DO TRADE DEFICITS MATTER? A COMPARITIVE STUDY ON THE CURRENT ACCOUNT DEFICIT OF MAJOR ECONOMIES

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Abstract

This study has been undertaken to understand and study the concept of the current account deficits of the major economies of the world. Methodology used for research is secondary in nature. The trade deficit in a country occurs due to the imbalance between the saving and investment rate of the country. A trade deficit generally translates into a current account deficit. Correlation is carried out between the current account deficits and the GDP growth of the advanced economies. It was found that though the current account deficit is an important factor it does not significantly affect the growth of the economy. Further, the paper also takes the examples of two economies viz USA and India and presents a case study on their growth.

Introduction

Buying more from rest of the world than a country sells – does it matter? This has been a long-standing issue, which has come into spotlight more and more in recent years. As countries develop, they will face the challenge of trade balance in the globalized world.

The trade theory is based on the principle of comparative advantage as proposed by Ricardo, which states that countries tend to export those goods & commodities in which they have a comparative advantage against other countries. Each country should produce and trade what it is relatively least bad at. Thus, every country should specialize in what it produces and trade what it no longer produces as much of.

Adam Smith, considered the father of economics, wrote in his seminal work, The Wealth of Nations – 'If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it from them…'
Ricardo accordingly focused on what generated efficiency and on increasing trade which made a nation productive and not on achieving a trade surplus or avoiding a deficit.

Further work through the 'new trade theory' expanded the thinking to make it more dynamic in nature. According to this, countries can shape their comparative advantage in an attempt to influence what they specialize in, for example government policies that promote certain sectors. A major factor in determining international patterns of trade are the very substantial economies of scale and network effects that can occur in key industries.

Objective

The main aim of this paper is to –

- Understand the concept of trade deficits in an economy
- Study the current account balance of world's top economies
- Understand the deeper perspective on 'Do trade deficits matter

Literature Review

Review of literature provides the information of research work already done by the researchers relating topic of study. The work related to study may support or conflict with present results.

Some of the research work related to this topic is as follows:

- International Business and Economics Research Journal: Trade Deficits always Matter – highlights on how trade deficits have mattered in the past, causing the countries to devalue their currencies and continue to do so.
- Linda Yueh: 'The Great Economists – how their ideas can help us today' – highlights the trade theory proposed by Ricardo and its relevance in current time, among other macro-economic issues.
- Ph.D thesis: Impact of Current Account Deficit on Economic Growth: A comparative study of selected developing countries – elaborates on the meaning of current account deficit, its types and how it can be calculated.
- Forbes: 'The trade deficit matter, but not how you think' – explains the flaw in the idea that as the trade deficit grows, it affects the growth of the economy.
- IMF: countries data source – highlights the data on the current account balance of the major economies.

Methodology

This research is exploratory in nature. It includes the study of secondary data from various reports, journals and research papers. Correlation is the statistical tool used for the analysis of the impact of current account deficit on their GDP growth.

Trade Deficits

A trade deficit is an economic measure of international trade wherein a country imports more than it exports. Therefore, it can be expressed as:
Trade Deficit = Total value of Imports – Total value of Exports
Trade balance comprises a major part of a country's current account. A trade deficit (or surplus) generally translates therefore into a current account deficit (or surplus). In addition since trade is associated with currency flows, a country that exports more than it imports will have a greater inflow of currency than outflow.

