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Tesi di laurea

Il Deficit Commerciale Statunitense: Cause e Sostenibilità
The U.S. Trade Deficit: Causes and Sustainability

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ABSTRACT

L'analisi dell'articolo accademico "Global Imbalances: Globalization, Demography and Sustainability" pubblicato nel 2008 sul Journal of Economics (Vol. 22, No. 3, pagine 93-112) offre un ottimo spunto per affrontare un tema già ampiamente trattato nel corso degli ultimi anni, ovvero il deficit commerciale degli Stati Uniti.

L'autore presenta un quadro diverso da quello ortodosso prendendo in considerazione aspetti spesso ignorati: il deficit commerciale è risultato di molteplici aspetti sociali ed economici caratterizzanti degli Stati Uniti che attutiscono la portata del deficit. La globalizzazione dei mercati finanziari a cui è andato incontro il sistema economico in questo decennio ha diminuito le cosiddette home bias, intese come una distorsione nella diversificazione di portafoglio, in base alla quale gli investitori sono portati a preferire i titoli domestici a quelli stranieri, portando un flusso di capitali sempre maggiore nel mercato statunitense in relazione al suo share del GDP globale.

Questo fenomeno, unito alla transizione demografica a cui è andato incontro ormai tutto l'Occidente ma ancora in uno stadio embrionale negli Stati Uniti, soprattutto grazie ad una decrescente ma tuttora consistente immigrazione e ad un tasso di natalità relativamente più alto che nei paesi Europei, rende, secondo la teoria esposta nell'articolo di Cooper, meno preoccupante la situazione statunitense nel medio periodo.

Nel primo capitolo viene introdotta ed analizzata la struttura della bilancia dei pagamenti e delle sue componenti tramite le principali formule della macroeconomia tradizionale. Segue poi un focus sulla situazione attuale del debito commerciale statunitense e sul suo andamento crescente nel corso degli anni passati, prestando particolare attenzione al ruolo giocato dal mercato finanziario statunitense nel permetterne la continua espansione.

Vengono infine fatti cenni sulle conseguenze di apprezzamenti e deprezzamenti del dollaro sul debito commerciale statunitense.

Nel secondo capitolo è continuata l'analisi della globalizzazione dei mercati finanziari, con particolare attenzione a quello statunitense, in grado di attrarre sempre più capitali grazie alla loro dinamicità e diversificazione. È poi analizzato il fenomeno dei deficit e surplus commerciali in relazione alla transizione demografica a cui le economie avanzate o in via di sviluppo stanno andando incontro e ai sistemi pensionistici sempre più precari che spingono i pensionati, presenti e futuri, a cercare stabilità in investimenti nel mercato finanziario più grande e diversificato al mondo, ovvero quello statunitense.

Infine, dopo aver discusso sulla sostenibilità del deficit commerciale nel medio periodo secondo la visione di Cooper, nel capitolo terzo sono passate in rassegna le varie teorie alla

base del crescente trade deficit statunitense, con particolare attenzione ai rischi di una drastica ed improvvisa riduzione del debito, e le principali opinioni del dibattito in corso sul tema del deficit commerciale statunitense tramite una politica di svalutazione del dollaro.

INTRODUCTION

Since the early Nineties the United States has had a broad and growing trade deficit. But sometimes this sounds as an oxymoron to non-insiders. Indeed, one is led to wonder: how can the most influential and powerful country of the world run such a huge debt without consequences? Which factors lie behind it? Is the U.S. deficit sustainable in the short, mid or long run?

The purpose of this paper is to present the point of view and the answers given on this topic by Richard N. Cooper, Maurits C. Boas Professor of International Economics at Harvard University, member of the Trilateral Commission, the Council on Foreign Relations and the Brookings Panel on Economic Activity. In his article “Global Imbalances: Globalization, Demography and Sustainability” published in 2008 on the Journal of Economics (Vol. 22, No. 3, pages 93-112) the author recognizes demographic and financial globalization changes along with investor desire for diversification as causes for the increasing investments in the United States, that finance the deficit.

Throughout the article, the author examines the increase in the deficit in terms of two important forces present in the world economy, globalization of financial markets and changing demographics. But these factors are not enough to answer other questions, such as whether non-U.S. investors will continue to be motivated to invest in the United States and whether their savings will be adequate to finance the deficit. In this paper will be discussed whether changes in the trade deficit are sustainable and pointed out that serious efforts to reduce the deficit may precipitate a financial crisis and severe economic downturn.

Moreover, it will also be explained why, according to Cooper’s view, the deficit is sustainable in the medium term and warns the readers to be cautious against policies that would force a decline in the deficit, in sharp contrast to the economic and political experts that express concern over the U.S. trade deficit, mainly because of their worry that non-U.S. investors will eventually discontinue financing the deficit.

The increasing amount of expenditures that is greater than the national income is thought by some to be detrimental to the U.S. economy and the result of a decline in U.S. savings. The author encourages looking beyond national income accounting relationships, offering a complex analysis of the imbalance in U.S. trade explaining why is highly unlikely that non-U.S. investors will not continue to finance the U.S. trade deficit.

1. THEORIES AND FACTS ABOUT TRADE DEFICIT

1.1. What is a trade deficit? The balance of payments components

Before starting to discuss about the U.S. trade deficit, in the first part of this paper, we will focus on which are the various elements that compose this indicator, which is the starting point to fully comprehend the next chapters.

The trade balance, also referred to as Balance of Trade (BoT), is the difference between exports (domestically produced goods and services sold to foreign countries) and imports (goods and services purchased from other countries).

$$(1) \text{ BoT} = X - M$$

On the one hand, exporting goods and services produces income for a country; therefore, exports add to the trade balance. On the other hand, when a country imports goods and services, it transfers part of its income abroad to pay for them. Therefore, the former variable (X) adds to the trade balance and, consequently, to the GDP while the latter (M) detracts. When a country exports more than it imports ($X - M > 0$), the country is said to have a trade surplus. When the opposite is true ($X - M < 0$), the country is said to have a trade deficit, which is the U.S. current situation. When a country exports exactly as much as it imports, the country is said to have balanced trade ($X = M$).

Sometimes, throughout the article, the author uses interchangeably the terms current account and trade balance while he is referring to the trade deficit, even though they are not exactly synonyms. Indeed, the current account is the sum of the trade balance, net income from abroad and net current transfers. The current account balance is the difference between the nation's income and expenditures, and any additional debt the country takes on to cover the difference (in cases when income exceeds expenditures, as it does in the U.S.).

$$(2) \text{ CA} = (X - M) + \text{NY} + \text{NCT}$$

Where CA is the current account, $(X - M)$ is the trade balance, NY is the net income from abroad and NCT are the net current transfers. The trade balance, as evinced by the formula, is a major component of the current account balance. The current account also shows the relationship between national saving and national investment. By the national income accounting identity, the current account balance is equal to the difference between national saving and national investment.

$$(3) \text{ CA} = S - I$$

Where CA is the current account and S and I are respectively national saving and national investment. Therefore, when a country has a trade surplus (a positive trade balance), national saving must, by definition, exceed domestic investment. That is, a country with a current account surplus is also a net lender (this country uses its savings not to invest domestically but to make loans to foreigners). For instance, in 2014 China has lend \$22 billion to countries in Latin America, such as Peru and Bolivia, exceeding the World Bank investments. When a country has a trade deficit (a negative trade balance), national saving must, by definition, be below investment. In this case, the country is a net borrower (as national saving is not sufficient to finance all of domestic investment, and so the extra investment must be financed by borrowing from abroad). The latter, as it will be explained later in this paper, is the case of the Unites States. The current account is only one part of a broader accounting concept called the balance of payments (also known with the acronym BoP) that tracks international transactions of goods, services, and finances. The balance of payments records the composition of the current account balance and of the transactions that finance it. There are three main components of the balance of payments: the current account, the financial account, and the capital account.

$$(4) \text{ BoP} = \text{CA} + \text{KA} + \text{FA}$$

Where CA is the current account and is equal to $(X - M) + \text{NY} + \text{NCT}$, KA is the capital account whose components are FDI (foreign direct investments), portfolio investments and other investments, such as transactions result in trade in non-produced, non-financial, and intangible goods (such as copyrights and trademarks). In the specific case of the United States, these assets do not amount much. In the specific case of the United States, these assets do not amount much.

