt, and government debt) from foreigners, as well.

The proper way to account for international transactions is to abide the fact that the value of the goods, services, and *assets* that Americans purchase from foreigners is approximately identical to the value of the goods, services, and *assets* that foreigners purchase from Americans. (Smith left out the assets part of the equation.) If there is a difference between the current account deficit and the net capital inflow, it is accounted for by the change in foreign reserves. The United States ran a $484 billion current account deficit with the rest of the world in 2015, and it ran a $484 capital account surplus. The capital account consists of three broad components: U.S. purchases of foreign assets; foreign purchases of U.S. assets; and, the change in foreign reserves. And it is a mathematical certainty that the current account plus the capital account equals zero. Put another way, the value of the current account deficit is identical to the value of the capital account surplus.

So, the U.S. trade deficit is financed by inflows of foreign capital used to purchase U.S. assets. Most of the assets purchased are equities and physical assets (direct investment). Some of the assets purchased are corporate debt and government debt. As of the end of 2014, Americans held a total of $24.6 trillion of foreign assets. Foreigners held a total of $31.6 trillion of U.S. assets. Of that $31.6 trillion foreign asset portfolio, treasury bills and bonds accounted for about $6 trillion – just under 20 percent of the total. It is only this portion – government debt owned by foreigners – that the American public (of this generation or the next) is on the hook to pay back. Corporate debt has to be repaid, but only by the shareholders and employees of the companies issuing the debt – not by you or me or our children, generally. Equity purchases don't have to be paid back*at all* – they're not loans! When European, Japanese, Korean, Chinese or any foreign investors purchase U.S. companies or make "greenfield" investments to build new production or research facilities or hotels or shopping centers, there is no debt to be repaid.

I asked Smith during our Twitter exchange to explain how my children are on the hook for Honda's investment in production facilities in Marysville, Ohio. He wrote: "*Simple. Honda owns the factory. Future profit from the factory goes to Honda. Honda uses profits to buy U.S. goods*." Huh? This is clearly not an outcome involving repayment of debt by me, my children, or anyone. Americans simply benefit from Honda's success, earning wages and profits they would not have enjoyed without Honda's presence – essentially, without the trade deficit that enabled Honda to invest in the United States; create value; hire Americans; support parts and other suppliers; create demand for retail establishments, restaurants, and homebuilders; pay taxes, support local little league teams, and reinvest proceeds in this virtuous circle.

Selling equity or property or even entire U.S. companies to foreigners does not constitute debt and it is not akin to subsidizing our consumption by draining down our assets, as some suggest. It's not a reverse mortgage. By the simple logic of supply and demand, the presence of foreigners in U.S. asset markets is good for U.S. asset holders. Foreign participation constitutes greater demand in the market, which increases the price of the assets in question. And, there are some real knock-on benefits associated with foreign-headquartered companies operating in the United States. These "insourcing" companies tend to perform well above the average U.S. company in terms of value creation, capital investments, research and development spending, compensation, employment, and many other metrics, as this paper documents.

In fact, there is a compelling argument that a trade deficit is actually good for the U.S. economy because the quality, experience, and successes of the foreign companies that actually come and operate in the United States are better, deeper, and more numerous, respectively, than the average U.S. company. But that's a topic for my next column.

Let me conclude this one by reiterating that only a portion of our trade deficit needs to be repaid by the American public to foreigners, and it is that portion used to finance government budget deficits — roughly one-fifth of the annual trade deficit. If Noah Smith and other economists worry about this debt, they should advocate reducing wayward government spending instead of restricting trade.

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