HOW DOES THE U.S. TRADE DEFICIT AFFECT U.S. BUSINESSES AND CONSUMERS?

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Introduction

The purpose of the essay is to analyze how the U.S. trade deficit affects U.S. businesses and consumers. To do so, we will define the concepts of U.S. “trade deficit”, “Business”, and “Consumers”. Then we will examine the relationships that could prevail between those three concepts and elaborate on the impacts that U.S. trade deficit have over the U.S. businesses and U.S. consumers. The development of the essay will be supported by some graphs and notes for helping on catching up clearly the fundamentals of the essay.

Body

This first portion of the essay entails the US concepts that we will analyze (U.S. trade deficit; U.S. businesses; and, U.S. consumers) and then shows their interrelationships.

Trade deficit

The first question we have to answer is: what do we mean by “trade deficit”? Where does it come from? Every country in the world records its international exchanges through an accounting process named “Balance of payments”. The Balance of payments (annexes-1A and -1B) is a yearly summary of all the economic transactions between residents of one country and residents of the rest of the world (Cowen & Tabarrok, 2012) and shows four parts: current account; capital account; balance of current and capital account; and, statistical discrepancy. The trade deficit is an economic measure of a negative balance of trade in which a country's imports exceeds its exports. (Investopedia US, A division of IAC, 2014). If the total value of exports of goods and services is lower than the total value of imports of goods and services, then, the result is a trade deficit. The trade deficit is an excess of a nation's imports of goods (tangibles) over its export of goods during a financial year, resulting in a negative balance of trade (WebFinance, Inc., 2014).

In the United States, the trade deficit is measured and defined by the Bureau of Economic Analysis. It defines U.S. imports as goods and services produced in a foreign country and bought by U.S. consumers (About.com (a), 2014). It refers to all goods that are shipped into the U.S., even if they are produced by an American-owned company. In the first quarter of 2014, the US trade deficit was $87.3 billions (annexe-2)

US Businesses

In reference to the flux of revenues and expenses (see annexe-3), we know that the U.S. business sector represents the production of U.S. goods and services that is made by workers who sell their workforce in return of wages and other benefits. The U.S. production businesses are sold both domestically and internationally.

When U.S. businesses sell products or services overseas, they make exportations. For example, if Microsoft Company sells a package of Windows 10 to an Italian purchaser, it makes an exportation that will be recorded into the current account of the U.S. balance of payments. Notice that the Italian purchaser, which makes an importation, will see it recorded onto the current account of the Italy Balance of payments. As it leaves one country as an export, it will enter another country as an import.

US Consumers

U.S. consumers are represented by the U.S. population and all other U.S. economic entities (businesses; Federal, state, municipal governments; public and private other U.S. economic entities). Consumers are economic entities that purchase goods and services from domestic and/or international providers. For example, John buy shoes from local store and orders a watch through the internet from a Chinese merchant; or, the US Defense ministry orders 100 new tanks from local producers and two submarines from a Canadian supplier; in both cases, the former purchase is a local spending and the latter is an import of goods.

Causes and effects of a trade deficit

Here we look at the causes and effects of U.S. trade deficit over U.S. businesses and consumers.

Causes

U.S. trade deficit exists because U.S. imports are greater than U.S. export, and is represented by a negative total value into the current account of U.S. Balance of Payments. That means U.S. import more foreign goods and services than they sell abroad U.S. goods and services. Why so?

One reason could be that foreign goods and services are cheaper and U.S. consumers can get more of them for their money rather than buying U.S. products and services. Or the United States is unable to produce all what it needs as, for sample, more than 80% of U.S. 2013 imports are goods ($2.268 trillion) and slightly less than a third of this is industrial machinery and equipment (About.com (b), 2014).

A trade deficit can also result if a domestic company manufactures a lot of its products in other countries. If the raw materials are shipped overseas to a plant, then it's counted as an export. When the finished good is shipped back home, it's counted as an import, even though it's made by a domestic company.

An expansionary (contractionary) monetary or fiscal policy increases (decreases) income, increases (decreases) imports and makes a trade deficit larger (smaller) (Colander, 2008).

Trade deficit effects

What are the effects of the U.S. trade deficit? The U.S. trade deficit, as any other trade deficit of any other country, will affect, obviously, the general economy of a country and particularly, some specific aspects such as, for few, Real GDP (Gross domestic product), rate of unemployment, rate of change, rate of inflation, standard of living, dependency on foreign countries, and national security.