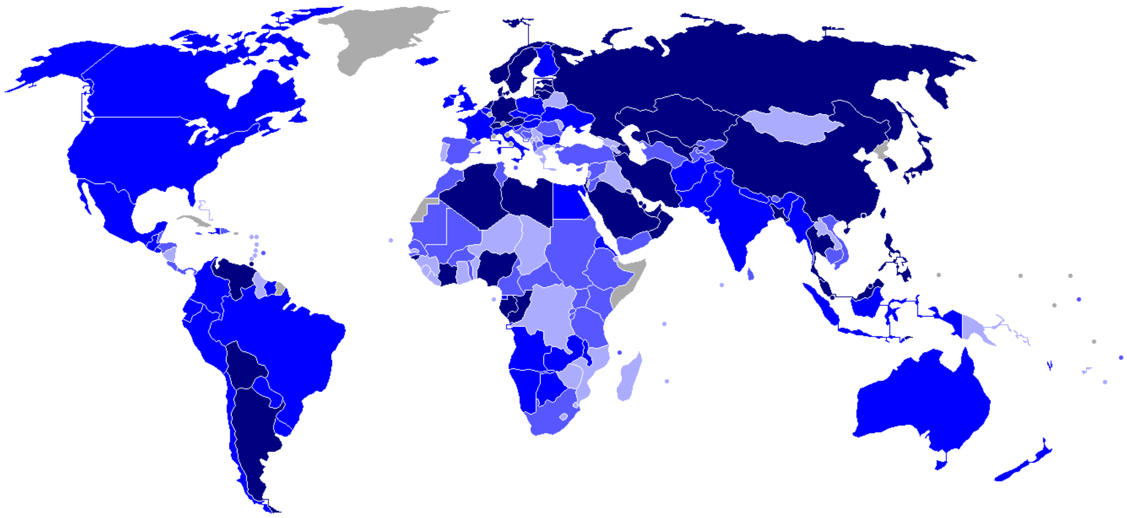

Fig 1: Quartile representation of current account balance as percent GDP by IMF WEO data
current account balance as percent GDP from IMF WEO data
Quartiles: −48.27% to −9.3125% | −9.3125% to −3.59% | −3.59% to 1.6125% | 1.6125% to 223.79%

What causes it?

A trade deficit typically occurs when a country's production of goods is not enough to meet the demands of its residents. In such a case, imports of goods from other nations increase to meet the balance demand.

The main reason for trade deficit is an imbalance between the savings and investment rates of a country. If a country as a whole spends more money than it makes, it will result in a current account deficit. In order to finance this spending a country will then resort to either borrowing from foreign lenders, which will in turn add to the nation's debt, or foreign investment in the country's assets and business, which is referred as the capital account.

There are several forces that impact the size of the trade deficit. Some of them are:

a. Increased government spending reduces the national savings rate and thereby raises the trade deficit.
b. The exchange rate of the country's currency effects it global competitiveness and thus its level of exports/imports.
c. A growing economy also often leads to a larger deficit, since consumers have more income to buy more goods from abroad.

These factors are generally seen by economists as more important than just the trade policy in determining the overall deficit. This is due to the fact that making it easier or harder to trade with specific countries tends to simply shift the trade deficit to other trading partners. Hence, trading relationships with specific countries need a closer attention as it may lead to conflating bilateral deficits.

Do trade deficits matter?

In order to determine whether trade deficits matter, a deeper understanding of the underlying principles of macro-economics is important and needs to be applied correctly. Gross domestic product (GDP) is the value of all goods and services produced in the country.

It is represented by the formula:
GDP = C + I + G + (X-M)
Where C is the consumption or consumer spend, I is the investment, G is the government spending, X is the exports and M is the imports. Thus X-M is the trade surplus or deficit depending upon which is higher.

It is sometimes believed that increase in imports will lower the GDP. But this is a misperception as imported goods end up either as C, I or G since either consumers or government will consume them or they are fixed assets thus qualifying as I (investment). This positive addition to either C,I or G offsets the negative effect of imports (M). In other words, imports do not have any effect on the Gross fixed product and its subtraction from the formula ensures that only domestically produced goods and services are counted.

However, a trade deficit does matter in a particular way. When there is a trade deficit, it is offset by an equal inflow of foreign investment, known as the capital account surplus. Therefore, an important outcome of trade deficit in a country is that the foreigners are investing in the economy. This is done by buying government or corporate bonds, real estate and building factories which in turn create jobs.

Another perspective on trade deficits is highlighted below.
Due to increase in imported goods, the price of consumer goods decreases in the country as foreign competition increases. Lower prices help reduce threat of inflation. A fast growing economy might import more as consumption increases which is not met by what the country produces. Thus a trade deficit could also indicate a growing economy.

However, running a persistent trade deficit has three key adverse effects on the economy of a country. One, the country's demand for foreign currency is usually greater than the supply. This leads to a steadily weakening home currency.