FA is the financial account, that shows differences between sales of assets to foreigners and purchases of assets held abroad.

Is also important to bear in mind that every international transaction is recorded as both a debit and a credit somewhere in the balance of payments, reflecting that every acquisition of a good, service, or asset must be paid for with a corresponding transaction. The result of this accounting identity is the fundamental balance of payments identity, which says that the sum of the current account, financial account, and capital account must be zero by definition.

1.2. The U.S. trade deficit

The U.S. trade deficit as tallied in the current account balance reached \$531.5 billion in 2015. This because it imported \$2.7618 trillion of goods and services while exported \$2.2303 trillion. The deficit has increased from 2013, when it amounted to \$478 billion. This increase is partially due to a stronger dollar, that recorded a growth of 25% in 2014 and 2015. But, it is less than the \$811.5 billion debt reached in 2006, which, as a percentage of GDP, stood at 6.1%. As can be evinced from the underlying graphs, the U.S. trade deficit has followed a negative trend path since the early nineties. Figures 1 and 2 show respectively the U.S. balance of trade in the last year and from 1950 to date, which allow us to see more clearly the deficit trend.

The U.S. Balance of Trade from January 2015 to January 2016

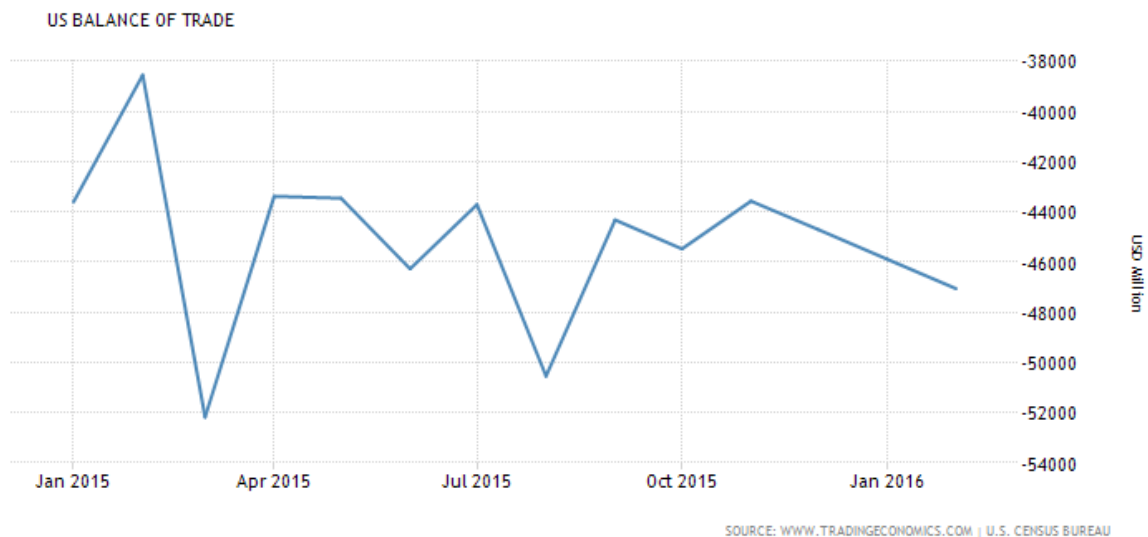


Figure 1

Source: Census Bureau, <http://www.tradingeconomics.com/united-states/balance-of-trade>

According to Figure 2, the United States has been running a trade deficit, even if less consistent than the one it is facing today, at least since the early 1970s.

The U.S. Balance of Trade from 1950-2015

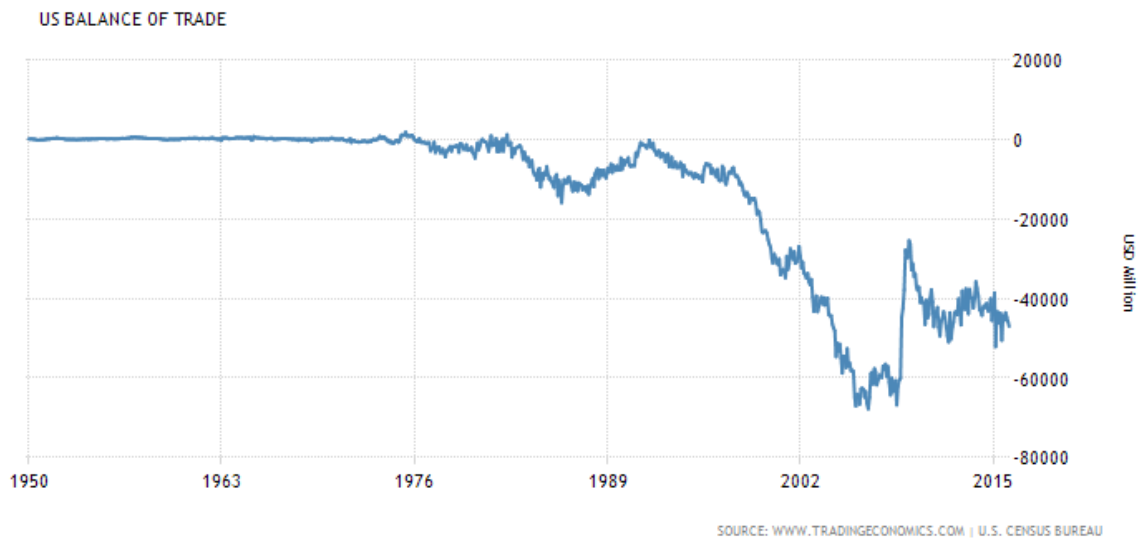


Figure 2

Source: Census Bureau, <http://www.tradingeconomics.com/united-states/balance-of-trade>

But how can the second world's richest country by 2016 GDP purchase more goods and services from the rest of the world than it sells? The answer can be found analyzing the financial account of the balance of payments. Besides the imports and exports variables of the balance of trade another major element needs to be considered while analyzing the trade deficit and the balance of payments, especially the United States ones: the financial assets. When countries are engaged in trade, they do not exchange just goods and services but also financial assets, and such transactions are tracked in the financial account. Comparing the graphs in Figure 2 and Figure 3 it is visible a symmetric trend throughout the period considered. It must be the case that the U.S. has sold more assets to foreigners than it has purchased from them. In other words, the U.S. has had to borrow from abroad since the early 1990s in order to finance its trade deficit. The money it receives for the sale of those assets has financed its trade deficit. Indeed, net financial inflows were \$657.4 billion in 2007, while trade deficit was of \$708.5 billion.

