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Inconvenient Truths About the US Trade Deficit
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CAMBRIDGE – The United States has a trade deficit of about $450 billion, or 2.5% of GDP. That means that Americans import $450 billion of goods and services more than they export to the rest of the world. What explains the enormous US deficit year after year, and what would happen to Americans' standard of living if it were to decline?

It is easy to blame the large trade deficit on foreign governments that block the sale of US products in their markets, which hurts American businesses and lowers their employees' standard of living. It's also easy to blame foreign governments that subsidize their exports to the US, which hurts the businesses and employees that lose sales to foreign suppliers (though US households as a whole benefit when foreign governments subsidize what American consumers buy).

But foreign import barriers and exports subsidies are not the reason for the US trade deficit. The real reason is that Americans are spending more than they produce. The overall trade deficit is the result of the saving and investment decisions of US households and businesses. The policies of foreign governments affect only how that deficit is divided among America's trading partners.

The reason why Americans' saving and investment decisions drive the overall trade deficit is straightforward: If a country saves more of total output than it invests in business equipment and structures, it has extra output to sell to the rest of the world. In other words, saving minus investment equals exports minus imports – a fundamental accounting identity that is true for every country in every year.

So reducing the US trade deficit requires Americans to save more or invest less. On their own, policies that open other countries' markets to US products, or close US markets to foreign products, will not change the overall trade balance.

The US has been able to sustain a trade deficit every year for more than three decades because foreigners are willing to lend it the money to finance its net purchases, by purchasing US bonds and stocks or investing in US real estate and other businesses. There is no guarantee that this will continue in the decades ahead; but there is also no reason why it should come to an end. While foreign entities that lend to US borrowers will want to be repaid some day, others can take their place as the next generation of lenders.

But if foreigners as a whole reduced their demand for US financial assets, the prices of those assets would decline, and the resulting interest rates would rise. Higher US interest rates would discourage domestic investment and increase domestic saving, causing the trade deficit to shrink.

The smaller trade deficit would help US exporters and firms that now compete with imports. But a decline in the trade deficit would leave Americans with less output to consume in the US or to invest in the US to produce future consumption.

And that is only part of the story. In addition to shrinking the remaining amount of goods and services available to US households and businesses, reducing the trade deficit requires making US goods and services more attractive to foreign buyers and foreign goods less attractive to US buyers. That means lower US export prices and higher import prices, brought about by a fall in the value of the dollar. Even with the same physical volume of national output, the value of US output to domestic consumers would fall, because the US would have to export more output to obtain the same value of imports.

Trade experts estimate that reducing the US trade deficit by one percent of GDP requires export prices to fall by 10% or import prices to rise by 10%. A combination of these price changes is about what it would take to shrink the current trade deficit by 2% of our GDP, bringing the US close to trade balance. But, because US exports and imports are 15% and 12% of GDP, respectively, a 10% decline in export prices would reduce average real (inflation-adjusted) income by 1.5%, while a 10% rise in import prices would reduce real incomes by an additional 1.2%.

Thus, eliminating the trade deficit would require shifting about 2.5% of US physical production to the rest of the world, as well as a change in export and import prices that reduces their real value by another 2.7% of GDP. In short, with no change in the level of national output, Americans' real incomes would decline by about 5%.

Over the longer run, the growth rate of national output depends on what happens to overall US investment in plant and equipment. If the trade deficit shrinks because consumption rises and investment falls, the lower level of investment would cause the growth rate to decline, further decreasing the long-run level of real income. But if the trade deficit narrows because households save more and government deficits are reduced, it is possible to have a higher level of investment – and thus higher incomes in the long term.

So changes in America’s saving rate hold the key to its trade balance, as well as to its long-term level of real incomes. Blaming others won’t alter that fact.

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