Au contraire Mr. President: trade deficit is not a big deal

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The Department of Commerce announced on Feb. 7 that the 2016 U.S. trade deficit in goods and services had increased slightly. It rose by $1.9 billion (0.4 percent) to $502.3 billion, up from $500.4 billion in 2015.

Because the U.S. economy has continued to grow, the trade deficit declined a bit in relative terms. It dipped from 2.8 percent of Gross Domestic Product (GDP) in 2015 to 2.7 percent last year.

That's hardly news, though. In the context of an $18 trillion U.S. economy, the trade deficit isn't a big deal.

The Alliance for American Manufacturing (AAM), a trade association skeptical of imports, issued a statement that said, in part: "We urge the White House and Congress to stop the unbalanced wave of imports through tax, trade, currency, infrastructure, and other policies that will restore some factory jobs."

What many people don't realize is that the "unbalanced wave of imports" already is counterbalanced by the substantial amount of foreign capital entering the United States.

This is explained by the balance of payments, which covers all of a country's international transactions. On one side of the balance is the current account, which consists mainly of trade in goods and services. It also includes smaller items, such as foreign remittances and income earned on foreign investments.

On the other side of the balance is the financial account. It is comprised of assets purchased in one country by people in another country.

In a nutshell, people in other countries invested enough money in the United States last year (a financial account surplus) to neatly offset America's current account deficit. As a matter of definition, the balance of payments has to balance.

But why does the United States have a current account deficit? It's not because of unwise trade policies, although some of them leave much to be desired. Rather, it's because America saves less money than it invests. Or, when expressed as an equation: current account = savings – investment.

There are many attractive investment opportunities in this country. The U.S. economy is performing better than those of most other developed nations. Stocks, bonds, commodities, and real estate all can be purchased freely in hopes of earning future returns.

Some of those investments are made by people from overseas. Those include equities and debt instruments, but also factories built in the United States by foreign firms.

On the other hand, Americans don't save as much of their income as people in many other countries do. U.S. gross domestic savings amount to about 17 percent of GDP. In China, the figure is quite high — close to 50 percent.

The relatively low U.S. savings rate can be explained in part by the tax code. Interest income earned on deposits is subject to taxation, which tends to discourage people from saving.

On the other hand, interest is tax deductible when paid by individuals on home mortgages. The tax code is setup to punish saving and to reward borrowing.

In addition, the federal government itself is a huge borrower. The Congressional Budget Office is projecting a budget deficit of $559 billion in fiscal year 2017 — a figure larger than the trade deficit.

Since the budget deficit represents federal expenditures that exceed tax receipts, it is funded entirely by borrowing. The budget deficit exacerbates the trade deficit by attracting a large flow of funds from other countries.

Counter to the views of those who believe imports damage the United States, most economists believe the trade deficit simply isn't a problem. Even if it was, imposing a tariff to restrict imports would do little to change it.

If countries sell us fewer goods, they will have less money with which to buy U.S. exports. A bigger concern is that half of all imports are used as inputs by U.S. manufacturers. Policy changes that reduce imports stand to harm the manufacturing sector by making it less competitive relative to firms in other countries.

However, all is not lost. The government could take two major steps that would reduce or eliminate the trade deficit. One would be to reform the tax code to eliminate its bias toward borrowing instead of saving.

The second would be to balance the federal budget, which would curtail the huge amount of investment currently needed to fund annual deficits.

Those steps may have less visceral appeal than restricting imports, especially ones that are “unfair.” Yet curtailing imports not only will hurt the U.S. economy, but also divert attention from needed tax and budget changes that actually could make a difference.

Daniel Pearson joined the Cato Institute after serving for 10 years on the U.S. International Trade Commission, the federal agency that, among other responsibilities, oversees the U.S. trade remedy laws. Pearson was nominated to the USITC by President George W. Bush and began his term as a commissioner on October 8, 2003.