Trade Deficits As Far As the Eye Can See

The trade deficit peaked at 6% of GDP in 2006. It fell during the recent recession – to about 3% of GDP. While this decline has quieted those who support protectionism, and allowed the Obama Administration to declare that there are no countries manipulating currency values, protectionism is never far from the political front burner.

As the trade deficit increases again in the next few years, and as manufacturing jobs disappear because of productivity increases, protectionism will once again become an issue.

But, this fear about the deficit ignores a major reason for it. Ultimately, the US trade deficit is a by-product of an attractive investment climate. Foreigners, with assets to invest, often need to worry about the risks of exposing those assets to a local banking system that makes ours look like a pillar of strength. Just look at Thailand’s populist upheaval, or the pressure for Greece to abandon the euro and devalue. No wonder central banks and other investors view US investments as preferable, even if investment returns (in dollars) are paltry.

Meanwhile, emerging markets have been growing very quickly in the global recovery. When countries grow, they need to issue more currency or suffer deflation, because they would not have enough money chasing the expanding amount of goods and services. So, for emerging markets, economic growth means having their central banks issue more currency and then buy more US Treasury debt.

Despite this, there are those who will claim the US trade deficit is unsustainable because it requires us to sell more and more assets to foreigners, going deeper and deeper into “net debtor” status. What these analysts are missing is that despite owing foreigners a great deal more than they owe us – that’s why we’re called a “debtor” country – US investors consistently earn more on their foreign assets than foreigners earn on their US assets.

This is complicated so here’s a simple example. Let’s say George owes Ivan $100 and at the same time Ivan owes George $50. Obviously George is the net debtor, by $50. But let’s also say George has to pay an interest rate of 3% on his debt to Ivan, while Ivan pays an interest rate of 8% on his debt to George. Then, despite being the net debtor, every year George gives Ivan $3 while Ivan pays George $4. Who would you rather be? George, obviously!

In the real world, the US is George. Although our investments abroad are smaller than foreigner investments here, US investments have earned $145 billion more than foreign investments in the past year. Free markets, property rights and enforceable contracts remain the true attractors of capital. As a result, capital will continue to flow to the US because it is viewed as a refuge from risk, even when returns appear low. Remember, there are always two sides to a coin. And looking at the other side gives a significantly different view.

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.