Foreign Assets in the U.S. from 1960 to 2045 – Net Direct Investment

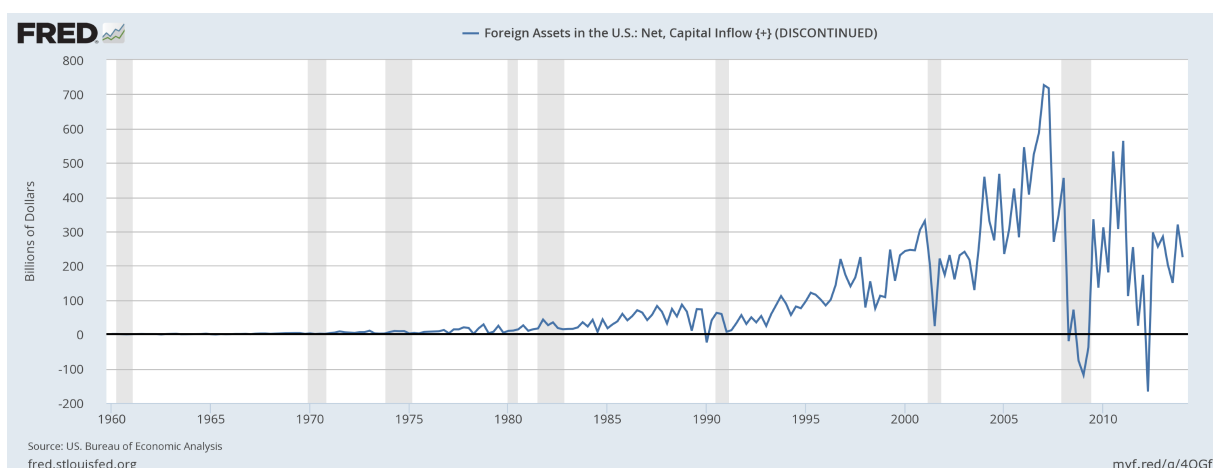


Figure 3

Source: U.S. Bureau of Economic Analysis, fred.stlouisfed.org, updated Jun 18, 2014

If a country systematically buys more than it sells, as has happened to the United States for the last 25 years, it has to pay for the excess by selling financial assets of the country, or by borrowing them from abroad. In the balance of payments, the financial inflows are an important counterpart to the trade flows. As it will be explained in chapter 2.3. of this paper, international financial flows take place also because of the investors' desire to diversify their portfolios, increase their rate of return and changing the interest rate risk profile. Countries not only differ in resources, technologies, and tastes, but they also differ in offerings of and preferences for risk and return on financial assets. So, beyond being linked through international trade flows, countries are also connected through international flows of financial assets.

Whereas a trade deficit implies that there must be some international financial inflow as a balancing entry in the international accounts, there are also large international flows of financial assets that are independent of the trade flows. For the United States, international capital flows both into and out of the country amount to trillions of dollars each year, consistently more than the cross-border trade flows. Moreover, even as the country as a whole borrows to finance the trade deficit, the inflow of financial capital generally exceeds the trade deficit, as foreign investors purchase U.S. assets and U.S. investors buy foreign assets.

A trade deficit that persists implies that borrowing must rise too, as does foreign ownership of domestic financial assets.

A rising current account deficit or a falling surplus over the rapid growth that the western countries have been facing since last century is not a remarkable event for the U.S. economy.

In the 1960s, a fast economic growth diminished steadily the previous account surplus. In the 1970s, modest deficits occurred along with each economic expansion. Anyway, from the 1980s through 2006, the average size of the U.S. trade deficits has been constantly increasing. Especially in recent years, when the United States have faced a more rapid growth than its major trading partners, trend forces and cyclical factors are partially responsible for this phenomenon.

The trade deficit widens alongside the economy expansion. This phenomenon is sometimes erroneously explained with the existence of trade barriers abroad, of foreign dumping of exports, of any inherent inferiority of the U.S. goods on the world market. The main variable that lies behind the trade deficit is more sociological than it is thought and deals with the macroeconomic spending and saving behavior at home and abroad. In the U.S. economy, as in the majority of the developed countries, there is a strong tendency to spend beyond current output, with the excess of demand met by a net inflow of foreign goods and services that results in the U.S. trade deficit. Clearly, the U.S. trade deficit in certain countries can persist only if exist foreign economies that produce more than is absorbed by their current spending and are able to export the surplus, financing deficits abroad.

1.3. How changes in the dollar's value affects the trade deficit

The currency exchange rates and the balance of trade are closely related through the effect of the former on the supply and demand for foreign exchange. When a country has a trade deficit or surplus there is relatively more supply or demand for a country's currency, which influences the price of that currency on the world market.

Currency exchange rates are referred to as relative values, which means that the price of a nation's currency is calculated in terms of another currency. These relative values are influenced by the demand for currency, which is in turn influenced by trade. If a country exports more than it imports and therefore has a trade surplus, there is a high demand for its goods and thus for its currency. On the other hand, if a country imports more than it exports and therefore has a trade deficit, there is relatively less demand for its currency, so prices should decline. In this case, a currency depreciates or loses value.

From 2001-2007 the dollar declined by 40% against the euro, making the U.S. services and goods 40% cheaper for Europeans and increasing its exports. As shown in Figure 3, the recession occurred in 2008 offset this advantage, causing global trade to decline: exports dropped from \$1.8 trillion in 2008 to \$1.5 trillion in 2009, while imports fell from \$2.3

trillion in 2007 to \$1.6 in 2009. Both export and import have risen since that fall, even though the dollar has maintained its strength since 2009 because of the global recession, particularly difficult in the euro zone, that has weakened the power of the EU currency, the euro.

U.S. Dollar Index (DXY) from 2008 to 2016



Figure 4

Source: www.tradingeconomics.com/united-states/currency, updated Jul, 2016

However, the dollar's long-term value is constantly pressured downwards by the U.S. debt. This happens because when a country faces a trade deficit it means that its imports exceed its exports. In this scenario the demand for foreign goods and services, and therefore for foreign currency, increases while the demand for the national currency, the dollar, decreases due to a slowdown in exports.

For the trade deficit to reduce, imports must fall and exports must rise. Indeed, one way this adjustment can take place is if the dollar depreciates, making imports more expensive for Americans and exports cheaper for foreigners. If trade deficits are sufficiently large and unsustainable, economists believe that they will be associated with a weakening dollar at some future date. In the long run, trade deficits may be expected to contribute to a weaker dollar, as the economy adjusts to create the surpluses needed to repay foreign investors. However, in the short run, the relationship between the trade deficit and the dollar is weak, and the value of the dollar is determined largely by investor preferences for U.S. dollar assets.