Real GDP, rate of unemployment
Rate of inflation

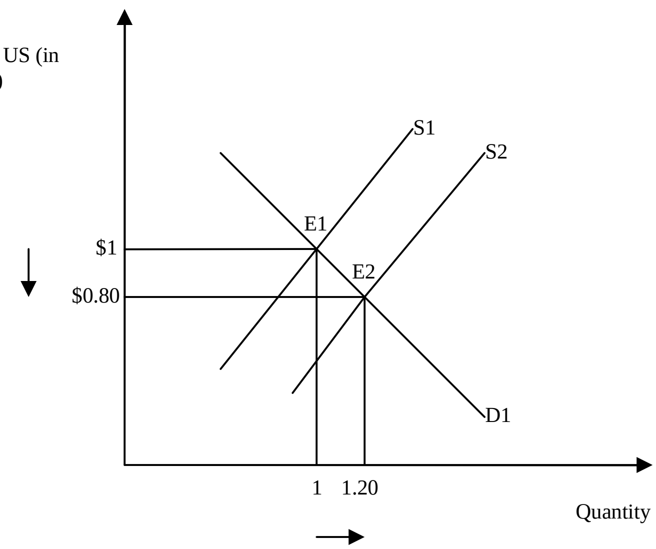
The Real GDP (Gross domestic product) represents the U.S. domestic production minus the impact of inflation. The real GDP is represented by an economic mathematical equation, Y=C+I+G+(X-M), where: Y=real GDP; C=Consumers expenses; I= Producers expenses; G=Governmental expenses; X=Exportations; M=Importations; and, X-M= net exportations.

Using that equation, if we keep C, I, and G constant, and if exportations (X) are greater than importations (M), which means we get a trade surplus, then Y will rise. On the contrary, if exportations (X) are lower than importations (M), which means we have a trade deficit, then Y will decrease. Thus a trade deficit is characterized by a decreasing real domestic production and rising rate of unemployment, which seems realistic, since the global U.S. consumption of goods and services are directed on buying foreign products and services more than U.S. products and services. The rate of inflation can rise, stays same or decrease depending of the scopes of variation of aggregate demand and aggregate supply (annexe-4).

Rate of change

The U.S. trade deficit means that U.S. consumers will buy foreign goods and services. To pay for foreign goods and services, the US consumers need foreign currencies. US consumers inject US currency into the exchange market and that raises the supply of US currency against the other currencies. If we maintain stable the other currencies, the rise of US currency supply implies the US currency will depreciate against other currencies. The graph-2 below shows a sample of US currency against CAN dollars. The depreciation of the US currency against the CAN dollar is a short-term effect of the US trade deficit. Since markets are dynamic, adjustments will continuously operate in the exchange markets (note-1).

Rate of change of US dollars against CAN dollar



At E1, we get $1US against $1CAN. US consumers rise their Canadian importations which mean US consumers increase the supply of US currency (from S1 to S2) and then US dollar depreciates (from $1US to $1.20US against $1 CAN).

Legend :
S1—S2 : Supply of US currency
D1: Demand of US currency

Source of template: Parkin Michael. Economics. Chapter 26. Pages 607-615.

Standard of living

A trade deficit gives the opportunity to the US consumers to benefit from a larger variety of goods and services at lower prices. It also raises the standard of living of US consumers in the short term. But, as time passes, domestic jobs are lost and outsourced to other countries and, although some US individuals can gain from trade deficit, the US standard of living can drop significantly.

> "Initially, a trade deficit is not a bad thing. It raises the standard of living of a country's residents, since they now have access to a wider variety of goods and services for a more competitive price. It can reduce the threat of inflation, since the products are priced lower. Over time, however, a trade deficit can cause jobs outsourcing (About.com (a), 2014)."

Dependency

A country that maintains a structural trade deficit against another country shows a significant dependency against that country for particular imported goods and services. Depending on types of imported goods and services, the trade-deficit-dependency-effect could be translated in terms of causes and effects of political and economic relationships between the two countries involved. Americans' appetite for imports and dislike for savings has created a "global co-dependency." As a result, the U.S. trade deficit has become an international puzzle because foreign producers depend heavily on U.S. markets and U.S. growth depends heavily on foreign capital (Bloomberg, L.P., 2014).

