



Free Trade Bulletin

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Are Trade Deficits a Drag on U.S. Economic Growth?

by Daniel Griswold, director, Center for Trade Policy Studies, Cato Institute

An almost universal consensus prevails that the record U.S. trade deficit for 2006 was a drag on U.S. economic growth. The consensus reflects a basic assumption that growing imports to the United States displace domestic production, reducing growth of real gross domestic product. But the consensus on trade deficits and growth ignores the actual record of the U.S. economy in recent decades and the positive correlation of imports to domestic production.

The consensus was on full display in mid-February 2007 when the U.S. Commerce Department reported a record U.S. trade deficit for 2006 of \$763.6 billion, including an unexpected jump in December's monthly deficit. The 2006 numbers reflected a deficit in goods of \$836.1 billion, which was offset in part by a surplus of \$66.0 billion in services.¹

Stories in the major media typically greeted the record deficit as bad news for overall economic growth. As the *New York Times* reported:

A growing trade deficit acts as a drag on overall economic growth. Economists said they expect that, in light of the new numbers, the government will have to revise its estimate of the nation's fourth-quarter gross domestic product to show slightly slower expansion.²

The *Washington Post* struck a similar note, reporting:

Though a record trade deficit had been expected, the acceleration in December caught economists by surprise, leading to the revision of growth forecasts. A bigger trade deficit means more U.S. demand for goods and services was satisfied by imports rather than by domestic firms.³

The Commerce Department itself reinforces the negative connection between trade deficits and growth in its quarterly reports on gross domestic product. Its January 31, 2007, preliminary report on 4th quarter 2006 GDP stated that, while GDP had been bolstered last year by exports and expenditures on personal consumption and equipment and software,

imports were bad news. "Imports, which are a subtraction in the calculation of GDP, increased," the report stated matter-of-factly.⁴

We can safely predict more worrying in the media and Washington about trade deficits and growth later this week (March 14) when the Commerce Department's Bureau of Economic Analysis releases preliminary numbers for the 2006 current account balance.

The Paradox of Faster Growth and Rising Trade Deficits

One glaring problem with the prevailing thesis on trade deficits and growth is that evidence from recent decades does not support it. In fact, the evidence more comfortably fits the alternative interpretation that an expanding economy promotes rising imports and an expanding current account deficit. An examination of annual changes in the current account balance compared to economic growth since 1980 shows that a "worsening" deficit is typically associated with faster economic growth, and an "improving" deficit with slower growth.

Table 1 shows years since 1980 arranged according to changes in the current account balance as a share of GDP. The first group in Table 1 includes the 8 years in which the current account balance as a percentage of GDP shifted in a positive direction compared to the previous year (i.e., the deficit shrank). The second group includes the 10 years in which the balance as a share of GDP shifted modestly in the negative direction (i.e., the deficit increased), up to 0.5 percent of GDP from the year before. And the third group includes the 8 years in which the balance turned sharply negative, by more than 0.5 percent of GDP.⁵

As the comparison shows, there is no evidence that an expanding current account deficit is associated with slower economic growth. In fact, data show the opposite correlation:

- In those years since 1980 in which the current account deficit actually shrank as a share of GDP, real GDP growth averaged 1.9 percent.

Table 1
Current Account Deficits and GDP Growth since 1980

Years in which the CA deficit shrank as share of GDP				Years in which the CA deficit grew up to 0.5 % of GDP				Years in which the CA deficit grew > 0.5 % of GDP			
Year	CA/GDP	Change in CA/GDP	Real GDP Growth	Year	CA/GDP	Change in CA/GDP	Real GDP Growth	Year	CA/GDP	Change in CA/GDP	Real GDP Growth
1980	0.1%	0.1%	-0.2	1982	-0.2%	-0.3%	-1.9	1983	-1.1%	-0.9%	4.5
1981	0.2%	0.1%	2.5	1985	-2.8%	-0.4%	4.1	1984	-2.4%	-1.3%	7.2
1988	-2.4%	1.0%	4.1	1986	-3.3%	-0.5%	3.5	1998	-2.4%	-0.8%	4.2
1989	-1.8%	0.6%	3.5	1987	-3.4%	-0.1%	3.4	1999	-3.2%	-0.8%	4.5
1990	-1.4%	0.5%	1.9	1992	-0.8%	-0.2%	3.3	2000	-4.2%	-1.0%	3.7
1991	-0.6%	0.7%	-0.2	1993	-1.3%	-0.5%	2.7	2002	-4.5%	-0.7%	1.6
1995	-1.5%	0.2%	2.5	1994	-1.7%	-0.4%	4.0	2004	-5.7%	-0.9%	3.9
2001	-3.8%	0.4%	0.8	1996	-1.6%	-0.1%	3.7	2005	-6.4%	-0.7%	3.2
Average growth:		1.9		Average growth:				Average growth:			

Source: Council of Economic Advisers, *Economic Report of the President*, February 2007, Tables B-1, B-4, B-103, B-106.

- In those years in which the deficit grew modestly, between 0.0 and 0.5 percent, GDP growth averaged 3.0 percent.
- And in those years in which the current account deficit expanded by more than 0.5 percent of GDP, real GDP growth grew by an average of 4.1 percent.

In other words, economic growth has been more than twice as fast, on average, in years in which the current account deficit grew sharply compared to those years in which it actually declined. If trade deficits drag down growth, somebody forgot to tell the economy.