2. HOW GLOBALIZATION AND THE DEMOGRAPHIC TRANSITION AFFECT THE U.S. TRADE DEFICIT

2.1. Globalization of financial markets

According to the Cooper's paper, full globalization of financial markets could be defined as the absence of home-country bias when allocating investments in portfolios. Home bias is a feature of international capital market also referred to as "the disinclination of capital to migrate" (Coeurdaer and Rey (2011)). According to the orthodox finance theory, investors hold a diversified portfolio of equities across the world if capital is fully mobile across borders, if there is absence of home-country bias. Thanks to the globalization our world has been through over the last 30 years many of the barriers to international trade have fallen. The process of 'financial globalization' fostered by capital account liberalizations, electronic trading, increasing exchanges of information across borders and falling transaction costs have led investors across the world to re-balance their portfolio away from national assets towards foreign assets, increasing the cross-border asset trade. Despite that, investors seem still reluctant to take full advantage of the positive outcome of international diversification and still hold a disproportionate share of local equities.

A no home bias diversification would mean that savings throughout the world would be invested in a country according to that country's shares of GDP in gross world product. Table 1 shows the GDP share of World Total (PPP) data for year 2014 for the G-20 economies.

Table 1

GDP as Share of World GDP at PPP by Countries – G20

Country	Level	Units	As Of	1Y Chg	5Y Ago	10Y Ago	25Y Ago
USA	16.14%	% of World GDP	2014	-0.14%	16.98%	19.64%	22.28%
China	16.32%	% of World GDP	2014	0.62%	13.71%	9.68%	4.07%
Japan	4.40%	% of World GDP	2014	-0.15%	4.90%	5.79%	8.79%
Germany	3.45%	% of World GDP	2014	-0.06%	3.72%	4.20%	6.10%
France	2.39%	% of World GDP	2014	-0.07%	2.65%	3.07%	4.14%
Brazil	3.02%	% of World GDP	2014	-0.10%	3.18%	3.08%	3.74%
UK	2.36%	% of World GDP	2014	-0.02%	2.53%	2.96%	3.65%
Italy	1.97%	% of World GDP	2014	-0.07%	2.36%	2.88%	4.23%
Russia	3.30%	% of World GDP	2014	-0.09%	3.44%	3.47%	n.a.
India	6.83%	% of World GDP	2014	0.25%	6.09%	4.91%	3.72%
Canada	1.48%	% of World GDP	2014	-0.01%	1.54%	1.73%	2.08%
Australia	1.01%	% of World GDP	2014	-0.01%	1.04%	1.09%	1.20%
Spain	1.45%	% of World GDP	2014	-0.03%	1.70%	1.94%	2.23%
Mexico	1.98%	% of World GDP	2014	-0.02%	2.03%	2.21%	2.63%
South Korea	1.65%	% of World GDP	2014	0.00%	1.67%	1.64%	1.20%
Indonesia	2.48%	% of World GDP	2014	0.04%	2.27%	2.03%	1.96%
Turkey	1.40%	% of World GDP	2014	-0.01%	1.34%	1.38%	1.39%
Saudi Arabia	1.49%	% of World GDP	2014	0.00%	1.38%	1.28%	1.39%
Argentina	0.88%	% of World GDP	2014	-0.03%	0.89%	0.81%	0.87%
South Africa	0.65%	% of World GDP	2014	-0.01%	0.68%	0.70%	0.88%

Source: [www www.quandl.com/collections/economics/gdp-as-share-of-world-gdp-at-ppp-by-country](http://www.quandl.com/collections/economics/gdp-as-share-of-world-gdp-at-ppp-by-country), updated 2015

According to this principle the savings of the other countries of the world would be invested in the United States in proportion to U.S. economy shares in the world economy (16.14% for 2014) and, vice versa, the savings of the United States would be symmetrically invested in the rest of the world.

Even though this is an oversimplification, it is a to understand the author's idea on how the globalization of financial markets has affected, and still affects, the U.S. trade deficit.

Using 2006 data, the author shows that eliminating home bias with the current levels of saving around the world would lead to an even larger U.S. account deficit.

Indeed, the U.S. share of the world economy was 17.5 percent in 2006. This means that, in absence of home bias, the rest of the world would have invested those percentages of its

saving in the United States over that year. But the amount of investments in the United States was below the supposed one in a situation of “no home bias”. In that situation the total foreign investments in the United States in 2006 would have been \$2.5 trillion, leading the U.S. current account deficit to \$1.200 billion.

Therefore, these numbers are substantially above the actual current account deficit observed for that year, which was equal to \$811 billion for 2006.

From this example, it can be deduced that the world economy is not completely globalized yet, but that it is slowly moving in that direction.

Moreover, this exercise also shows that the U.S. trade deficit is destined to grow as home bias continues to decline.

2.2. Demographical Factors and the S-I Balance

It will be now examined the role of demography in explaining why some countries with current account surpluses and excess savings allow countries with budget deficits to absorb their savings. But why does an excess of national saving over domestic investment occur in some countries? There are many reasons why this happens, from the insecurity about the future to the unreliability of governments.

Cooper focuses on one another, and less discussed, reason why have been invested so much in the U.S., that is the significant demographic transition many countries are going through in these years.

Indeed, he describes the effect of aging societies on savings and investments in the context of increasing life expectancy and low birth rates in many countries.

On the first hand, according to Figure 5, in the last 50 years life expectancy of American people has increased by approximately 8.2 years, from 70 years to 78, without a corresponding increase in working years.

Life expectancy at birth in the U.S. from 1960 to 2014

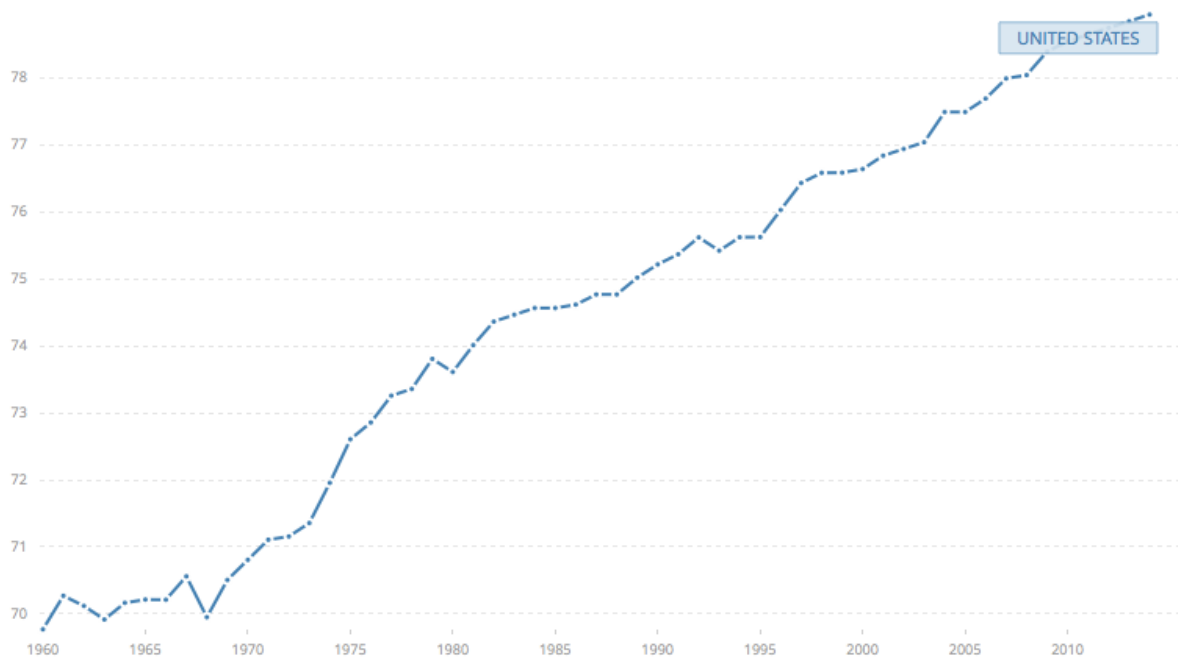


Figure 5

Source: Data Worldbank, World Population Prospects and U.S. Census Bureau: International Database

This is obviously leading to an increase in household savings for retirement. In addition to that, several countries are lately experiencing uncertainty about the financial feasibility of their pension scheme, which represents another explanation to the raise of precautionary saving that we are witnessing nowadays. Uncertainty also exists in the length of life which keeps to rise indefinitely, given the continuous progress in medical technology.

