ECONOMIC ANALYSIS

The trade deficit: Don’t fear the beast

Amanda Augustine / Kan Chen / Shushanik Papanyan

Public perception towards the trade deficit has shifted from being fact-based to sentiment-based. Economic pattern of the deficit strongly correlates with the structural shift in the U.S. economy. U.S. has a higher per capita deficit with Ireland and Germany than it does with China or Mexico. Trade, like technology, shifts demand between occupations and reallocates productive human capital.

Trade openness, coupled with digitization, enhances low-cost access to global markets for SMEs.

As of writing, the U.S. has free trade agreements in force with 20 countries, primarily with Middle Eastern and Central and South American nations. These agreements are designed to facilitate trade and investment and to achieve foreign policy goals. Opponents of free trade, however, point to the widening trade deficit as evidence of mistaken and unfair U.S. foreign trade policies. In 2016, the U.S. trade deficit widened to $500.6 billion – its highest level since 2012. Both exports and imports declined compared to 2015 levels, but exports fell 2.2%, whereas imports declined 1.8%. The rising trade deficit was driven by the goods sector, which ran a deficit of $749.9 billion in 2016, while the services sector actually had a surplus of $249.9 billion last year.

The trade deficit has been labeled as the culprit behind economic ailments such as unemployment and weak economic growth. This public perception of the deficit, fueled by misconceptions related to trade with China and trade’s impact on manufacturing jobs, is unwarranted. In the modern world of technology and digitization, the knowledge-intensive portion of trade flows has become increasingly dominant. Thus, the U.S. has an advantage as its knowledge-intensive flows have been on the rise, and its trade surplus of services enabled by information and communication technologies has been accelerating.

Figure 1

U.S. Trade Balance as a % of GDP

Source: BBVA Research & BEA

Figure 2

U.S. Trade Balance as a % of GDP

Source: BBVA Research & Census
Why does the deficit give trade a bad name?

Foreign trade stood out as a major theme of the most recent presidential election. A Pew Research Center survey published before election night found that voters’ opinions on free trade were nearly evenly split, with 48% of registered voters saying that free trade agreements had been a bad thing for the U.S., versus 41% saying they had been a good thing, with voters largely split along party lines. However, a Gallup poll conducted last month demonstrates that perceptions have changed since the election; a record-high 72% of Americans see foreign trade as an economic opportunity, up from just 58% last year, while only 23% view it as a threat. Moreover, a higher share of respondents across all party groups saw trade as an opportunity (80% of Democrats, 66% of Republicans). The positive perception among liberal voters may be a signal of resentment against Trump’s anti-trade rhetoric. On the other hand, conservative voters may be responding to Trump’s promise to replace or renegotiate existing trade deals, such as the Trans-Pacific Partnership (TPP) and NAFTA.

The news coverage on trade deficits has significantly increased since 2015, despite the relatively stable trade-to-GDP ratio. Figure 3 demonstrates the share of sentences that mention “trade deficits” by each national news channel. We can see that even in 2012, another election year, news channels rarely talked about the imbalance of trade.

Figure 3

<table>
<thead>
<tr>
<th>Sentences Mentioning “Trade Deficits,” %</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.6%</td>
</tr>
<tr>
<td>0.5%</td>
</tr>
<tr>
<td>0.4%</td>
</tr>
<tr>
<td>0.3%</td>
</tr>
<tr>
<td>0.2%</td>
</tr>
<tr>
<td>0.1%</td>
</tr>
<tr>
<td>0.0%</td>
</tr>
</tbody>
</table>

Source: BBVA Research & Internet Archive TV News Archive

The topic of trade deficits became increasingly politicized after Donald Trump launched his presidential election campaign in June 2015. For example, Figures 4 and 5 show word clouds that are relevant to the term “trade deficits” before and after June 2015. We can see that the way the media discusses trade deficits has dramatically changed. Prior to the most recent election cycle, the words describing trade were more fact-oriented using economic terminology, whereas afterwards, these words took the form of sentiments towards the increasing deficit, with more populist terminology.
Why is there a trade deficit?

The recent unfavorable spotlight on the U.S. trade deficit does not align with the economic trends in the trade deficit itself. While negative, the U.S. trade deficit in both dollar amounts and as a share of GDP contracted during the Great Recession and has normalized at a more favorable level for the U.S. since then. The timeline and economic pattern of the trade deficit strongly correlate with the structural shift in the U.S. economy from the manufacturing to the services sector, coupled with the infiltration of technology, the rise of information and communications technologies (ICT) and digitization.

