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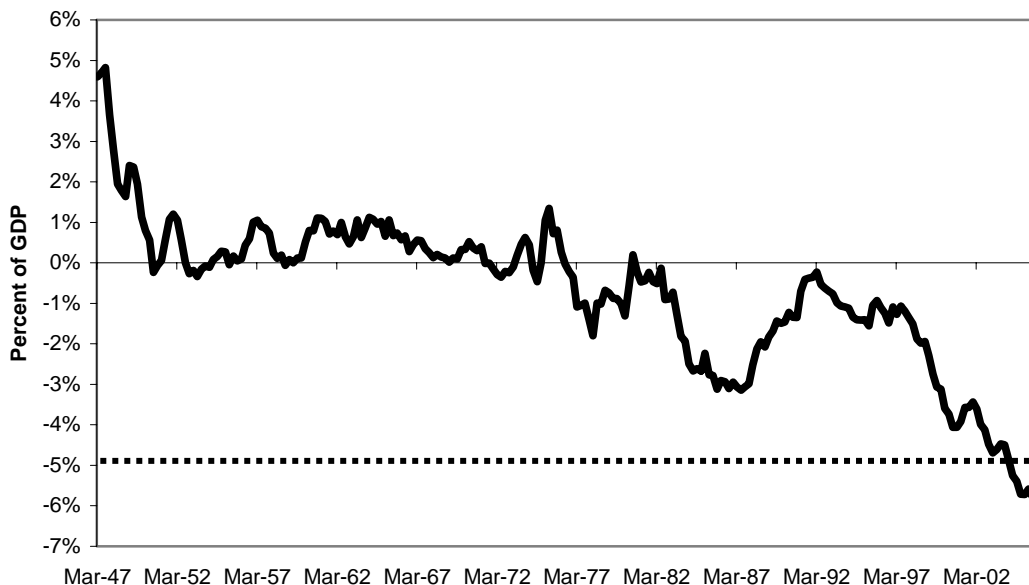
No Easy Solutions for Chronic U.S. Trade Deficit

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The most recent U.S. trade deficit figures released today underscore yet again the chronic nature of the nation's trade imbalances. After posting record trade deficits in 2005, the Census Bureau estimates released today indicate that the trade deficit amounted to \$62.0 billion in March 2006, bringing the total trade deficit for the first quarter of 2006 to \$196.2 billion, or a comparatively high 6% of gross domestic product (GDP) (figure 1). If the trade deficit continues at that rate for the rest of the year, the trade deficit could approach \$800 billion by the end of 2006.

Figure 1: Trade Balance Relative to Gross Domestic Product (GDP), 1947 to 2006



Calculations based on Bureau of Economic Analysis, 2006, National Income and Product Accounts, Washington, D.C. BEA; U.S. Census Bureau, FT900

Date

Several long term factors evident since March 2001 are responsible for the growing trade deficit:

- **Growing energy dependence:** A growing appetite for petroleum imports, which totaled \$20.0 billion in March 2006 and \$65.2 billion in the first quarter, up from \$26.6 billion in the first quarter of 2001, highlights the nation's growing dependence on foreign energy sources.

- **Weaker demand for U.S. high technology exports:** The Census Bureau reports a deficit of \$7.2 billion in the first quarter of 2006 compared to a surplus of \$4.6 billion in the first quarter of 2001.
- **Weaker demand for U.S. services:** Trade in services such as education and tourism have widened the U.S. trade deficit. A surplus of \$13.9 billion in the first quarter of 2006 compares to a surplus of \$18.1 billion in the first quarter of 2001.
- **Growth of foreign borrowing keeps dollar high and broadens deficit:** High budget deficits have forced the U.S. to borrow money overseas, which in turn has kept the dollar high. Although the dollar has fallen this year against most major currencies, its decline has been slower than otherwise would have been the case because of the budget deficit. A high value of the dollar makes U.S. exports more expensive abroad. In addition, managed exchange rates in some parts of the world, such as China, have also impeded export growth and contributed to the flood of imports.

These disparate trends illustrate the need for a multi-pronged approach to reduce the trade deficit. There is no silver bullet. Greater emphasis on energy independence, investment in innovation, attention to the declining services trade surplus, government fiscal discipline, and engagement with China on exchange rates are all key elements of this multi-pronged approach.

What's more, action is urgently needed since delay will only drive the U.S. economy faster into massive amounts of debt. The trade deficit has continuously widened throughout this current business cycle and has exceeded 5% of gross domestic product (GDP) since the middle of 2004 (figure 1). Most economists consider trade deficits that are above this threshold unsustainable in the long run.

