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The Dollar and the U.S. Trade Deficit

Overview

Since taking office, the Trump Administration has used the overall and bilateral U.S. trade deficits as one of its barometers for evaluating the success or failure of the global trading system, U.S. trade policy, and trade agreements. In an effort to reduce the trade deficit and for other policy objectives, the Administration has renegotiated existing trade agreements, withdrawn from or suspended negotiations on other trade agreements, initiated new agreements, and placed tariffs on a range of imports. Previous administrations and Members of Congress, while expressing concern, have not legislated policies specifically to reduce the trade deficit.

The Trump Administration also has advocated for depreciating the dollar against other major currencies, reasoning that a weaker dollar would increase U.S. exports and reduce the nation's trade deficit. Additionally, the Administration contends that certain countries are manipulating their currencies to give their exports a price advantage. On February 3, 2020, the Commerce Department issued a rule that allows currency manipulation potentially to be considered as a domestic subsidy under U.S. countervailing duty laws. The International Monetary Fund (IMF) concluded in its July 2019 report on external balances that current accounts and currencies may be under- or over-valued at times, but this largely reflected domestic economic policies. Economists have raised concerns about the broader long-term impact on the U.S. economy of financing trade deficits.

Origin of the Trade Deficit

Changes in exchange rates can affect trade balances through changes in export and import prices and through changes in asset prices and income flows. Most economists argue that the U.S. trade deficit is largely the product of a low national savings rate, attributed in part to U.S. macroeconomic policy, or the combination of fiscal policy—notably large and persistent federal government budget deficits—and monetary policy. This combination of policies determines the overall national saving-investment balance, which determines the inward and outward flows of funds that affect the value of the dollar and the U.S. trade balance.

Most economists argue that attempting to alter the current account balance (comprised of trade in goods, services, and official flows) and, by implication the trade deficit, without addressing the underlying macroeconomic conditions, likely will be counterproductive and create distortions in the economy. Also, most economists contend that, absent changes in the underlying macroeconomic conditions, targeting individual bilateral trade balances most likely will result in trade diversion and offsetting changes in trade balances with other partners, without altering the overall

trade deficit. Most economists also argue that attempting to alter the long-run exchange rate of the dollar that differs from its market price is difficult to sustain.

Exchange Rates and Capital Flows

Exchange rates reflect the relative prices of currencies, and changes in those rates can affect trade flows by changing export and import prices. As a result, an appreciation in the dollar relative to other currencies raises the dollar-denominated prices of U.S. exports. In contrast, a depreciation in the dollar would have the opposite effect: export prices would fall and import prices would rise.

Under the current system of floating exchange rates, extensive cross border capital flows, and the role of the dollar as the dominant global currency, financial transactions are a major factor affecting exchange rates and current account balances. The balance of payments is a system of off-setting accounts. Under this arrangement, a surplus or deficit in the current account is offset by an equal transaction in the capital account, which is comprised of foreign deposits in U.S. banks, foreign purchases of U.S. businesses and real estate, and foreign purchases of U.S. government and corporate debt and equities. For some analysts, the ability of the U.S. economy to finance its trade deficits through such capital inflows reduces the constraint of domestic savings.

Most capital account assets are highly liquid and transactions respond rapidly to political and economic events and instantaneously transmit market signals across national borders. As a result, shifts in the capital account in response to market events can drive movements in the exchange rate which, in turn, can affect the current account and the trade balance. From this perspective, efforts to devalue the dollar likely would have an immediate impact on capital flows and investor's expectations that could blunt, or offset entirely, the intended change in the dollar's exchange rate.

Role of the Dollar

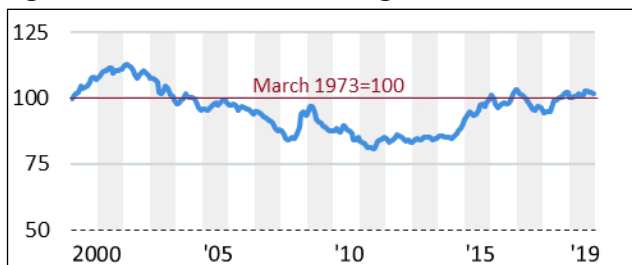
Currently, the dollar effectively serves as the dominant global currency. As such, the international value of the dollar reflects a broad range of international and domestic economic activities that can far outweigh the size of domestic trade balances alone. On a daily basis, the value of global foreign exchange transactions eclipses the total global value of economic output and the value of all traded stocks and bonds. According to a recent survey, the dollar accounts for 88% of *daily* global foreign exchange market turnover of \$6.6 trillion, or four times the *annual* amount of U.S. exports of goods and services. The volume of dollar turnover reflects its wide range of uses in international financial transactions, including two-thirds of global central

banks' reserves, broadly as an invoicing currency to fund international commercial activities, non-U.S. banks' foreign currency holdings, and, non-U.S. corporate borrowings from banks and the corporate bond market. Also, a number of internationally-traded commodities, such as crude oil, are priced in dollars.