Source: BBVA Research & BEA

Source: BBVA Research & BEA
The last positive trade balance for the U.S. occurred in 1975, and while the balance has been negative since then, it was not until 1997 that the trade deficit dipped deeper into negative territory. The trade deficit reached its highest level in 2006 at $771 billion and 5.6% of GDP. However, since 2013, it has stabilized around $500 billion and 2.9% of GDP.

The structural break test confirms the timeline of structural changes in the trade deficit, but also reveals that the periods for structural changes in the trade deficit closely coincide with structural changes in both imports and the trade balance of goods. Despite the misperception from the accounting perspective that increasing deficits lead to lower growth, both the rapid growth in imports as a share of GDP and the trade deficit during the 1992-2006 time period were backed by a high U.S. growth rate, which averaged 3.7% excluding the recession.

<table>
<thead>
<tr>
<th>Trade Deficit</th>
<th>Structural Break Periods and Change in the Share During that Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stable</td>
<td>1990 - 1991, Stable</td>
</tr>
<tr>
<td>Goods Trade Balance</td>
<td>Raised by 0.8%, 1990 - 2006, Raised by 4.8%, 2007 - 2016, Reduced by 1.3%, 2013 - 2016, Stable</td>
</tr>
<tr>
<td>Services Trade Balance</td>
<td>Raised by 1.6%, 1990 - 2016</td>
</tr>
<tr>
<td>Exports</td>
<td>Raised by 7%, 1990 - 2016</td>
</tr>
<tr>
<td>Imports</td>
<td>Raised by 12%, 1990 - 2006</td>
</tr>
</tbody>
</table>

Source: BBVA Research

Another contributing factor to the growth in the trade deficit was the imports of crude oil and other petroleum goods. The most recent structural break in the trend of imports has been towards flatter import growth since 2007 and is due to the rise in digital flows and data flows. This break corresponds to the period when the U.S., as well as its top trading partners, experienced a slowdown in trade.

By contrast, U.S. exports and the trade balance in services do not exhibit any structural breaks. Moreover, the trade balance in services has been positive with an upward trend since 1986. The growth in ICT services and ICT-enabled services is the backbone of the upward trend in the services trade balance.
Is China “killing us”?

The top five countries with which U.S. had a trade deficit in 2016 were China, Japan, Germany, Mexico and Ireland — in that order. Currency manipulation is one of the most common issues brought up by Trump during his presidential campaign. It is true that China used to be criticized for its large-scale intervention of the exchange rate of renminbi that resulted in an unfair competitive advantage. Yet the accusation of currency devaluation seems out-of-date today, as the renminbi has appreciated 20% since China’s exchange rate reform in 2006. In fact, China sold more than $570 billion of foreign currency last year in order to keep the yuan from depreciating further amid its current economic slowdown. The weakened Chinese economy has resulted in its own set of problems for the U.S. due to declining demand for U.S. goods, such as oil, steel and food and less investment in real estate.

To gain a different perspective on the U.S. trade deficit with China, it is also a useful exercise to look at the figures on a per capita basis. When looking at the U.S. trade balance with each country divided by that country’s population, we see that the U.S. has a higher per capita trade deficit with Ireland and Germany than it does with China or Mexico. These European countries’ relatively small workforces produce high-value goods for export to the U.S., whereas, China and Mexico’s larger workforces produce greater quantities of low-value goods destined for the U.S. For example, Germany exports more chemicals and transportation equipment to the U.S., while China’s largest exports to the U.S. include computer and electronic components and apparel and accessories. Considering the trade deficit per capita with these countries during the post-crisis period, the deficits with Germany and Ireland have deepened more than that with China and Mexico.

Moreover, the U.S. trade deficit with China can be seen as a large inflow of foreign capital that strengthens the American economy. As we discuss above, the balance of payments implies that a country with a trade surplus, such as China, must manage increasing foreign reserves by using them in the form of net foreign investment. These capital inflows are used to purchase U.S. Treasury securities, real estate or bank deposits and to invest directly in American factories and businesses.

Protectionist policies against Chinese imports, such as imposing an import tariff, might decrease the bilateral trade deficit, but would just shift part of that deficit to other countries; therefore, they would do very little to shrink the overall U.S. trade deficit. American consumers would likely suffer the most from these policies as prices for popular goods would rise.
Does trade lead to job losses in the manufacturing sector?

The share of Americans employed in manufacturing dropped from over 30% right after World War II to around 10% percent in 2012. Determining how many jobs have been lost due to trade alone is challenging because of the difficulty of isolating the effects of trade from other factors. But most studies agree that trade has played some role in this job loss. Acemoglu et al. (2016) found that import growth from China between 1999 and 2011 led to an employment reduction of 2.4 million workers in the U.S. However, a recent study (Hicks et al., 2015) also found that, rather than trade, increasing automation is primarily responsible for driving the declining share of employment in manufacturing. Technological change was estimated to be responsible for the vast majority — over 85% — of lost factory jobs from 2000 and 2010, largely due to productivity gains. In the post-crisis period alone, manufacturing output has risen by over 30%, despite the drop in manufacturing employment.