On the other hand, a birth rate at 13‰ in 2014, tend to decrease investment.

Birth Rate in the U.S. per 1,000 people from 1960 to 2014

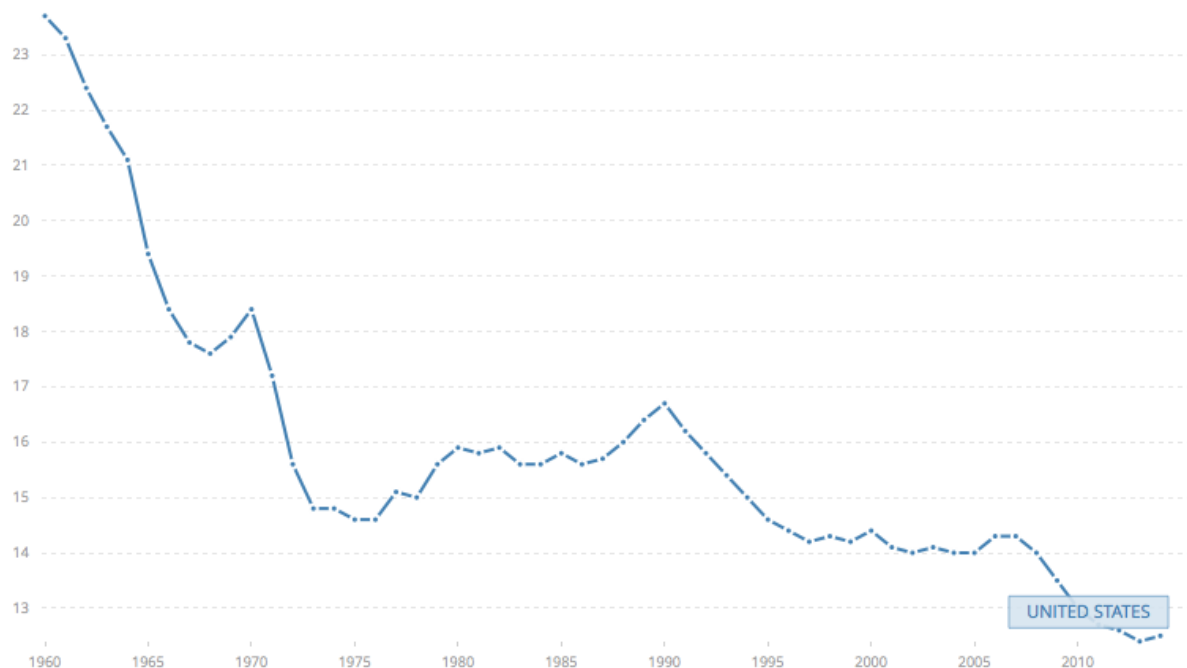


Figure 6

Source: Data Worldbank, World Population Prospects and U.S. Census Bureau: International Database

This occurs because low natality, in the long run, reduces the demand on education and housing. This translates into a lower labor force, which is also translated into some capital-labor substitution that will consequently increase the already existing inclination to invest abroad. Indeed, the aging of the population, along with the recognition of the need for increased savings for the retirement years, influences whether savings are directed outside the home country. According to the U.S. Census Bureau projections, in the most high-income countries such as China and Japan, population are not reproducing themselves anymore. The average birth rate in Germany is 9‰, 8‰ in Japan, and 9‰ in Singapore and Hong Kong, still lower than the 13‰ reached in the U.S. In all these old and new industrialized countries, the number of young adults is declining as a consequence too. The U.S. Census Bureau projections have indeed shown that percentage of people aged 19-25 will drastically reduce between 2005-2025, reaching approximately 19 percent in China, 21 percent in Japan, 16 percent in Germany and 24 percent in the newly industrialized Asian countries. Moreover, in countries such as Germany and Japan, the increased longevity did not counterbalance the significant decline in births.

In this scenario, Richard N. Cooper states that the United States stands out as an exception: indeed, while the birth rate has declined as in the other countries, it remains above 2 per woman. But the United States is an exception also because of the immigration factor.

In fact, the U.S. population has risen by almost a million of immigrants per year, coming especially from Latin America, mostly of who are young people who will integrate in the U.S. labor force.

Because of this phenomenon, according to U.S. Census Bureau projections¹, the U.S. population is projected to increase from 319 million to 417 million, reaching 400 million in 2051. By 2044, almost more than half of all Americans are projected to belong to a minority group (any group other than non-Hispanic White alone); and by 2060, nearly one in five of the nation's total population is projected to be foreign born. Figure 7 shows the projected rate of growth of the native and foreign-born populations by decade. Between 2010 and 2020, the foreign-born population is projected to increase by nearly 20 percent, compared with only 6.4 percent for natives.

Change in Population Size by Nativity: 2010–2020 to 2050–2060

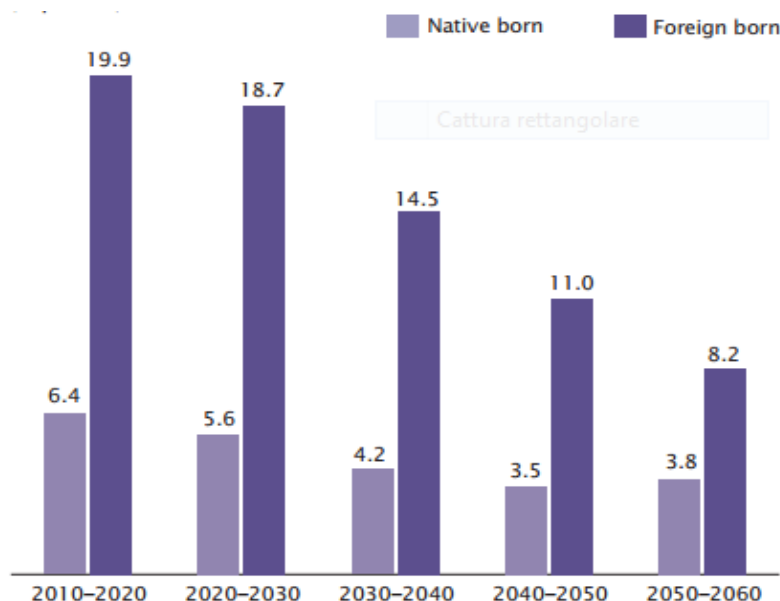


Figure 7

Source: U.S. Census Bureau: 2014 National Population Projections and 2010 American Community Survey, p. 3

¹ Population Estimates and Projections, U.S: Census Bureau, Current Population Reports, By Sandra L. Colby and Jennifer M. Ortman, Issued March 2015, P25-1143

China is, on the other hand, following another path compared to other high-income countries. In fact, according to the China Statistical Year Book, the rural population remains large despite the already occurred drop, and urban migrations can therefore be expected.