National Security

Generally a country tries to avoid of needing foreign goods and services related to its national security, but sometimes it's unavoidable. The trade deficit created by importations of goods and services for national security purposes creates risky international exchanges and increases national insecurity. The heavy reliance on imports and the erosion of manufacturing capacity could expose the U.S. to global economic disruptions. These economic security concerns are amplified by role of China, which now accounts for around 30 percent of the trade deficit. Developments give China both real and financial leverage over the U.S. economy. Given the uncertainty surrounding the U.S.–China relationship, this leverage is a major national security risk (NSF review, 2006).

Economic vulnerability

Trade deficit is the result of importations greater than exportations. To pay for the importations, U.S. businesses and consumers inject US dollars into the exchange currency market. They change their US dollars into other currencies and pay for the importations using the currency of the country from which they make importations. The country that exports has in hand, an excess of US dollars (importations greater than exportations) that it keeps in reserves. But those reserves have to be used and not left idle. The country will use the reserves currency to pay for its own imports and/or make investments.

As U.S. business and consumers rise their importations, they create a situation where more and more of U.S. production of similar products are switching into the hands of the exporters. We also have all other importations that United States will not produce because they are cheaper to be produce from the exporters. The exporters return the excess of U.S. currency in terms of cash inflows (foreign direct investment) into the U.S. economy by buying several assets, such as enterprises, real estate, securities, and so on. Consequently they become makers of decision of significant portion of varying U.S. industries. At long term, the U.S. economy goes into the hands of foreign makers of decision for a significant part, and that raises the vulnerability of U.S. economy because the foreigners will first take care of their own national economic interests before the U.S. economic interests. This has resulted in many of our core industries now being controlled and managed for the benefit of foreign companies and countries (Economy in crisis, 2014).

Conclusion

A trade deficit is represented by a negative value of the current account which is part of Balance of payments of a country. The U.S. trade deficit, which represents a value of imports of goods and services greater than exports, appears to be favorable at short-term to the country such as benefiting of lower prices from foreign goods and services, increasing profits margin of U.S. businesses, decreasing rate of inflation and rising standard of living. But it shows at longer term some threats such as a decrease of real GDP, rise of unemployment, rise of inflation for local economy, enforcement of dependency from foreign products and services, a risk for the national security, and an increased vulnerability of U.S. economy from foreigners (Note-2).

The components of US trade deficit should be investigated more deeply in a more exhaustive analysis so as to determine the balance of benefits and threats issues from. At this point, we cannot say if the US trade deficit is a good or a bad thing. The essay presented has been oriented to discussing mainly the effects of the US trade deficit over US businesses and consumers. It has certainly not covered all the elements of the subject, but pertinent highlights have been identified.

Note-1

US trade deficit and short-term effect over rate of change

The US trade deficit means that US importations are greater than US exportations. To pay for the US importations, US consumers offer a rising US currency supply on the market of currencies. The rise of US currency supply makes the US currency to depreciate (US currency lost value against another currency). In our graph the depreciation of US currency goes from $1CAN to $1US (E1) to $1CAN to $1.20 US (E2).

US trade deficit and medium and long-term over rate of change

As the US currency depreciates, the price of imported goods and services become more expensive and that slows down the level of importations which consequently makes reducing the supply of US currency on the currency exchange market. The US currency tends to appreciate against other currencies. Take notice that appreciation of US currency does not mean it gets back to the initial position E1 in the market of change.

The dynamic game of appreciation and depreciation of one currency against other currencies run and run, day after day, depending on the influence of many variables that would require an exhaustive analysis which is not the purpose of this essay.

Note-2

A study (econometric statistical model) conducted by Mohsin Abbas from Superior University, Lahore, Pakistan, and Hassan Raza from University of Lahore, Lahore, Pakistan, presented, in March 2013, the results of the effects of trade deficit on the economy of Pakistan, in which trade deficit where the independent variable and gross domestic product, foreign direct investment, and exchange rate were the dependent variables.

Some of the results, related to the purpose of this essay are presented here:

H0: There is no association between trade deficit and growth rate.

H1: There is a significant association between trade deficit and growth rate.

Null hypothesis is rejected, so we conclude that there is relationship between the above two variable.

H0: There is no correlation between trade deficit and foreign direct investment.

H1: There is a significant correlation between trade deficit and foreign direct investment.

Null hypothesis is rejected, so we conclude that there is relationship between the above two variable.