Also, a high trade deficit also forces a country to constantly look to foreign investors to make up the gap between its export earnings and its pay-outs for imports. Finally, in a slow-growing world, a rising trade deficit could be an indication that domestically produced goods are unable to compete against imports. If local factories shut down, that may lead to job losses.

Current account Deficit

As mentioned previously, a trade deficit (or surplus) generally translates therefore into a current account deficit (or surplus).

It measures the change over time as per three different accounts.

i. The trade account – measures the difference between value of imports and exports of the goods and services. It is the primary cause for the fluctuations in the current account deficit.
ii. The income account – measures the income paid to the foreigners and the net of income received from the foreigners. Income deficit arises when the value of income paid to foreigners exceeds the value received from them.
iii. The cash transfer account – component of direct transfers includes government grants to the foreigners.

The Current account deficit (CAD) for the world's largest economies is given in the table and chart below.

Table 1: Current account balance as percent of GDP of major economies

Sr. No	Country	Current account balance as a % of GDP
1	USA	-2.40
2	China	1.37
3	Japan	4.01
4	Germany	8.05
5	United Kingdom	-4.07
6	France	-1.42
7	India	-1.90
8	Italy	2.89
9	Brazil	-0.48
10	Canada	-2.98

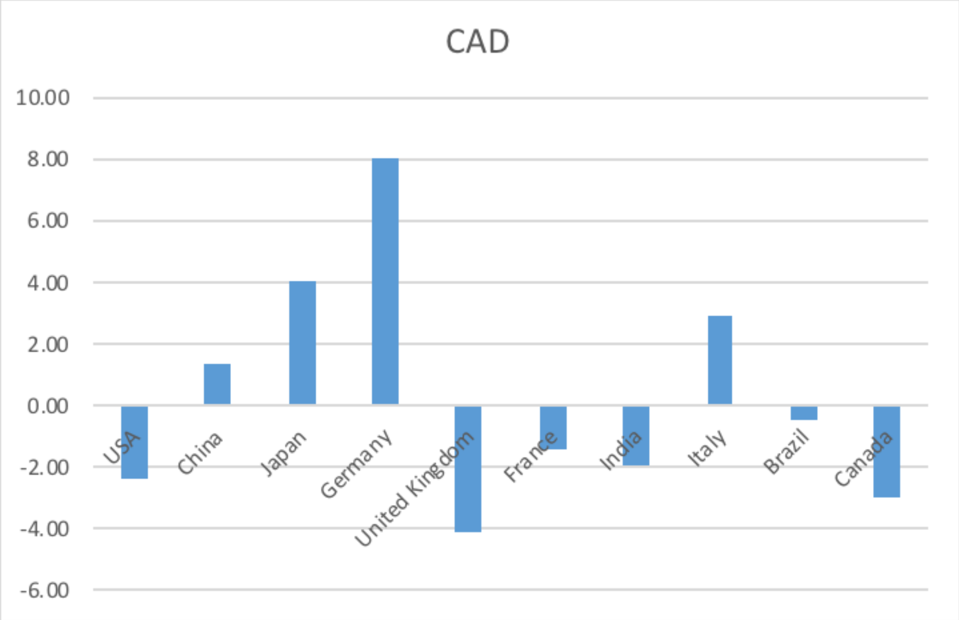

Fig 2: Current account deficit of major economies

CAD (trade deficit) vs GDP growth

The table and chart below depicts the current account deficits along with the GDP growth rate in 2017.

Table 2: CAD and GDP growth in 2017

Sr. No	Country	Current account balance as a % of GDP	Percentage of GDP growth 2017
1	USA	-2.40	1.8
2	China	1.37	6.7
3	Japan	4.01	1.7
4	Germany	8.05	2.2
5	United Kingdom	-4.07	2.3
6	France	-1.42	1.8
7	India	-1.90	6.6
8	Italy	2.89	1.5
9	Brazil	-0.48	1.0
10	Canada	-2.98	3.0
Correlation		-0.18231031	