Sector-Specific Trends

The rising tide of petroleum imports is a significant factor in the overall trade deficit. Whereas the overall trade deficit grew by 101.6% from the first quarter of 2001 to the first quarter of 2006, the trade deficit in petroleum products grew more quickly, by 144.7%, over the same period. In the first quarter of 2001, U.S. imports of petroleum products exceeded exports by \$26.6 billion, or 1.1% of GDP. Five years later, imports have grown to \$65.2 billion or 2% of GDP, including a deficit of \$20.0 billion in March 2006. Had that deficit remained at the same absolute level as March 2001, the total trade deficit would have been 19.6% smaller.¹ Had the petroleum deficit remained at the same share of GDP as in March 2001, the total trade deficit would have been smaller, but still a significant 15.6% (Table 1).

¹ There are several possible counterfactual scenarios. Two are considered here. First, the nominal trade balance in specific areas would have held constant, and second, the trade balance in specific trade areas relative to the gross domestic product would have held constant. The difference between the two scenarios can be summarized as follows. Holding a trade balance constant relative to GDP increases the impact on the trade deficit if the starting point is a trade surplus and reduces the impact on the trade deficit if the starting point is a trade deficit, compared to holding the trade balance constant in nominal terms.

Table 1
Contributors to the Trade Deficit

Trade deficit in/with	Reduction in trade deficit if...	
	Balance had remained the same as in March 2001	Balance had remained same share of GDP as in March 2001
Goods and Services:		
• Petroleum products	19.6%	15.6%
• Advanced technology products	6.0	6.7
• Services	2.2	4.9
Top Five Trading Partner Countries:		
• Canada	2.7	0.3
• Mexico	4.3	3.3
• China	14.9	12.2
• Japan	1.5	-1.3
• European Union	7.1	4.9

Notes: All figures are in percent. A positive sign indicates a reduction in the trade deficit, whereas a negative sign indicates an increase in the trade deficit. All figures are based total quarterly sums. Dollar figures are in nominal dollars. Percent are percent of gross domestic product (GDP). Categories of trade deficits can overlap. Authors' calculations based on U.S. Census Bureau, FT 900, U.S. International Trade in Goods and Services, Washington, D.C.: Census (various issues).

America's appetite for petroleum imports has clearly had a significant impact to date on the trade deficit, but other factors have played substantial roles, too. As previously noted, the U.S. has lost ground in high tech products, or what the Census Bureau refers to as "advanced technology products," including electronics, information technology, life sciences, and aerospace technology. The deficit of \$7.2 billion in the first quarter of this year is especially alarming when compared to a situation in which the U.S. had maintained its competitive position in high tech products as of March 2001. If that had been the case, then the trade balance would have been between 6% and 6.7% lower, as indicated in Table 1. The impact of the deterioration in high tech products would be even greater if it were measured from the peak trade surplus in this area in 1998. Then, quarterly surpluses totaled between \$8 billion and \$11 billion.

Similarly, the U.S. has been losing its competitive edge in trade in services, such as financial services, tourism, and education. Beyond the declining surplus in trade in services reported today, consider that between 2000 and 2004, the last year for which data are available, half of the decline in service trade was due to the decrease of tourism. Had the total service trade surplus remained constant, the trade deficit would have been between 2.2% and 4.9% smaller. A growing instead of declining service trade surplus would be even greater if the preceding decline in service trade were included. After all,

the U.S. service trade surplus started declining in 1999 from a quarterly high of \$21 billion.

Country-Specific Currency Trends

When the trade data are separated by country, it becomes clear that while China is the single largest contributor to the growth in the U.S. trade deficit, deficits with other countries also pose a significant problem. The rise in the trade deficit between the U.S. and China contributed between 12.2% and 14.9% to the growth in the total trade deficit. The remaining four of America's five largest trading partners — Canada, the European Union, Japan, and Mexico — also contributed substantially to the U.S. trade deficit. While China is often the scapegoat for our growing trade deficits, it is clear that the problems associated with the U.S. trade deficit are broader and more complex.

Indeed, even where exchange rates could move freely the deficit has widened. The trade deficit increases with Canada, the EU, and Japan contributed to about three-quarters of the impact of net Chinese imports in the growth in the U.S. trade deficit. One reason is the greenback did not fall enough in value or remained stable against the currencies of these major trading partners in recent years. And the surprising strength of the dollar rests mostly with the U.S. federal government, which needed to borrow large amounts overseas to finance its budget deficit. Between March 2001 and the end of 2005, the last year for which data are available, foreigners financed 83.4 percent of the budget deficit.

The most recent trade deficit figures should spark a multitude of policy responses. For instance, [greater energy conservation would reduce the need to import petroleum-related products](#). Greater emphasis on innovation could ultimately help to stabilize and improve America's position in high tech cross-border trade. And our nation's trade in services could improve if the U.S. once again attracted more tourists and students to the U.S. to visit and study. Finally, the U.S. needs a broad-based approach to reduce upward pressure on the U.S. dollar. Pressure on the dollar could be reduced if countries with [controlled exchange rates were to revalue their currencies](#), but the U.S. cannot rely solely on other countries' currency policies, over which it obviously has little control. Rather, the U.S. can and should focus on [reducing its own budget deficit](#), which would lessen the need to borrow funds overseas and thus weaken demand for dollars.