(Note-2 / next)

H0: There is no association between trade deficit and exchange rate.

H1: There is a significant association between trade deficit and exchange rate.

Null hypothesis is rejected, so we conclude that there is relationship between the above two variable.

(Institute of Interdisciplinary Business Research, 2013)

The results are clear that there is certainly a significant impact of trade deficit over growth rate (which can be linked to real GDP), foreign direct investment, and exchange rate. Other interesting results can be consulted if you read the entire paper.

ANNEXE-1A

Let us take a look at a picture of Balance of payments. As you can see there are four components: Current account; capital account; balance of current and capital account; and, overall balance, which is always equals to “0”.

BALANCE OF PAYMENTS (TEMPLATE)

CURRENT ACCOUNT					
		Merchandise exported	88.7		
		Merchandise imported	95.4		
	Balance on merchandise trade			-6.7	
		Services exported	49.1		
		Services imported	24.8		
	Balance on services			+24.3	
	Balance on goods and services				-17.6
	Unilateral transfers		5		
Balance on CURRENT ACCOUNT					-12.6
CAPITAL ACCOUNT					
		Domestic government investment	-3.2		
		Domestic private investment	-4.3		
	Domestic investment in foreign assets			-7.5	
		Foreign government investment	8.7		
		Foreign private investment	10.2		
	Foreign investment in domestic assets			+18.9	
Balance on CAPITAL ACCOUNT					+11.4
Balance on CURRENT And CAPITAL ACCOUNT					-1.2
	Statistical discrepancy			+1.2	
OVERALL BALANCE					0.0

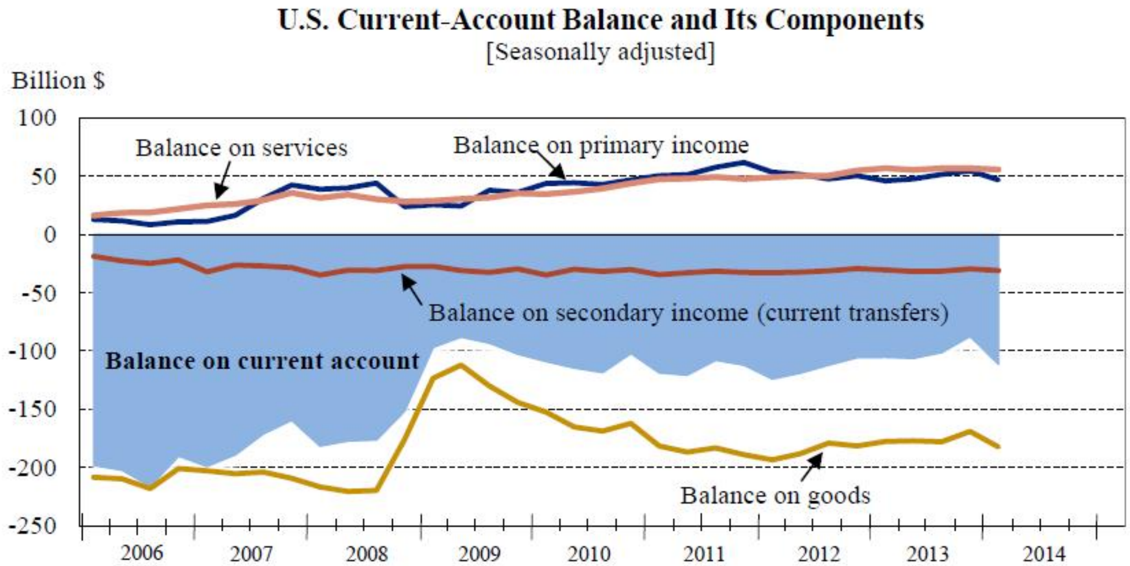
Annexe-1B

Balance of Payments:

> Set of accounts that record a country's international transactions, and which (because double entry bookkeeping is used) always balance out with no surplus or deficit shown on the overall basis. A surplus or deficit, however, can be shown in any of its three component accounts: (1) Current account, covers export and import of goods and services, (2) Capital account, covers investment inflows and outflows, and (3) Gold account, covers gold inflows and outflows. BOP accounting serves to highlight a country's competitive strengths and weaknesses, and helps in achieving balanced economic-growth (WebFinance, Inc., 2014).