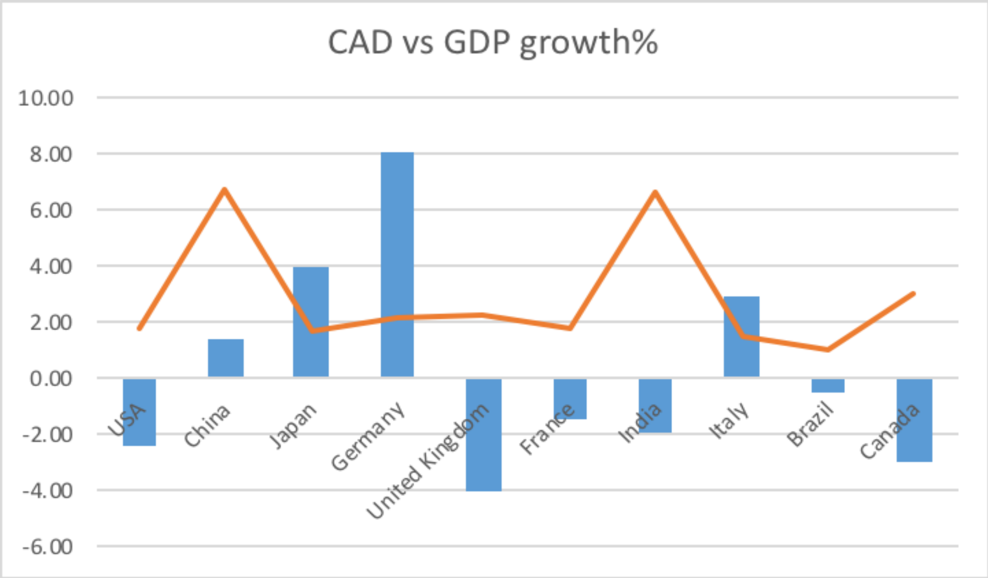

Fig 3: CAD vs GDP growth%

A correlation analysis of the impact of current account deficit on their GDP growth has been carried out with the data in the table above. The results show a correlation of -0.182, which implies a low negative strength of association.
From the above it is apparent that current account deficit, while an important parameter to monitor, does not impact the country's economic growth in a major way as there are other variables also in play.

Case studies

a. USA

The United States has a large trade deficit but it enjoys the privilege of the US dollar being the world's reserve currency.
For decades, the U.S. has run a deficit in the trade of goods, importing more goods than it exports, as seen in the chart below. The main reason cited is that the steadily increasing U.S. trade deficit is based on two things - the availability of cheaper labour overseas and the consumption habits of Americans. Therefore, the U.S. has had to import increasing amounts of capital from investments by foreign governments and businesses to fund this trade deficit, thus increasing its national debt.

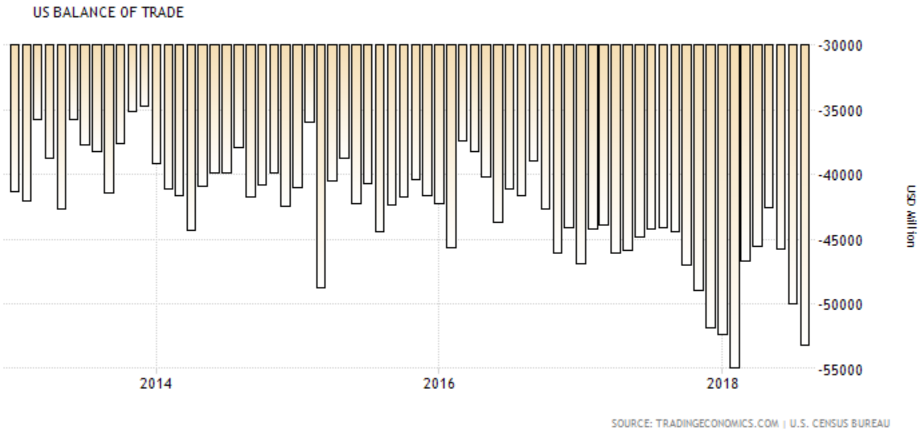

Fig 4: USA balance of trade

However, there is no concrete evidence to support the conclusion that a deficit in traded goods causes a net import of capital.

