The US Trade Deficit Is Set to Shrink: That's a Good Thing…Right?

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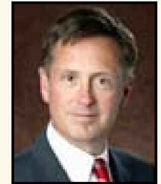

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Over the past 12 months, there has been no material improvement in the US trade deficit. It has remained stuck at a bloated level of roughly $700 billion per year. But don't be misled – the underlying fundamentals that drive the US trade deficit are in fact moving downward, and the US trade deficit is set to plunge in the months ahead. In light of citizens' concerns in recent years about the sustainability of the US trade deficit, we might expect them to cheer a sharp decline in the dollar value of the deficit as the US "does its part" to reduce global imbalances. But in fact, a sharp decline in the US deficit indicates trouble ahead for the global economy, because the US trade deficit is the rest of the world's trade surplus. During much of this decade, a rising US trade deficit has been a source of positive growth in demand for the global economy. However, if the deficit starts to shrink sharply in the months ahead (as I expect), this will represent a force of contraction in the growth of global demand. As this contraction is likely to occur during a period of US recession, financial crisis and collapsing demand for global commodities, a shift in global policy or an adjustment in global interest rates, commodity prices and stock prices may not be sufficient to generate demand growth outside the US to make up the difference. Indeed,

I think it is *not* likely to be sufficient, thus the title of this *Global Perspectives*. Global imbalances are shrinking. Oil at or below $100 per barrel and the CRB (Commodity Research Bureau) commodity index down 25% or more mean smaller imbalances (surpluses) for the oil and commodity exporters. Recession in the US and, at a minimum, sharp slowdowns in economic activity in Europe mean smaller imbalances (surpluses) in Japan, China and the rest of Asia.

Now, you might ask, isn't this a good thing? Well, given the concerns people have expressed in recent years about the sustainability of global imbalances, perhaps it would be good in the context of a prospering global economy operating at, or even above, full capacity. But that is not the global economy we are in today, as is clear from the accumulating macroeconomic data (well-summarised in the recent International Monetary Fund (IMF) *World Economic Outlook*[1]) and, importantly, from the policy actions and statements of the world's major central banks. Earlier this year, and following the Fed's lead, the Bank of England, the Bank of Canada and the Reserve Bank of Australia had all cut interest rates in the face of actual and expected slowdowns in domestic aggregate demand, due in no small part to the direct and indirect effects of the global financial crisis. For a time, the European Central Bank (ECB) remained on its own track, hiking rates in July on concerns about elevated headline inflation. However, at his press conference on October 2nd, ECB president Jean-Claude Trichet indicated that the balance of risks for Europe had shifted in light of the weakening economic data (in the second quarter, economic growth in the euro area was negative for the first time in the 10 years since the euro's adoption) and improving prospects for lower inflation following the collapse in oil prices. Indeed, most available indicators signal an outright contraction in economic activity for many euro zone member countries and perhaps again also for the Economic and Monetary Union as a whole.

On October 8th, the world's major central banks – including the ECB – announced a coordinated global rate cut of 50 basis points, citing concerns that prospects for global economic activity had deteriorated significantly. China (*yes*, China) joined in this action, cutting interest rates for the second time in three weeks and lowering reserve requirements, reflecting concerns that the Chinese export machine will stall sufficiently to reduce economic growth by 2 to 3 percentage points. China has also sharply slowed the pace at which it allows its currency, the renminbi (RMB), to appreciate. Indeed, the forward markets now price in the expectation of a depreciation of the RMB.

The sharp drop in oil prices helps diminish concerns about headline inflation – oil futures price oil at $72 per barrel for October 2009 delivery, not the $140 print we saw just three months ago in July for July 2009 delivery! As a result, measures of expected inflation from breakevens, the spread between yields on inflation-linked and nominal government bonds, have plummeted since June.

The challenges facing the global economy are clear. While global imbalances are declining, they do so in the context of a global financial crisis, a global investment bust in housing and a global profits squeeze that, along with a surge in risk aversion and a global credit crunch, have sent equity markets plunging. As I noted in the March 2007 *Global Perspectives*,[2] the global imbalances that widened during this decade were to some extent a *symptom* of and a *transmission mechanism* for the excesses in global capital markets, and not their proximate cause. As the bursting of the property bubble and the global financial crisis have led to a generalised sharp slowdown in global demand growth (re-coupling with a vengeance), this is reflected in shrinking imbalances. The real question is, will domestic demand around the world increase sufficiently to maintain global economic activity at its potential as global imbalances shrink? The

financial markets and policy makers are answering this question for us daily, and their answer is NO. And sadly, I think they are probably right.

Why the US Trade Deficit Will Shrink

In order to think about the US trade deficit, it is useful to combine arithmetic, accounting and economics. First, the arithmetic: the nominal non-oil deficit is at its lowest level in at least eight years – not as share of gross domestic product (GDP), but in absolute dollars. Arithmetically, *all* the increase in the trade deficit since 2000 has been "accounted for" by the hefty bill for imported oil. If oil prices stay at current levels, then according to the PIMCO forecast for US growth and global growth, the US trade deficit could shrink by $100 to $150 billion per year ($8 to $12 billion per month) by mid-2009 (see Chart 1). This is just the arithmetic that will dominate the flows in the short term (much as they drive headline consumer price index (CPI) calculations). Of course, if oil prices stay around present levels, then US exports to oil producers will slow, and global re-coupling will also, over time, slow exports to other countries. So, you might ask, won't re-coupling together with declining imports by commodity exporters and other countries keep the US deficit elevated? I don't think so, and economic forecasters increasingly agree. To explain why, I turn next to accounting, and then to economics (in order of importance!).

