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Another Nonproblem

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Can the United States run a trade deficit - where the United States imports more than it exports - forever?

Most commentators have argued the big trade deficits the United States has run over the last couple of decades eventually will cause great economic hardship or even disaster in the United States. In fact, the United States has run trade deficits for most of its history, and the disaster has yet to strike. How can this be?

Federal Reserve economists recently examined the data carefully and come up with solid explanations. The following summarizes and simplifies some of their key findings as to why the trade deficit is not a problem.

When the U.S. (or any other country) buys more goods and services from foreigners than it sells to them, it needs to "borrow" - that is, receive loans or investment funds from other countries - to finance the difference between what it imports and exports. It is commonly assumed that these "loans" need to be repaid, which is not necessarily so any more than it is necessary for you or a subsequent owner to "pay back" in entirety a mortgage on a house. A piece of farmland can have a mortgage on it until infinity, provided the rate of return on the land is more than sufficient to cover the debt payments.

Foreigners now own more than $20 trillion of U.S. assets (stocks, bonds, direct investment, etc.), and U.S. citizens and entities own more than $17.5 trillion of foreign assets, leaving the United States with a $2.5 trillion net asset deficit, which is about 17 percent of gross domestic product. This net asset position as a share of GDP has remained

relatively constant in recent years, even though both the assets owned in the U.S. by foreigners and the assets owned by U.S. citizens in other countries have increased rapidly.

For instance, if over the next 15 years the U.S. GDP doubles and the net asset deficit number also doubles to $5 trillion, it will still represent only 17 percent of GDP. But it will also enable the United States to run an additional $2.5 trillion in trade deficits (the difference in the current $2.5 trillion net asset position and the future $5 trillion asset position) without the country being any worse off. In fact, it will be better off because of all of those additional imports it has received without having to export an equal amount of goods and services.

You may be thinking, "How can this be? There has to be a trick in here somewhere." Much of the answer lies in the makeup of the investments foreigners make in the U.S. versus the investments that U.S. citizens make in other countries. Assume there are two individuals, Mr. Kato, a Japanese citizen, and Mr. Adam Smith, an American. Mr. Kato buys $300,000 of U.S. government bonds, which yield 6 percent, and Mr. Smith buys $200,000 of stock in a Japanese business, which provides him with a 9 percent dividend. Mr. Kato receives $18,000 in interest payments from the U.S. each year, and Mr. Smith receives $18,000 in dividends from Japan each year. Thus the net flow of money between the two countries is equal, even though Mr. Smith invested $100,000 less in Japan than Mr. Kato did in the United States.

Ten years after their purchases, Mr. Kato sells his U.S. government bonds and receives his $300,000 back. Mr. Smith sells his investment in the Japanese company for $300,000, even though he only paid $200,000 for the stock, which means he had a $100,000 capital gain. You may ask, "Why did not Mr. Kato invest in the Japanese company rather than U.S. government bonds?" In fact, Mr. Kato may have done both if he had a total of $500,000 to invest, and Mr. Smith also may have bought $300,000 of U.S. government bonds in addition to his Japanese stock. Both men found it to their advantage to put their precautionary savings in low-risk U.S. government bonds (that pay more than Japanese government bonds) and put their higher-risk investment in a Japanese company.

Both Mr. Kato and Mr. Smith are equally well off after 10 years with the same risk profile and investment strategy. The United States is better off because no more dollars flowed out than flowed in, and a U.S. citizen had an extra $100,000 to spend in the United States. Japan also was better off because it received investment funds that produced a higher rate of return for the Japanese economy.

Though the above example was greatly simplified, it illustrates part of the reason that the U.S. trade deficit is not a problem is that U.S. investment in other countries receives, on average, a higher rate of return (because more of it is in equities) than foreign investment does in the United States (because more of it is in bonds).

As long as the United States is politically and economically more stable than many other countries, the trade deficit can persist without doing any damage to the U.S. economy - for many decades or even centuries. So drop this from your list of worries.

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