The migration to the cities would increase the urban labor force, which can be expected to increase demand for housing, schools, and productive capital stock.

The author concluded the chapter arguing that, despite an increased longevity and low natality, not all the aging countries run current account surpluses.

In order to support this thesis, he adduces the example of Italy and Spain, two countries that run significant trade deficit despite their considerably low birth rates.

The countries that have the largest trade surpluses in the world, such as China, Japan, Germany and the newly rich Asian countries, are also country that are experiencing the demographic transition, characterized by low birth rates and advancing life expectancy.

Together with the globalization of finance and the reduction in home bias, demography helps to explain why a greater share of savings is flowing out of these economies.

But these two arguments do not yet explain why all these capitals are flowing to the United States and not to other countries around the world where the demographic transitions is even less advanced.

2.3. Why keep investing in the United States?

Thus, countries have diversification, globalization, and demographic reasons to invest their savings outside the home country. But the question still remains: why should they invest in the United States?

The author offers various reasons for non-U.S. investors to invest in the United States.

The financial system in the United States and its GDP are large, but, as mentioned in chapter 1.2.1, the U.S. financial market is even larger, with more than half of the marketable securities (stocks and bonds) in the world, and the markets are highly liquid compared to other financial markets and offer a wide diversity of financial assets, increasing their attractiveness to passive investors.

Also, the legal system respects property rights and provides relatively swift and impartial conflict resolution, differently from countries such as Russia, Bolivia and Argentina, where effective confiscations are a relatively common practice.

Lastly, the U.S. market reflects a dynamic and innovative economy with a great deal of intellectual capital, flexibility, and relatively high risk-adjusted returns on capital, while other

developed economies, such as China, still have a poor institutional setting for investments despite their high investment rates.

Theoretical models that take empirical characteristics of financial markets into consideration find it not surprising that capitals flow to the U.S. economy.

Caballero, Farhi and Gourinchas (2006) explain the significant demand for U.S. securities due to the shortage of financial assets outside the United States. The authors underline the importance of US assets in global portfolios, that has increased from 1990 to 2004, amounting to over 17 percent of the rest of the world's financial wealth, which is equivalent to 43 percent of their annual output. Figure 8 illustrates how foreign ownership of U.S. assets has risen from 1945 to 2015, due to a general increase in cross-border investments, resulted from an increasingly globalized financial market, and how it has been nearly matched by rising U.S. ownership of assets abroad. The underlying Figure also shows how, since 1985, foreigners have consistently owned more U.S. assets than Americans own foreign assets.

Ownership of Financial Assets (Percent of U.S. GDP) from 1945 to 2015

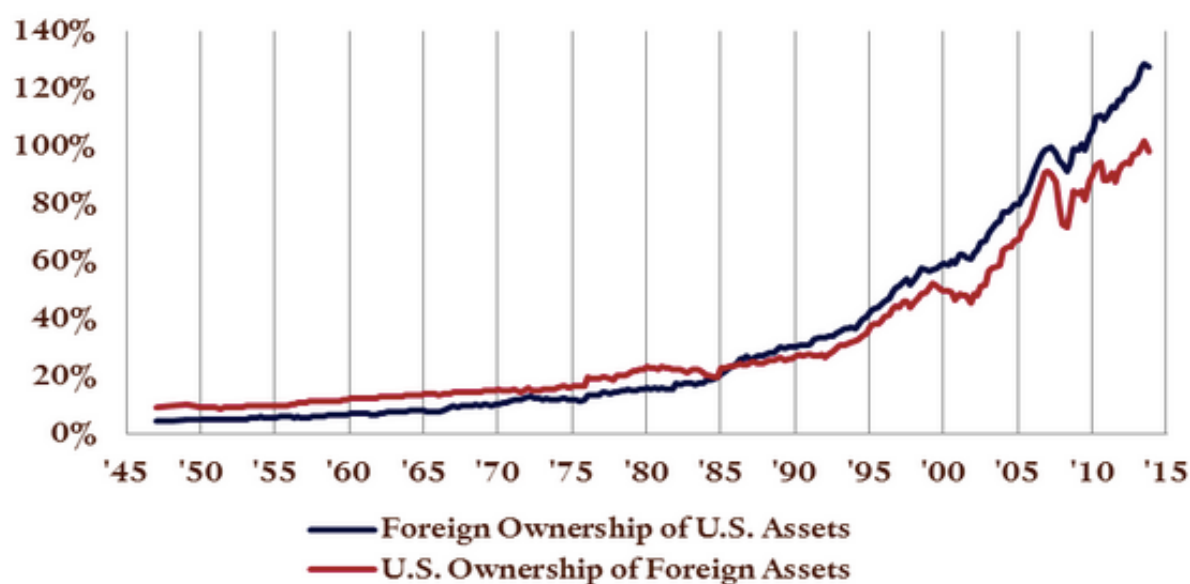


Figure 8

Source: Council on Foreign Relations, January 21, 2015, Dinah Walker

Caballero and Antras (2007) show also that financial market imperfections in developing countries can lead to a net outflow of capital towards countries that have higher endowments of capital per worker. A financially underdeveloped economy that opens the capital account without liberalizing trade is likely to experience capital outflows to more financially developed ones.

On the other hand, foreign investors in the United States have to face the risk of a dollar depreciation, as seen in the historical series of Figure 4, that could hurt their rate of return measured in home currency, but apparently this exchange rate risk does not overwhelm the combination of risk and yield typical of the U.S. financial markets.

According to historical data and statistics, foreign investors seem to believe that in the long run appreciation will roughly balance depreciations, or that a severe depreciation of the dollar would be enough damaging to other economies to compensate actions by their monetary authorities.

3. SUSTAINABILITY AND CAUSES OF THE U.S. TRADE DEFICIT

3.1 Sustainability of the U.S. Trade Deficit

A major topic of discussion over the U.S. trade deficit is whether it is sustainable or not, based on two major concerns. The first concern is the fear that the numerous non-U.S. official agencies, such as central banks, that have invested in the United States and represent a majority of the share of the U.S. treasuries, as can be evinced from Figure 9, will suddenly stop increasing their holdings of U.S. assets or even sell their existing ones.