Sources: Bloomberg, PIMCO
Forecast and actual US trade deficit as a share of US GDP.
Forecast based on Bloomberg consensus, September 2008.

Chart 1

The trade deficit can be described in several ways, but as a matter of accounting, we can define it in terms of national savings less investment. National savings comprise

household, corporate and government savings, while investment is made up of business and residential investment:

Trade Imbalance = Savings – Investment

In other words, the trade imbalance equals whatever savings are left over after all the investment spending is done. If investment exceeds savings, then a nation runs a trade deficit and must make up the shortfall by attracting capital inflows from foreign investors. Thus, as a matter of accounting, in order to forecast a declining trade deficit, one needs to forecast *a decline in investment that exceeds any expected decline in saving.*

Now consider the economic perspective. Historically, during periods of recession and in the early quarters of recovery, investment declines more than saving, and I expect the current cycle to be no different. Residential investment has collapsed and is likely to contract for several more quarters. Commercial property investment, which until recently had held up quite well, has turned south and, as in past cycles, will likely be a continuing drag on economic activity. Business equipment investment is now falling as tighter lending standards, a forecast for weak US and global growth and the credit crunch force companies to pare back capital spending plans. Thus, it seems likely that investment will subtract from economic growth for some time to come.

What about saving? The US household savings rate is likely, on average, to be a positive number. Yet in recent years the household savings rate has been essentially zero. As I discussed in March 2007, the global savings glut, boosted by the recycling of petrodollars, contributed to the negative savings rate in the US, and the mechanism was the housing bubble. As household wealth collapses with falling share and house prices, economic analysis and empirical evidence predict that household savings will increase, and indeed this has already begun. The US will never match Japan's 15% household savings rate, but it is probably heading for

a 4% to 5% savings rate, which would be 4 or 5 percentage points more than households have been saving until recently.

Ultimately, a higher savings rate is a good thing. But as Keynes made clear 70 years ago, a collapse in investment can contribute to a *paradox of thrift*: individuals' desire to save more during an investment bust leads in the aggregate to a contraction in economic activity, which in the open economy is transmitted via a falling trade deficit in deficit countries and a falling surplus in surplus countries.[3] It is also true, as Keynes pointed out, that a sufficient *fiscal* policy response *can*, in theory, alleviate the paradox of thrift in the face of an investment bust and maintain the economy at full employment. But I judge that this is not likely to happen over the next year or so given the present circumstances. After all, a $300 billion rise in the budget deficit this year has not prevented the unemployment rate from rising from 4.4% to 6.1%, and I doubt that any fiscal package that can be enacted next year will fully do so either. The Troubled Assets Relief Program (TARP) legislation the US government just enacted may well make a substantial contribution to alleviating the financial crisis, but in and of itself it does not reduce national savings. It merely transfers the ownership of an existing stock of assets from financial institutions to the Treasury.[4]

Along with the declining global imbalances discussed above, a second transmission mechanism for propagating global recoupling is commodity prices. As prospects for global demand have worsened, oil and commodity prices have collapsed. Over time, and starting soon, these lower oil and commodity prices will *reduce* the excess of savings over investment – and thus the trade surpluses – in the oil and commodity exporting countries. In a sharply slowing or contracting global economy, this decline in commodity income – a worsening of the terms of trade in the commodity exporters – is likely to be substantial, and is likely to swamp any decline in investment that may occur in these countries, resulting in smaller trade surpluses in the commodity exporters.

Bottom Line

In sum, the US trade deficit is set to shrink in tandem with shrinking trade surpluses in the commodity exporters and the other countries who export to them. Were this to occur in the context of a stable and prosperous global economy, this would of course be a desirable outcome (reflecting more savings in the US and less residential investment in the US than we saw during the housing bubble). But that is not the world we are in today. Declining global imbalances will be one propagation mechanism, along with the financial crisis, through which global re-coupling – a synchronised global downturn – occurs, and with a vengeance. As the IMF *World Economic Outlook* warns, it will not be pretty. But hey, global imbalances *are* shrinking. That's a good thing…right?

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[1] *International Monetary Fund,* World Economic Outlook *(October 2008).*

[2] *Richard Clarida,* Global Perspectives: *"Petrodollars, the Savings Bust and the U.S. Current Account Deficit" (March 2007), http://australia.pimco.com/LeftNav/Global+Markets/Global+Perspectives/2007/Global+Perspectives+March+2007.htm.*

[3] *John Maynard Keynes,* The General Theory of Employment, Interest and Money *(1936). For additional comments on the paradox of thrift and trade imbalances, see Paul McCulley's* Global Central Bank Focus: *"The Paradox of Deleveraging" (July 2008), http://australia.pimco.com/LeftNav/Featured+Market+Commentary/FF/2008/Global+Central+Bank+Focus+July+2008+The+Paradox+of+Deleveraging.htm and Chris Dialynas and Saumil Parikh's Spotlight (April 2006).*

[4] *Business savings in the form of corporate profits are likely to decline in coming months as well. However, I expect in this cycle as in previous cycles that business investment will decline by more than business savings, and companies will cut back their capital spending plans in a weak global economy with tight credit.*

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