Annexe-2

The U.S. current-account deficit—a net measure of transactions between the United States and the rest of the world in goods, services, primary income (investment income and compensation), and secondary income (current transfers)—increased to $111.2 billion (preliminary) in the first quarter of 2014 from $87.3 billion (revised) in the fourth quarter of 2013. As a percent of current-dollar GDP, the deficit increased to 2.6 percent from 2.0 percent. The previously published current-account deficit for the fourth quarter was $81.1 billion.



Annexe-2 (next)

- The deficit on international trade in goods increased to $182.3 billion from $169.1 billion as goods exports decreased and goods imports increased.
- The surplus on international trade in services decreased to $55.5 billion from $56.6 billion as services exports decreased and services imports increased.
- The surplus on primary income decreased to $46.7 billion from $54.6 billion as primary income receipts decreased and primary income payments increased.
- The deficit on secondary income (current transfers) increased to $31.0 billion from $29.5 billion as secondary income receipts decreased and secondary income payments increased.

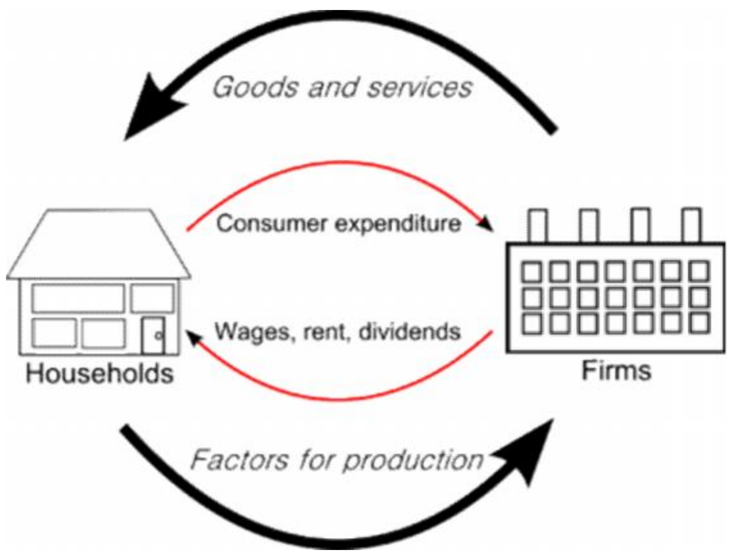
Net borrowing from financial-account transactions were $77.5 billion in the first quarter, down from $143.5 billion in the fourth.

- Net U.S. acquisition of financial assets excluding financial derivatives was $144.9 billion in the first quarter, down from $195.5 billion in the fourth.
- Net U.S. incurrence of liabilities excluding financial derivatives was $229.8 billion in the first quarter, down from $341.8 billion in the fourth.
- Net transactions in financial derivatives were $7.5 billion in the first quarter after net transactions of $2.9 billion in the fourth.

(Blog at WebPress.com, 2014.)

Annexe-3

CIRCULAR FLOW OF INCOME



Basic diagram of the circular flow of income. The functioning of the free-market economic system is represented with firms and households and interaction back and forth

Annexe-4

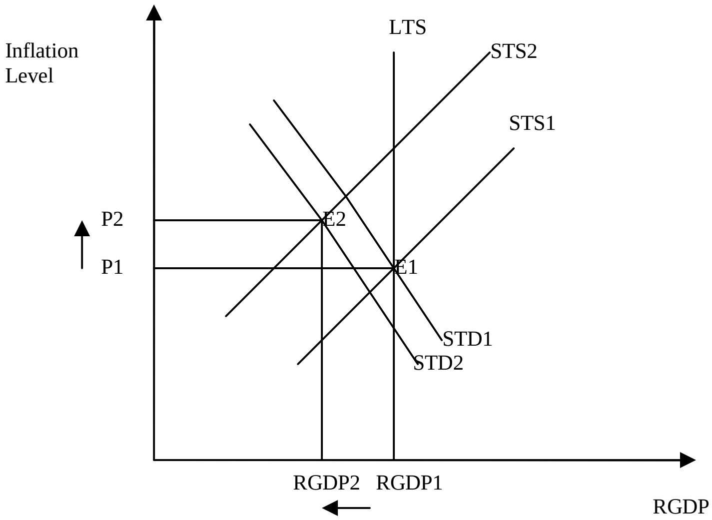
There are three possibilities. The scope of change of STS1 to STS2 is greater than, equal, or lower than the scope of change of STD1 to STD2. In all three cases, the RGDP decreases and rate of unemployment increases. Rate of inflation increases, decreases, or stays the same, depending on respectively if the scope of aggregate supply's move is larger than, equal or lower than the scope of aggregate demand's move.