U.S. and Foreign Ownership of U.S. Treasuries (Percentage of U.S. GDP)

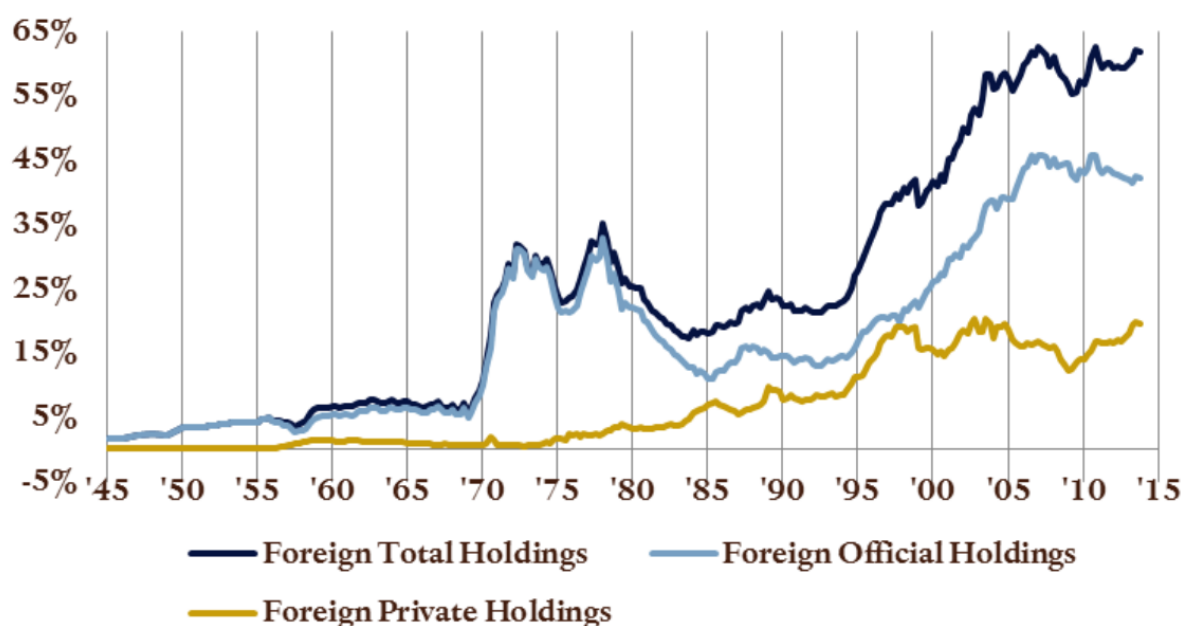


Figure 9

Source: Federal Reserve: Bureau of Economic Analysis, www.cfr.org/cgs, January 21, 2015, Dinah Walker

The second concern is that the trade deficit is growing too rapidly relatively to the size of the U.S. economy. He explains that neither concern should suggest the deficit is not sustainable over the medium term and that there are no indicators that non-U.S. investors will soon become satiated with U.S. dollar investments.

In fact, according to the International Financial Statistic Annual Report published by the IMF, foreign central banks added approximately \$2 trillion to their reserves over the last decades, whose two-third are held in dollar-denominated assets. This phenomenon finds its explanation after the several crises the western world faced since the 1990s, which led some countries to increase their domestic money supplies by buying foreign rather than domestic claims, mainly to build precautionary foreign exchange reserves.

Some countries may also want additional foreign investments because of the limited opportunities for further productive investments at home. For instance, oil-exporting countries, such as Kuwait and Norway, have invested part of their current account surpluses in other countries of the world for future generations, so that significant savings from these countries may endure for many years.

China, differently from other countries, has many profitable domestic investment opportunities but, however, has a poorly developed capital market and a rudimentary government bond market that offer a very limited choice of financial assets to savers.

China also maintains tight control on resident capital outflow, despite its state-owned banks own over \$1 trillion in foreign exchange rates.

Cooper's paper also points out something that is often unspoken: the inflows of private funds are noticeably greater than inflows of official funds, which are mainly foreign exchange reserves invested in the United States.

Moreover, it is also incorrect the statement that central banks are financing the United States current account deficit. It would be more correct indeed to say that foreign central banks are financing American investments abroad.

Another feature of the U.S. economy, that should help investors to be less concerned about the U.S. trade deficit, is that the total value of financial assets has risen significantly more rapidly than the underlying economy. Put in another way, while nominal GDP grew by 7.4 percent a year in the period from 1965-2006, total financial assets grew by 9.2 percent a year. This phenomenon reflects in particular innovations by the financial sector, which is devising financial instruments to appeal to a wider variety of circumstances and tastes.

Because of that characteristics of the U.S. Economy, the U.S. financial assets, even though cannot grow indefinitely, can grow for many years before beginning to strain the American capacity to provide financial assets.

3.2. The present debate over the U.S. trade deficit

Over the years, many explanations of the persistent U.S. trade deficit have been proposed.

As discussed in the first part of the paper, a trade deficit is caused by a change in national saving or investment or both. U.S. national saving began slightly declining in the 1950s, and this decline further accelerated in the 1980s. Both federal government and personal saving declined during the period.

The US Government Accountability Office has outlined over the past years the main institutional causes for the widening U.S. trade deficit. The most important cause of the increased U.S. trade deficit, according to the GAO, was the sharp rise in the value of the dollar, which caused the prices of U.S. goods to rise compared to the prices of foreign goods. The strong U.S. economic recovery has also played an important role over the rise of the deficit, causing U.S. consumption of goods, including imports, to rise, while the Latin American debt problem curtailed U.S. exports. Although foreign trade barriers reduced international trade, they did not account for the huge increase in the U.S. trade deficit after 1980 and U.S. products became less competitive due to the rise of the value of the dollar, rather than decreases in productivity.

The increase in labor productivity that the U.S. has experienced since roughly 1996 might also be part of the explanation behind the widening of the U.S. trade balance. An increase in productivity can both increase the investment rate and lower the saving rate. This, in turn, would lead to a wider current account deficit (Valderrama 2007).

Many academics and policymakers have also expressed concern about the widening U.S. trade deficit. However, there is a lot of disagreement about the severity of the problem and the potential consequences. According to the former Fed Governor, Ben Bernanke in a 2005, to understand the U.S. current account deficit, one must look beyond the U.S. borders. He argued that over the past decade a combination of diverse forces has created a significant increase in the global supply of saving which helps to explain both the increase in the U.S. current account deficit and the relatively low level of long-term real interest rates in the world today.

Another prominent U.S. economist, Paul Krugman, shows his concern over the long run sustainability of the trade deficit, stating that the U.S. can run huge deficits for the time being, because foreigners are temporarily willing to lend them huge sums of money. But one of these

days to come, the easy credit will come to an end, and the United States will have to start paying its way in the world economy.

An unconventional point of view on the deficit is the one supported by Gregory Mankiw, according to which the trade deficit is not a problem in itself but is a symptom of a problem. The problem is low national saving, instead. Given that national saving is low, he is not eager for the trade deficit to disappear, because that would mean that domestic investment would need to fall to the low level of national saving.

3.3 Why forcing down the trade deficit is dangerous

Lastly, it will be discussed the dangers of the trade deficit being forced down through various proposed fiscal and exchange rate policies, arguing that policy-induced appreciation in many currencies against the U.S. dollar could provoke a massive outflow of funds from the United States that would generate financial havoc in the world.

The deficit is likely to change in the future, however, and if the U.S. trade deficit declines significantly, the trade surpluses of other trading partners, such as China or Germany, will also decline.

A more natural dollar depreciation should reflect the consumption patterns in aging societies around the world. The author concludes that changes in the U.S. dollar and the current account deficit should reflect the advantages of the United States as a vibrant and innovative economy with a financial system that provides innovative products for those around the world who want to invest for their retirement years.

Viewed in the context of globalization and demographic change in other high-income countries, the large U.S. current account deficit is both comprehensible and probably even welfare-enhancing from a global point of view, so long as the funds are productively invested in the U.S. economy. Prospective retirees around the world are making investments in the U.S. economy that are profitable and secure, and which they hope to liquidate later.

