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SETTLING THE U.S. TRADE DEFICIT: WHAT, WHY, HOW, WITH WHOM

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The American public knows that with a stable dollar the prices of the goods and services they purchase on a regular basis, such as food, clothing, housing, transportation, health care, do not change from day to day. They are less familiar, however, with a weaker dollar and how it impacts their livelihood. Simply put, a weaker dollar exchanges for less of a given foreign currency than formerly. Thus, the dollar is weaker if \$1 exchanges for 1.13 euros when formerly it exchanged for 1.38 euros. Conversely, a stronger dollar exchanges for more of a given foreign currency. Thus, the dollar is stronger if \$1 exchanges for 105 yen when previously it exchanged for 90 yen.

The exchange rate is determined in the currency market which functions like a stock exchange. Trades are executed through brokers or market makers who provide access to a network of approximately 4,500 world banks that buy and sell currencies electronically. Trading is prompted by the anticipated gain from holding one currency versus another. If, for example, the U.S. dollar exchanges today for 105 yen and a currency trader expects that the dollar will exchange next week for 115 yen, that trader would sell yen and buy dollars today in anticipation of the gain of 10 yen for each dollar sold and exchanged for 115 yen next week. On a daily basis, trading volume in this market exceeds \$1.5 trillion.

The Chinese currency is one very important exception. For years the Chinese yuan was pegged to the U.S. dollar at the rate of 8.27 yuan to \$1. Thus, whatever happened to the dollar in the currency market, the exchange rate with the yuan remained at the rate fixed by the Chinese government. In 2005 the yuan was re-pegged at 8.11 to the dollar, and allowed to fluctuate up or down by 0.3 percent depending on movements in a basket of major foreign currencies.

A weaker dollar means that U.S. consumers are disadvantaged because the dollar exchanges for less of a foreign currency than before, effectively making foreign-produced goods more expensive. For example, if a German camera is priced at 1,100 euros and \$1 exchanges for 1.20 euros, the camera costs \$917 (1,100 euros / 1.20 euros). If the exchange rate changes such that \$1 exchanges for 0.90 euros, the same camera then costs the U.S. buyer \$1,222 (1,100 euros / 0.90 euros). The re-pegging of the yuan to the dollar from 8.27 to 8.11 resulted in a weaker dollar.

By making foreign-produced goods costlier, a weaker dollar weakens the demand of U.S. consumers and producers for foreign-produced goods and strengthens their demand for U.S.-produced goods. This shift toward U.S.-produced goods triggers an increase in production at U.S. firms and more jobs for U.S.

workers. The weaker dollar against the yuan made Chinese goods and services more expensive for U.S. buyers and U.S. goods and services more attractive for Chinese buyers.

A stronger dollar means that U.S. consumers are advantaged because the dollar buys more of a foreign currency than before, effectively making foreign-produced goods cheaper. For example, if a Japanese DVD is priced at 25,000 yen and \$1 exchanges for 90 yen, the DVD costs \$278 (25,000 yen / 90 yen). If the exchange rate changes such that \$1 exchanges for 105 yen, the same DVD then costs the U.S. buyer \$238 (25,000 yen / 105 yen).

By making foreign-produced goods cheaper, a stronger dollar strengthens the demand of U.S. consumers and producers for foreign-produced goods and weakens their demand for U.S.-produced goods. This shift away from U.S.-produced goods means fewer jobs for U.S. workers.

In addition to problems of piracy of intellectual properties and dumping products in the United States, the Chinese government has been under attack for undervaluing the yuan making their goods and services so cheap as to drive U. S. producers out of business because they cannot compete profitably at the prices set for imported Chinese goods and services. Thus today U.S. retailers, for example, are awash with goods produced in China, and the trade deficit with China continues to climb. In 2006 the deficit with China reached \$232.6 billion, or nearly 28 percent of the entire U.S. trade deficit of \$838.3 billion. The size of the deficit with China reflects a huge imbalance between what China exports to the United States (\$287.8 billion) and what China imports from the United States (\$55.2 billion). Further, the deficit with China is more than twice as high as the U.S. \$105 billion trade deficit with OPEC.

Canada is the U.S.'s most important trading partner in the sense that Canada holds the top ranking in exports to the United States (\$302.4 billion) and imports from the United States (\$230.6 billion). The \$71.8 billion trade deficit with Canada is much smaller than the U.S. deficit with China because Canadian exports to the United States more closely match its imports.

The trade deficit with China means that the Chinese are awash with U.S. dollars. They can sell their dollars in the currency market but selling today is not to their immediate advantage unless they think that in the future the currency market will drive the dollar even lower. Alternatively, they can lend their dollars to interested parties in the United States or buy U.S. assets. In 2005-06, foreign owned assets in the United States, including assets owned by China, increased by \$3.0 trillion.

Among the assets that foreign investors are buying are the securities issued by the U.S. Treasury to finance the federal budget deficit. One-fourth of the \$8.9 trillion U.S. public debt is held by foreign interests. Shares in troubled U.S. financial institutions are another. Citigroup, for instance, just sold a \$7.5 billion share to Arab emirate Abu Dhabi in order to cover heavy losses in sub-prime mortgages.

How long can or will the United States continue to run a trade deficit? One answer is as long as foreign creditors and investors are willing to buy U.S. assets or lend monies to U.S. public and private interests. Another is as long as it takes to weaken the dollar sufficiently to boost U.S. exports and shrink U.S. imports. Another is not to worry: the "invisible hand of the market" sorts out these issues. Still another raises a different question. Are you comfortable with borrowing money from or selling assets to the

Canadians, Chinese, Germans, Japanese, Mexicans, Nigerians, and Venezuelans with each of whom the United States in 2006 had a trade deficit of at least \$25 billion?

Put differently, the question is not only ‘what are you buying and selling?’ but also ‘who are your trading partners?’

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