In reality, trade deficits tend to be pro-cyclical, growing when the economy expands and contracting when the economy slows or slips into recession. The trade deficit “improved” during each of the three recessions the nation has suffered in the past quarter century—in 1981–82, 1991, and 2001. With the help of payments from Gulf War allies, the current account actually moved briefly into surplus in 1991.⁶ Thus, U.S. Treasury Secretary Henry Paulson stood on solid empirical ground when he noted in a March 1 speech on trade, “Critics often ask: If trade is so good for America, why do we run a trade deficit? These critics might be interested to know that the last time we ran a trade surplus [1991] our economy was in recession.”⁷

The same forces are at work when the economy expands robustly, such as it did in the 1990s. Many Democratic leaders tout the strong growth of the economy when Democratic president Bill Clinton and his economic team were in office, especially in the second half of the 1990s through 2000. The U.S. economy performed well during that period by almost every measure: GDP growth, manufacturing output, net job creation and real incomes surged while unemployment and poverty rates fell.

What is almost never acknowledged by trade-deficit crit-

ics is that the same period also witnessed a rapid “worsening” of the trade deficit. The current account deficit grew as a share of GDP in every year beginning in 1996 through 2000, rising from 1.5 percent of GDP in 1995 to 4.2 percent in 2000. Many of today’s critics of the trade deficit claim credit for the strong economy of the late 1990s while demonizing the growing current account deficits that quite naturally accompanied the expansion.

The year 2006 was no exception to the general rule despite the downward revision of GDP growth in the 4th quarter. On the basis of the first three quarters of current account numbers for 2006, the current account deficit for all of 2006 will reach about 6.6 percent of GDP, a modest expansion from 2005’s share of 6.4 percent.⁸ GDP growth in 2006 was also in the moderate range at 3.2 percent, placing last year comfortably within the established pattern.

Economic Growth Fuels Import Growth

Belief that a growing trade deficit means slower growth rests on the enduring myth, perpetuated by the U.S. Commerce Department’s own language, that imports simply subtract from economic growth. The prevailing orthodoxy in public discussion about trade is that a surge in imports will depress growth because imports are assumed to largely displace domestic production. Although there is an appealing plausibility to the belief, the evidence since 1980 contradicts it.

Applying the same test as above to changes in imports and GDP since 1980 shows that, contrary to popular wisdom, faster import growth has been associated with faster domestic economic growth. In years since 1980 in which imports of goods and services fell as a share of GDP from the previous year, economic growth averaged 2.1 percent. In years in which imports grew by up to 0.5 percent of GDP, growth averaged 3.3 percent. And in years in which imports

surged by more than 0.5 percent of GDP, growth averaged 3.6 percent.⁹

The same economic expansion in the late 1990s that saw a rapid expansion of the trade deficit also saw a rapid rise in imports of goods and services. For all the same reasons, recessions tend to dampen demand for imports. During each of the three most recent recessions, imports as a share of GDP have dropped sharply. That simple fact alone should give protectionists pause. Their dream scenario of sharply declining imports is frequently accompanied by the economic nightmare of recession.

Paradox Explained: How Growth Drives Trade Deficit

How can the seeming paradox of faster growth and expanding trade deficits be explained? The evidence certainly does not suggest that an expanding trade deficit somehow fuels more rapid economic growth or that a trade deficit is necessarily good for the overall economy.

More plausibly, causation flows from economic growth to the trade balance. An expanding economy increases demand not only for domestic production but also for imports. It also promotes more domestic investment as businesses seek to meet rising demand and capitalize on new investment opportunities.

Rising investment opportunities, in turn, attract foreign capital to the United States to fund investment over and above what can be financed through domestic savings alone. Those capital inflows are the flip side of the current account deficit: the greater the net inflows of capital from abroad, the greater the current account deficit needs to be to accommodate those inflows. Thus, when GDP growth accelerates, so does domestic investment, inflows of foreign capital, and the current account deficit. While a growing current account deficit is not the cause of faster GDP growth, it is often its handmaiden.

Our simple comparison of the current account balance and GDP growth does not account for a host of other factors that can influence both growth and the trade balance. But at the very least the data fail to show any discernable negative effect on economic growth from a rising trade deficit. Absent any real evidence, the standard assumption that trade deficits are a drag on growth should be re-examined before it is repeated again uncritically.

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1. U.S. Department of Commerce, “U.S. International Trade in Goods and Services: December 2006,” U.S. Bureau of the Census, February 13, 2007, www.census.gov/foreign-trade/Press-Release/current_press_release/press.html.
 2. Jeremy W. Peters, “U.S. Trade Deficit Grew to Another Record in ’06,” *New York Times*, February 14, 2007.
 3. Peter S. Goodman and Nell Henderson, “Oil Prices, Imported Goods Push Trade Gap to Record: Growth Forecasts Cut; Democrats Urge Action,” *Washington Post*, February 14, 2007.
 4. U.S. Commerce Department, “Gross Domestic Product: Fourth Quarter 2006 (Advance),” Bureau of Economic Analysis, January 31, 2007, Table 2.—Contributions to Percent Change in Real Gross Domestic Product.
 5. Council of Economic Advisors, *Economic Report of the President*, February 2007, Tables B-1, B-4, and B-103, www.whitehouse.gov/cea/pubs.html.
 6. Those payments, approximately \$40 billion, were subtracted from the 1991 current account number used in Table 1 in order to provide a more accurate picture of the economy’s impact on that year’s current account deficit.
 7. Hon. Henry Paulson, U.S. Secretary of the Treasury, Speech before the Economic Club of Washington, March 1, 2007, www.ustreas.gov/press/releases/hp285.htm.
 8. Author’s calculations.
 9. Author’s calculations, based on *Economic Report of the President*, Tables B-1, B-3, and B-106.

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