On the other hand, many scholars have increasingly warned that the large U.S. trade deficit is unsustainable and may threaten the macroeconomic stability.

One of the main supporter of a U.S. trade deficit reduction is William Cline (2005), who provides a good account of the standard arguments for why the U.S. government in combination with other countries should seek to manage a reduction in the U.S. trade imbalance. In sharp contrast to Cooper's view, Cline believes that the U.S. deficit is not

sustainable but precarious: this is why he backs the idea that the U.S. trade deficit should be reduced to no more than 3 percent of GDP.

Cline proposes a package of changes in fiscal and exchange rate policies in many countries to bring about the desired correction. Fiscal policy in his opinion, is the only instrument that can be effectively employed to increase national savings and thereby reduce the trade deficit (Cline 2007, 7). This lead us to conclude that a reduction of the federal budget deficit follows a complementary path toward the ultimate goal of reducing the trade deficit. As seen in the previous chapter, according to some economists, a widening trade deficit poses major risks for the U.S. economy and the U.S. government should be therefore inclined to adopt fiscal policies that aim to reduce the budget deficit directly. Many times has been told that the large U.S. trade deficit could lead into a deeper economic crisis if investors were to lose their appetite for dollar-denominated assets, restraining the overall economic growth. However, the actual experience with the U.S. trade imbalances over the last decades is that both the United States and economies in the rest of the world have adjusted to them rather smoothly. Attempts to manage a forced reduction in the U.S. imbalance might be enormously misguided at best, and at worst may precipitate in a financial crisis. For instance, if we accept Cline's (2005) argument that the current deficit should be reduced by 3 percent of GDP, this would require that U.S. expenditure drop by three percentage points of GDP. Simultaneously, foreign surpluses, considered together, would have to decline by 3 percent of U.S. GDP, implying an increased demand relative to output by that amount somewhere else in the world. It is commonly stated that in order to bring about the required substitutions in product demand, the U.S. dollar must depreciate approximately by 30 percent on a trade-weighted basis. However, the other side of the coin is that such a policy would run a severe risk of reducing world aggregate demand by decreasing U.S. expenditures without a corresponding increase in other countries, leading to an economic recession.

3.4 Instability

Trade deficits often raise concern about the potential instability of external sources of finance. What may happen if foreign investors decide to pull their investments out of the United States, undermining domestic capital markets and the worldwide economy? There are several reasons why a sharp turnaround in foreign capital flows is unlikely to happen. Over the last decades, the experience of other countries with the panic of foreign investors has demonstrated that such reaction tends to be a result of the growing likelihood that they would

not be repaid and that debt service payments were unsecure. This often happens when a country's capacity to pay debt service was put in danger by a continuous weak economic growth or the rapid consumption of the nation's foreign exchange reserves in the protection of an overvalued currency. These risks do not seem to be applicable to the circumstances of the United States, which has strong growth and does not fix its exchange rate.

Moreover, a considerable amount of investments made in the United States have been long-term in nature and are not particularly susceptible to quick changes in commitment. It is very probable that the majority of foreign investors usually see the U.S. economy as a stronghold of long-run economic strength and will continue to invest for long-term profit. On the other hand, it is true that a sizable share of the stock of U.S. foreign debt is in short term assets that can be quickly moved. That these types of assets will change direction as relative yields rise abroad is quite likely and does raise the risk of instability somewhat. But given the lack of the risk factors previously mentioned, it is far more likely that such capital outflows will be part of an orderly adjustment process and will not lead to a situation of economic instability. The consequences of any leak of foreign capital, without any compensating increase in domestic saving, would probably raise interest rates and extinguish credit sensitive activities. It is very likely that a falling dollar and a shrinking U.S. trade deficit would be more disruptive to the more export dependent and exchange rate sensitive economies of Europe and Japan.

The United States suffered a very orderly correction from a large trade deficit in the 1985-1990 period. Anyways, the current task is likely to be more complicated and to bring with it a bigger risk of a disorderly adjustment for four principal reasons. The first one is that oil prices were falling sharply in the late 1980s, but nowadays oil prices are rising sharply, with some unpredictable bumps. This will add to the inflation impact of a falling exchange rate and hinder the Federal Reserve's ability to counter the interest rate outburst. The second reason is that in the 1986-1990 episode, other economies central banks, especially Japan's, were willing to buy a large volume of dollar assets, assuring a stabilizing counter force on the falling dollar and the rising yen. Since there already is a huge stock of dollar assets being owned abroad, this action seems quite unlikely today. The third reason is that in the 1986-1990 period, Europe, the strongest market for U.S. exports, was booming, while today economic growth in Europe is much slower. Lastly, the fourth reason is that the size of the imbalance is now twice as large. For the United States, the pain of such an adjustment would be attenuated by the large size of the overall U.S. capital market relative to the scale of the foreign capital flows. Over the last years, the total funds raised in U.S. credit markets have been around \$2,200 billion. For this reason, net borrowing from the rest of the world at

around \$600 billion to \$800 billion per year represents 25% to 30% of the nations' annual flow of credit. This is a magnitude of significance, but if withdrawn gradually it is not necessarily overwhelming for the United States.

CONCLUSION

This paper has analyzed the issues presented by Cooper in his article, focusing on the theory according to which the U.S. trade deficit should pose less concern than it daily does on the news and in politics' speeches. It has also emerged how the topic still presents unclear points, since the problem of the trade deficit seems to have multiple factors lying beneath it. The causes of the deficit and the possible policies that governments should put in practice are still a field for discussion. This is because, as has been explained, this phenomenon is not still fully comprehended: too many and drastically different approaches have been proposed throughout the years and the idea of a self-regulating mechanism ruling the economy is still eradicated in the U.S. scenario. We have also seen how literature, from these aspects, has tried to theorize it.

We have showed how the globalization of financial markets has helped in reducing the bias in allocating national savings of countries running trade surplus abroad, increasing drastically the amount of money borrowed from the U.S. to import from abroad. The demographical transition that many countries are going through has also played a fundamental role in understanding why so much capital is flowing toward the U.S. economy. As explained by Caballero, Farhi and Gourinchas in 2006 and Caballero and Antras in 2007 the main reason why this phenomenon occurs is that retirees prefer to invest in a secure and solid financial market rather than in the unregulated and partially developed one of the developing countries such as China and India.

Thanks to these factors, the sustainability of the trade deficit should not pose concern in the medium term: the investors will not be soon satiated with U.S. assets and as long as these investments are directed towards the U.S. companies and their development it seems to be both beneficial and economically enhancing. The attempts to reduce drastically and not gradually the trade deficit through a dollar depreciation risks to damage our economy, always more interrelated, modifying the equilibriums.

Overall, the argument suggested in this paper is that, in the mid-run, the U.S. trade deficit can continue and even expand for some years, since it represents intertemporal trade within a world with aging rich societies.

On the other hand, it is also important not to underestimate the problem of the trade deficit: it is clear the U.S. trade deficit will not be able to grow indefinitely throughout the years relatively to GDP nor the foreign-owned share of the U.S. financial assets can rise. In the long term all the theoretical and empiric evidences show that it will have to be reduced through commercial and fiscal policies, but it still remains unclear the best way to proceed.

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