Notice that the economic situation involves here represents short- and medium-term changes and it implies limited number of variables on graphs.

Annexe-4 (next)

CASE-1: The move of STS1 to STS2 is greater than the move of STD1 to STD2

REAL GDP AND TRADE DEFICIT
(STS1-STS2 distance > STD1-STD2 distance)

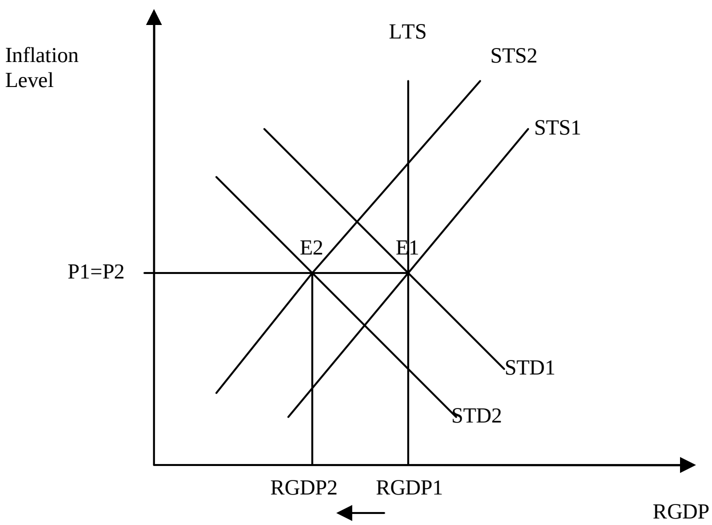


We start at E1 on the LTS curve where we have full employment. The trade deficit makes STD1 to move downward left to STD2, followed by an upward left move of STS1 to STS2. The economy reaches E2 where the rate of unemployment has increased and the US real gross domestic product has decreased. <u>The rate of inflation rises.</u>

Annexe-4 (next)

CASE-2: The move of STS1 to STS2 equals the move of STD1 to STD2

REAL GDP AND TRADE DEFICIT
(STS1-STS2 distance = STD1-STD2 distance)



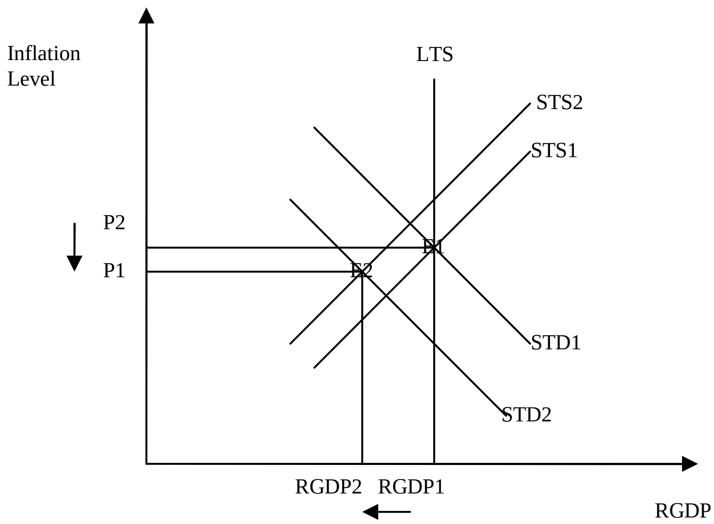
We start at E1 on the LTS curve where we have full employment. The trade deficit makes STD1 to move downward left to STD2, followed by an upward left move of STS1 to STS2. The economy reaches E2 where the rate of unemployment has increased and the US real gross domestic product has decreased. <u>Inflation stays same.</u>

Annexe-4 (next)

CASE-3: The move of STS1 to STS2 is smaller than the move of STD1 to STD2

REAL GDP AND TRADE DEFICIT

(STS1-STS2 distance < STD1-STD2 distance)



We start at E1 on the LTS curve where we have full employment. The trade deficit makes STD1 to move downward left to STD2, followed by an upward left move of STS1 to STS2. The economy reaches E2 where the rate of unemployment has increased and the US real gross domestic product has decreased. <u>Inflation decreases.</u>

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