The Balance-of-Payments Deficit: Not to Worry

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Quick. What's the trade deficit between California and the rest of the world? Don't try Googling it because you won't find an answer. No government agency —or private entity—computes the dollar value of goods that people in the rest of the world sell to or buy from Californians. Why not? Because it doesn't matter.

Yet governments do that computation for countries. Do trade deficits between countries matter? They do, but a lot less than most people think. A high trade deficit is not a definite sign of an economy's weakness, and a low trade deficit or high trade surplus is not a definite sign of an economy's strength.

First, let's define our terms. By the most comprehensive measure, there can never be a balance-of-payments deficit. If we import a higher dollar value of goods and services than we export, then the extra dollars we spend on imports balance that difference, and the net balance is zero.

Of course, when people refer to a balance-of-payments deficit they are not thinking about this comprehensive measure; they're thinking about a narrower measure—the merchandise trade deficit. This is the difference between the dollar value of what we spend on imports and what we are paid for exports. In 2008, the latest year for which these data are available, Americans spent $840 billion more on imports than foreigners spent on U.S. exports. Offsetting this was a U.S. surplus on services of $144 billion. The net balance of trade on goods and services, therefore, was $696 billion. To put this into perspective, this was about 4.8 percent of the total U.S. gross domestic product.

Where did this $696 billion go? It went to other countries, of course, but most of it came back in one of three forms: 1) foreign purchases of American bonds, mainly government bonds; 2) foreign purchases of other assets such as stocks, land, and property; and (3) so-called direct investment whereby foreigners build plants and equipment in the United States.

Is this bad? Consider each in turn.

1) If foreigners refused to buy government bonds, the U.S. government would need to offer higher interest rates to make holding the bonds attractive to Americans. That would drive up the cost of financing the U.S. budget deficit. We can decry this deficit—and I do—but given that it exists, which is better: having the irresponsible federal government paying a higher or lower interest rate? I vote for the latter.

2) One reason foreigners invest in U.S. stocks, land, and property is that the United States is still a relatively safe haven for investment. Granted, it's probably less safe than it was before the U.S. government changed the rules with its bailout, the so-called Troubled Asset Relief Program (TARP), and with the so-called stimulus package. But it's still safer than investing in much of the rest of the world. So rather than being bad, the size of this investment is actually good.

3) The same reasoning applies here. It's good, not bad, that foreigners find it attractive to invest directly in the United States. It's especially good for U.S. workers. The more capital there is per worker, the higher worker productivity is and, therefore, the higher are real wages.

Dollars on the Penny

What if the money doesn't come back in any of the above three forms of investment but, instead, is held in U.S. dollars? That's even better for Americans. Instead of giving up capital in return for merchandise, we are giving up paper money. According to the Bureau of Engraving and Printing, the average cost of a unit of paper money is 6.4 cents. Because of the production process, the cost is probably higher for a one-hundred-dollar bill, and presumably a disproportionately high number of such bills is held abroad. But it's still likely to cost under 25 cents to print a one-hundred-dollar bill, and the bills take an average of 89 months to wear out. Getting valuable goods in return for paper money that sells for dollars on the penny is a good deal for Americans. Jay Leno, in a 1980s ad for Doritos, said "Crunch all you want. We'll make more." Similarly, if people in other countries hold on to their paper U.S. bills, the Federal Reserve can make more.

But aren't we as a nation, by spending more on imports than our exporters earn, actually saving less and implicitly giving up capital for consumption goods? Yes, we are. But that's the result of decisions that millions of us make individually. And it really doesn't matter, at an individual level, whether we save less to buy imports or to buy domestically produced consumption goods. Either way, we're giving up capital for consumption. Is this a bad idea? We're showing by our actions that we think it's not. We're showing that many of us value those high-quality Toyotas more than we value the shares of General Motors stock or U.S. government bonds that we could have bought instead. Do you think you're giving up too much capital for consumer goods? Then spend less and save more.
I mentioned earlier that a small balance-of-payments deficit is not necessarily a sign of economic strength. Between 1980 and 2008, there have been only three years in which the United States has had a merchandise trade surplus: 1980, 1981, and 1991. Those were all years in which the U.S. economy was in recession. That is no coincidence. When economic growth is high, we tend to spend a higher share of our income on imports. The years with the highest merchandise trade deficits also tended to be the years with the highest economic growth.

What about the danger that foreigners will own a large share of the U.S. capital stock? First, it's not a danger. Even if it happened, it would simply mean that U.S. workers would work for foreign employers. While some of these foreign owners would be worse than U.S. employers, some would be better. Incidentally, during the 1988 U.S. presidential campaign, Democratic candidate Michael Dukakis told workers at a St. Louis automotive parts plant: "Maybe the Republican ticket wants our children to work for foreign owners . . . but that's not the kind of a future Lloyd Bentsen and I and Dick Gephardt and you want for America." The problem? The workers he was speaking to were employed by an Italian corporation.

Second, the amount of U.S. capital owned by foreigners at the end of 2008 was $23.4 trillion. But the amount of foreign capital owned by Americans was $19.9 trillion. This difference of $3.5 trillion is only about 7 percent of the $48 trillion total value of physical assets.
To look at the $3.5 trillion another way, it is less than $70 trillion. Why is that relevant? Boston University economist Laurence Kotlikoff says that's the amount

by which the present value of the U.S. government's future promises to spend exceeds the present value of the government's future projected tax revenues.

Now that's something to worry about.