Now, according to macroeconomic measurement convention, the three components of a country's balance of payments must sum to zero: a country's balance in the trade of goods, its balance in the trade of services, and its balance of capital inflows/outflows. So, if trading in goods and services is collectively in deficit, then capital inflows must be positive by an equal amount. But that statement does not affirm that the trading deficit causes the capital inflow. It could equally be true that the inflow causes the trading deficit.
US is now working to reduce its trade deficit. One of the first policy steps it has taken under President Trump is to identify the trading nations with whom the US runs a big trade deficit, and force them to reduce it. It has released a new Trade Policy Agenda 2017 to identify and crack down on such trade partners. While China (US runs a trade deficit of $300 billion with it), Germany ($68 billion) and Mexico ($62 billion) are high on this hit-list, India figures on it too given that the US runs a trade deficit of $30 billion with it.

It has therefore begun to renegotiate the regional trade deals like NAFTA and also impose an import duty on some goods imported from these countries. It is also coaxing US top companies to relocate its manufacturing within the country.

b. India

India's current account deficit has widened in the last 4 years primarily because of the increase in the deficit on the merchandise trade account. While imports have increased, export performance has been quite indifferent. This is despite the fact that India has formalised several free trade agreements.

As seen in the chart below, India's current account deficit to GDP was 1.9% in 2017 and this has further widened to 2.3% in 2018 as of now. The merchandise trade deficit of $157 billion in 2017-18 was the widest it has been since 2012-13. At that time it was $190 billion and came down to $100 billion in 2016-17.

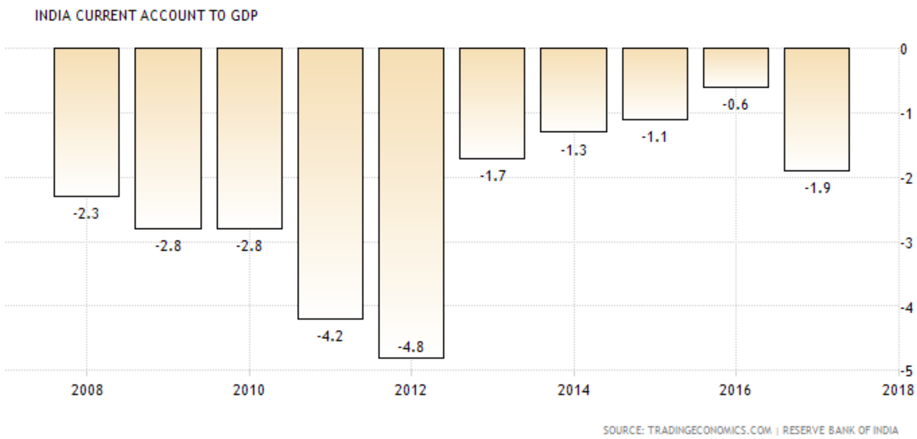

Fig 5: India Current account to GDP

However last year the imports surged and export growth remained moderate. This was due to various reasons like the disruption caused by the implementation of GST plus some longer term issues like losing the competitive edge in categories like textiles and agricultural exports. Surge in imports of gems and jewellery have also led to a widening of the trade deficit. The increase in 2018 is further impacted by the rising oil prices and a depreciating rupee.

The government has now announced several steps to reduce the current account deficit this year. These include curbs on non-essential imports , take steps to boost exports, along with a number of measures to shore up the rupee and control the current account deficit.

Conclusion

Most economists do not worry about trade deficits to a large degree as they do not see the trade gap as money lost to other countries. That's because trade imbalances are affected by many of the macroeconomic factors, including the relative growth rates of countries, the value of their currencies, and their saving and investment rates.
However the country governments need to keep a close watch on the trade and current account deficits as this has to be financed through borrowings and maintaining a healthy balance of payment (BOP).

References

International Business and Economics Research Journal (2014) – Trade Deficits Always Matter, April.

Ph.D thesis (2013) - Impact of Current Account Deficit on Economic Growth: A comparative study of selected developing countries.

Linda Yueh: 'The Great Economists – how their ideas can help us today'

Forbes - The trade deficit matter, but not how you think

Countries data source : https://www.imf.org/external/datamapper/BCA_NGDPD@WEO/FRA/GBR/DEU

Quartile representation of current account deficit as per GDP
https://www.imfconnect.org/content/dam/imf/Spring.../SM17/.../WEO_SM17.pdf