Fundamentally, an appreciation of the dollar increases the amount of foreign currency needed to acquire dollar-denominated assets and, therefore, raises the price of U.S. exports and potentially lowers export sales. On the import side, an appreciation of the dollar lowers the price of imports and makes imports cheaper for U.S. consumers. In contrast, higher export prices reduce foreign purchases of U.S. exports, potentially reducing U.S. economic activity.

Over the past two decades, the dollar has remained relatively high on a real trade-weighted basis against other major currencies, as indicated in **Figure 1**. From 2002 to 2008, the dollar depreciated against other major currencies, but appreciated during the 2008-2009 financial crisis as investors and others favored safe-haven currencies such as the dollar. Following the financial crisis, the dollar depreciated between 2009 and mid-2011, returning close to its pre-crisis value. After appreciating between 2011 and 2017, the dollar temporarily depreciated between 2017 and 2018, ostensibly due to stronger economic growth in Europe, an appreciating Euro, and concern over U.S. economic growth. Through 2019, the dollar again appreciated, regaining most of the value it lost during the previous two years.

Figure 1. U.S. \$ Real Trade Weighted Broad Index



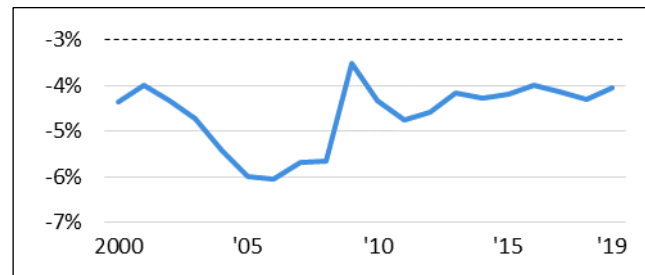
Source: CRS. Data from Federal Reserve.

The Merchandise Trade Account

In contrast to movements in the dollar's exchange rate over the past two decades, the U.S. merchandise trade deficit has trended downward in nominal terms, but, at around 4% as a share of U.S. GDP in 2019, has decreased slightly since 2013, as displayed in **Figure 2**. From 2002 to 2008, the dollar depreciated by 25% against the currencies of major trading partners, while the merchandise trade deficit increased by 75%, from -\$475 billion to -\$833 billion, seemingly at odds with the notion that a depreciating dollar, by itself, can stem the nation's trade deficit. The U.S. trade deficit reversed during the 2008-2009 financial crisis, reflecting a contraction in global trade due to a decline in trade financing and a global economic recession. Between 2009 and 2011 the U.S. trade deficit increased by 11%. Subsequently, the trade deficit increased another 20% between 2011 and 2018 to -\$887 billion as the dollar

appreciated by 26%. Data indicate that the U.S. trade deficit in 2019 was -\$866 billion.

Figure 2. U.S. Goods Trade as a Share of GDP



Source: CRS. Data from Bureau of Economic Analysis.

Exchange rate-induced changes in export and import prices could alter the amounts, or volumes, of exports and imports, as consumers and businesses substitute for lower priced goods. Following an appreciation in the dollar, export volumes could fall and import volumes rise, which could increase the trade deficit. In contrast, a depreciation in the dollar potentially could reduce the trade deficit as export volumes increase and import volumes fall. As previously indicated, however, this relationship has not held up well since 2013. A shift in trade volumes could be more directly affected by the response in the capital account to changes in the exchange rate.

The analysis assumes that changes in the exchange rate will be fully passed along to consumers and producers and that consumers and businesses will respond fully to changes in goods' prices. To the extent that changes in the exchange rate are not fully passed through to goods' prices, trade volumes would be less responsive to a change in the exchange rate.

Exchange rates and trade balance linkages are also affected by global value chains (GVCs) that are characterized by trade in intermediate goods, or goods used as inputs to the final production of goods and services. Trade in intermediate goods means that imports are essential inputs in the production of exports; measures to restrict imports invariably negatively affect exports. As a result, attempts to depreciate a currency to promote exports invariably increase domestic production costs and reduce exports.

Select Issues for Congress

- If the trade deficit is the result of macroeconomic policies, as is generally accepted, what might be an effective approach to reducing or ending the trade deficit?
- Since the dollar serves as the dominant global currency, should Congress assess and evaluate what this continuing role implies for the U.S. economy?

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