In the short-run, trade, like technology, shifts demand between different occupations and reallocates productive human capital. Domestic workers employed in industries subject to competition from imports — typically low-skilled occupations or manufacturing-related — may experience the brunt of the impact due to the cost of adjustment and may enter transitional unemployment. As these displaced workers search for new job opportunities, the economy temporarily falls short of full employment. In the long-run however, the economy should move towards full employment as the displaced workers find jobs in expanding export-oriented industries. Regardless of the cause behind job loss — whether it be trade or automation — funding towards creating more comprehensive worker retraining programs is necessary in order to properly train the unemployed for high-demand skills and jobs.

Table 2

<table>
<thead>
<tr>
<th>2016 U.S. Top Trading Partners by Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong> ($, billions)</td>
</tr>
<tr>
<td>China</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>Mexico</td>
</tr>
<tr>
<td>Ireland</td>
</tr>
</tbody>
</table>

Source: BBVA Research, Census & IMF

Figure 12

| U.S. Trade Deficit per Capita, Selected Countries, $ |

Source: BBVA Research, Census & IMF
Is the trade deficit a cause for worry?

The public perception and media coverage indicate that the trade deficit is perceived in a largely negative light. However, an analysis of the actual impact of trade indicates that this reputation is undeserved and that the economic effects of trade aren’t so straightforward. As discussed earlier, trade has a flip side in that a country with a trade deficit receives inflows of capital in the form of net foreign investment. In a country like the U.S. with a reputation for a solid and vibrant economy, that capital inflow is quite large as foreign investors actively seek to move their assets into the country. The U.S. net international investment position has dropped from -$1.7 trillion to -$7.8 trillion in just the last decade, indicating that the value of foreign investments in the U.S. is well above the value of U.S. investments overseas.

The protectionist and “fair trade” policy arguments in the U.S. and other economies are losing credibility due to the rapidly changing structure of trade. While in the past, global trade was dominated by capital- and labor-intensive flows, in the new world of technology and digitization, the knowledge-intensive portion of trade flows has become increasingly dominant. This holds true especially in the case of U.S. trade flows. Additionally, the U.S. and other economies have witnessed a rise in the creation and cross-border flows of purely digital goods and services. These digital goods and services are either a transformation of previously existing labor-/capital-intensive goods and services or new products. Furthermore, ICT and digitization have challenged traditional business models by their ease of entrance into international markets, modification and ease of new payment systems and rise of microscale activities and microshipments. Thus, ICT and digitization have further fragmented trade flows, accelerating flows of intermediate goods rather than those of completed products. The fragmentation of trade flows, coupled with the creation and enhancement of e-commerce platforms, has empowered smaller market participants and made them viable global competitors.

The U.S., together with other high income economies, has an advantage in the age of new technology. Knowledge-intensive flows have been on the rise, and the trade surplus of services, backed by ICT, has been growing in the U.S. since 1985. In the U.S., the relative ease of access to venture capital and the low cost to start a business form opportunities of further growth in exports of knowledge and specifically technology-
driven services and goods. At the same time, open flows of digital goods and services carry risks of data security and intellectual property protection. These risks should be monitored and regulated by the government.

Figure 15

Imports and Exports by Category as a Share of Total
%

<table>
<thead>
<tr>
<th>Imports</th>
<th>Exports</th>
<th>Net Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor Intensive</td>
<td>Capital Intensive</td>
<td>Knowledge Intensive</td>
</tr>
</tbody>
</table>

Source: BBVA Research & Census

Bottom line

Due to the deepening infiltration of ICT and digitization into the wholeness of economic activity, political arguments for protectionism and for “fair trade” have been rendered old-fashioned. Implementation of such policies would hurt the comparative advantage of the U.S. as they primarily focus on employment growth, and therefore undermine domestic economic trends as well as structural differences between the economies. The effect of digitization on international trade is comprehensive and creates an array of opportunities for small and medium sized businesses and startups by increasing the ease of access to global markets. Overall, ICT and digitization have broadened and deepened the network of trade flows as these trends continue to 1) change tangible flows into intangible, digital flows that have lower costs of access and transport; 2) enhance manageability of physical flows by digital tracking; and 3) intensify the relationship between trade and global income via the global use of online platforms for e-commerce.
References


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